

Rating: Buy
S&P 500: 1199

Lukoil Oil Company Profits in Refining

<i>Symbol</i>	(LKOD) LUKOY	<i>Ebitda Next Twelve Months ending 6/30/06 (US\$mm)</i>	9,100
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	0
<i>Price (US\$/sh)</i>	34.75	<i>Natural Gas and Oil Production/Ebitda (%)</i>	30
<i>Pricing Date</i>	5/27/05	<i>Adjusted Reserves/Production NTM</i>	20.0
<i>Shares (mm)</i>	834	<i>EV/Ebitda</i>	3.3
<i>Market Capitalization (US\$mm)</i>	29,000	<i>PV/Ebitda</i>	4.9
<i>Debt (US\$mm)</i>	1,500	<i>Undeveloped Reserves (%)</i>	0
<i>Enterprise Value (EV) (US\$mm)</i>	30,500	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	4.20
<i>Present Value (PV) (US\$mm)</i>	44,900	<i>Present Value Proven Reserves(US\$/boe)</i>	1.03
<i>Net Present Value (US\$/share)</i>	52	<i>Present Value Proven Reserves(US\$/mcf)</i>	0.17
<i>Debt/Present Value</i>	0.03	<i>Earnings Next Twelve Months (US\$/sh)</i>	6.04
<i>McDep Ratio - EV/PV</i>	0.68	<i>Price/Earnings Next Twelve Months</i>	6
<i>Dividend Yield (%/year)</i>	2.9	<i>Indicated Annual Dividend (US\$/sh)</i>	1.00

Note: Estimated cash flow and earnings tied to one-year futures prices for oil.

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

Summary and Recommendation

We continue to recommend purchase of the American Depositary Receipts of **Lukoil Oil Company (LUKOY)** as a leading equity participation in the unfolding value of Russian oil and gas. Lukoil is our cheapest stock relative to the resources it appears to represent. The stock has appreciation potential of 50% to reach our estimated net present value of \$54 a share. Through high taxes, the Russian government is keeping most of the profit from export sales of crude oil. Russia also appears to be slowing oil exports to make oil production last longer. Meanwhile, Lukoil makes most of its money in an integrated profit from running half of its oil production through its own refineries.

Oil Exports Heavily Taxed

Financial results for the fourth quarter and full year 2004 reported in recent days reflected further shifting of profits from production to downstream (see table Next Twelve Months Operations). Earnings per share exceeded our most recent estimate after adjusting for a four for one split of the ADRs. Though Ebitda was about 6% less than our estimate, it continues high relative to stock price.

As a result of minerals tax, social tax, income tax and an onerous excise tax, we project that Lukoil would report cash flow (Ebitda) of just \$4.20 a barrel of production for the next twelve months. In oil-consuming countries where it is in the national interest to encourage production financially, the cash flow would be some \$25 a barrel. In an exporting country like Norway where it is in the national interest to retain more of the value of the resource, the cash flow would be perhaps \$15 a barrel on a comparable basis.

In contrast, Lukoil reports downstream cash flow that amounts to almost \$20 a barrel of crude oil refined. How can that be when recent futures prices indicated a New York Harbor 3-2-1 crack

Please see disclosures on the final page.

spread, or refiner's margin of less than \$8 a barrel? Lukoil's financial statements explain that most oil consumed in Russia is supplied by integrated producer/refiners and there is no domestic crude oil price determined in arms length transactions. As a result, profit on crude oil produced for domestic consumption shows up in the downstream segment. Some refined products are also exported and apparently are charged less of an export tax than is crude oil.

Lukoil Oil Company
Next Twelve Months Operations

	<i>Q4</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Next</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>3/31/06</i>	<i>6/30/06</i>	<i>Twelve</i>
										<i>Months</i>
										<i>6/30/06</i>
Volume										
Oil (mmb)	164	635	160	162	164	164	650	160	162	650
Oil (mbd)	1,780	1,739	1,780	1,780	1,780	1,780	1,780	1,780	1,780	1,780
Price										
Oil (\$/bbl)										
WTI Cushing	48.31	41.44	49.65	51.05	51.57	52.68	51.24	52.78	52.47	52.38
Lukoil export	40.52	34.50	41.64	42.82	43.26	44.19	42.99	44.27	44.01	43.93
NY Harbor 3-2-1 (\$/bbl)	5.72	7.74	6.17	11.13	8.84	6.17	8.08	6.74	9.50	7.81
Revenue (\$mm)										
Oil	6,634	21,896	6,670	6,935	7,082	7,235	27,922	7,091	7,127	28,535
Other	2,993	12,162	2,993	2,993	2,993	2,993	11,971	2,993	2,993	11,971
Total	9,627	34,058	9,663	9,928	10,075	10,228	39,893	10,084	10,120	40,506
Expense (\$mm)										
Fixed	1,527	4,838	1,527	1,527	1,527	1,527	6,107	1,527	1,527	6,107
Variable	4,580	14,514	4,605	4,788	4,890	4,995	19,278	4,896	4,921	19,701
Other	1,393	7,285	1,393	1,393	1,393	1,393	5,573	1,393	1,393	5,573
Ebitda (\$mm)										
Exploration and Production	527	2,543	538	620	666	713	2,537	668	680	2,727
Other	1,600	4,877	1,600	1,600	1,600	1,600	6,399	1,600	1,600	6,399
Total Ebitda	2,127	7,420	2,138	2,220	2,265	2,313	8,935	2,268	2,279	9,125
Exploration	46	171	46	46	46	46	184	46	46	184
Deprec., Deplet., & Amort.	269	1,075	269	269	269	269	1,076	269	269	1,076
Ebit	1,812	6,174	1,823	1,905	1,950	1,998	7,675	1,953	1,964	7,865
Interest	28	201	28	28	28	28	113	28	28	113
Ebt	1,783	5,973	1,795	1,877	1,922	1,969	7,563	1,925	1,936	7,753
Income Tax	624	1,694	628	657	673	689	2,647	674	678	2,713
Net Income (\$mm)										
Exploration and Production	156	1,229	276	320	345	371	1,313	347	353	1,416
Other	934	2,956	821	827	830	833	3,309	830	830	3,322
Unallocated	69	94	70	73	75	76	294	75	75	301
Total	1,159	4,279	1,166	1,220	1,249	1,280	4,916	1,251	1,258	5,039
Shares (millions)										
Per share (\$)	834	834	834	834	834	834	834	834	834	834
Per share (\$)	1.39	5.13	1.40	1.46	1.50	1.53	5.89	1.50	1.51	6.04
Ebitda Margin (E&P)	8%	12%	8%	9%	9%	10%	9%	9%	10%	10%
Tax Rate	35%	28%	35%	35%	35%	35%	35%	35%	35%	35%

Present Value in a World Context

Our estimate of present value of \$54 a share in place for more than a year implies a multiple of near-term cash flow, PV/Ebitda, of 4.9, that is at the low end of the range for producer/refiners (see table Functional Cash Flow and Present Value). The segmentation of cash flow above is consistent with company reporting while the classification of present value below is more consistent with the framework we use in valuing other companies.

Please see disclosures on the final page.

Lukoil
Functional Cash Flow and Present Value

	<i>NTM Ebitda</i> <i>(US\$mm)</i>	<i>Adjusted</i> <i>R/P</i>	<i>PV/</i> <i>Ebitda</i>	<i>Present</i> <i>Value</i> <i>(US\$mm)</i>	
Natural Gas					
Oil	2,700	20.0	10.4	28,000	62%
Downstream	6,400		2.6	16,900	38%
	9,100		4.9	44,900	100%
Debt (US\$mm)				1,500	
Net Present Value (US\$mm)				43,400	
Shares (mm)				834	
Net Present Value (US\$/sh)				52	

Reconciling the different segmentation for cash flow and present value we see an unrealistic cash flow multiple of 2.6 for the Downstream segment. A more consistent number for comparative purposes would be the median cash flow multiple of 6.3 for 14 companies in our coverage. The higher multiple would imply lower cash flow of \$2.7 billion. Since Lukoil refines about 325 million barrels of crude annually, the lower cash flow would still be about \$8 a barrel. That would be more comparable for the crude oil refined and could include marketing and other downstream activities. Remaining reported cash flow for downstream, \$3.7 billion, could be considered attributable to the oil production segment.

Instead of a 10.4 multiple for the Oil segment, the comparative number would be present value of \$28 billion divided by redefined production cash flow of \$6.4 billion, a multiple of only 4.4 times. Adjusted reserve life index need be just 6.6 years to justify a 4.4 multiple assuming recent futures prices. Yet Lukoil reports reserves that imply an adjusted life index of more than 20 years without counting natural gas. The company has been working to extend licenses to qualify its reserves under more stringent Securities and Exchange Commission rules.

Slow Oil, Speed Natural Gas

President Putin may have had other reasons for shutting down Lukoil rival, Yukos, but one benefit for Russia was to slow down Yukos' pell-mell oil expansion. In our opinion, Russian oil production has peaked like it as in the U.S. and for light, sweet crude oil globally. It is more in the long-term interests of Russia to make current production last rather than export the cream for temporary gain.

Meanwhile oil production profits should sort out to encourage optimal long-term investment. Low domestic prices need to be corrected. Eventually tax discrimination against exports also needs to be relieved.

In contrast, Russia has among the world's largest natural gas reserves that are barely tapped. Those should be developed more rapidly to the benefit of Russia and the environmental health of the world. Lukoil has natural gas reserves that we practically ignore, for now, but should be more valuable with time.

Please see disclosures on the final page.

Buy Oil and Gas Producers at Mid Decade

Multi-fold gain potential for oil and gas price over the years ahead justifies investment in recommended oil and gas producers, in our opinion. A McDep Ratio of 1.0 normally implies that a stock would be priced at present value assuming a constant real oil price of US\$40 (see table Rank by McDep Ratio).

Rank by McDep Ratio: Market Cap and Debt to Present Value

	Symbol/ Rating		Price (\$/sh) 27-May 2005	Shares (mm)	Market Cap (\$mm)	Net Present Value (\$/sh)	Debt/ Present Value	McDep Ratio
Producer/Refiners - Large Cap and Mid Cap								
Kinder Morgan, Inc.	KMI	S2	77.71	125	9,710	20.00	0.74	1.76
Marathon Oil Corporation	MRO	B	48.90	349	17,050	42.00	0.30	1.11
Imperial Oil Limited (30%)	IMO	B	71.64	105	7,510	64.00	0.10	1.11
Norsk Hydro ASA	NHY	B	83.27	252	21,010	101.00	0.16	0.85
Petro-Canada	PCZ	B	56.82	263	14,970	70.00	0.19	0.85
ConocoPhillips	COP	B	107.55	710	76,400	140.00	0.21	0.82
Suncor Energy	SU	B	39.06	461	18,010	54.00	0.10	0.75
PetroChina Company Ltd (10%)	PTR	B	64.11	176	11,270	94.00	0.05	0.70
Lukoil Oil Company	LUKOY	B	34.75	834	29,000	52.00	0.03	0.68
<i>Total or Median</i>					205,000		0.16	0.85

Kurt H. Wulff, CFA

Disclaimer: This analysis was prepared by Kurt Wulff doing business as McDep Associates. The firm used sources and data believed to be reliable, but makes no representation as to their accuracy or completeness. This analysis is intended for informational purposes and is not a solicitation to buy or sell a security. Past performance is no guarantee of future results.

McDep does no investment banking business. McDep is not paid by covered companies including revenue from advertising, trading, consulting, subscriptions or research service. McDep shall not own more than 1% of outstanding stock in a covered company. No one at McDep is on the Board of Directors at a covered company nor is anyone at a covered company on the Board of Directors of McDep.

McDep or its employees may take positions in stocks the firm covers for research purposes. No trades in a subject stock shall be made within a week before or after a change in recommendation.

Certification: I, Kurt H. Wulff, certify that the views expressed in this research analysis accurately reflect my personal views about the subject securities and issuers. No part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in this research analysis.

Research Methodology/Ratings Description: McDep Associates is an independent research originator focused on oil and gas stocks exclusively. The firm applies the thirty years of experience of its analyst to estimate a present value of the oil and gas resources and other businesses of covered companies. That value is compared with a company's stock market capitalization and debt. Stocks with low market cap and debt relative to present value tend to outperform stocks with high market cap and debt relative to present value. Buy recommendations are expected to deliver a total return better than 7% per year above inflation. Hold recommendations assume the attributes of the underlying business are reflected in the current price of the stock. Sell recommendations are expected to deliver a total return less than inflation.

Please see disclosures on the final page.