

# BST Research

## ROSNEFT – LARGEST RUSSIAN OIL PRODUCER WITH AMBITIONS IN THE NATURAL GAS MARKET

### Russia Equity Research

01 November 2021

#### Summary Overview

ROSNEFT Ticker:	ROSN
Current share price	622
# shares outstanding, mil shares	10 598,18
Market cap, Rub billion	6 592,07
EV	10 396,07
Net debt, Rub billion	3 804,00
Revenue 2021	8 353,74
EBITDA 2021	2 214,07
Net profit 2021	832,46
EV/Sales	1,24
EV/EBITDA	4,70
P/E	7,92
Net debt / EBITDA	1,72
Forecast dividend for 2021, Rub	39,3
Forecast dividend for 2022, Rub	47
Target share price, Rub	720

- **Rosneft is the largest oil and gas company in Russia** and the second in the world in terms of production volumes. Being one of the lowest-per-barrel of oil producers in the world, Rosneft stands to benefit significantly from the current oil price rally.
- **One of the main growth factors for Rosneft is Vostok Oil project**, scheduled to start production in 2024–2025, and peak, after 2030 at 2.3 million b/day. In a recent stake sale, the project was valued at US\$ 70 billion.
- With Rosneft new gas projects (Rospan and Kharampura) up and running, **by the end of 2022, Rosneft may increase gas production 80% from current levels.**
- **Rosneft may start export sales of gas through North Stream -2 pipeline.**

#### Company Overview

Rosneft is the largest oil and gas company in Russia and the second in the world in terms of production volumes. Rosneft's activities cover the production and processing of oil and gas, a network of filling stations, and petrochemicals. The company's assets are located in 23 countries around the world, although the bulk of them, of course, are located in Russia. The share of Rosneft in world production is 6%.

The company receives about 92% of its revenue from the sale of oil and petroleum products. Although the share of gas and petrochemicals in revenue has been small, the recent launch of Rospan gas project will allow the company to increase gas production significantly in the coming years.

The key sales regions are Russia, Asia (mainly China) and Europe. Within the Russian Federation, Rosneft mainly sells oil products from its own refineries, while more crude oil goes to the Asian customers. In recent years, the share of Asia in revenue has been gradually increasing, and this trend is likely to continue into the future as oil consumption in Europe decreases due to the environmental agenda.

#### Market Situation

Prices for WTI and Brent crude oil are trading in the range of \$75-80 a barrel, and are looking to keep rising. The recent rise in oil prices came after the latest data on US inventories confirmed an increase in demand,

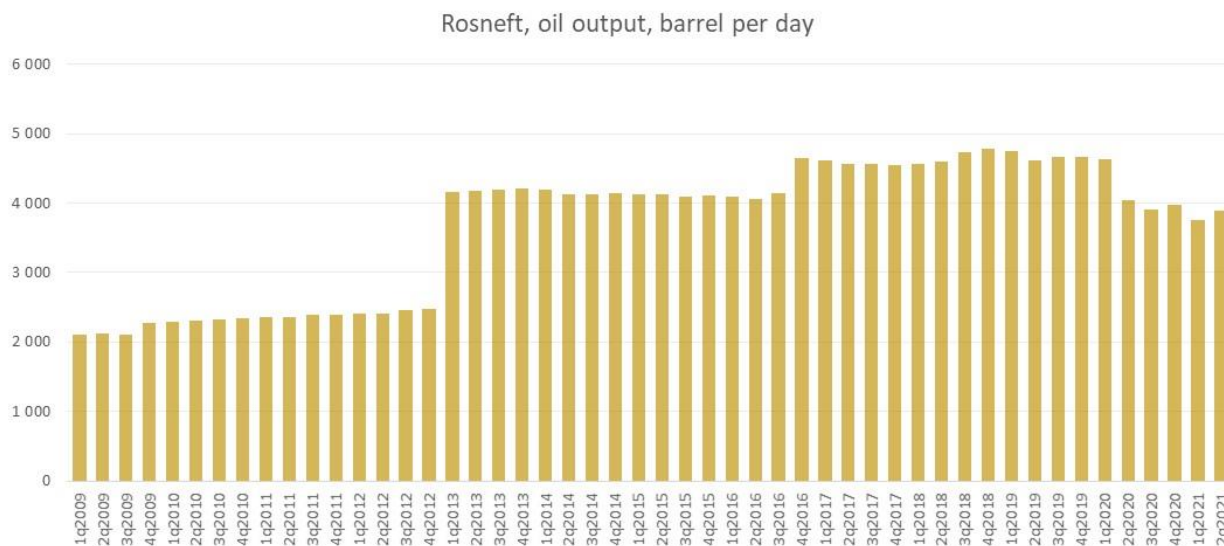
but it was also helped by the fact that the fuel shortage in the UK, it would seem, should have a special impact on Brent. In addition, significant upward pressure on natural gas prices in recent days has also boosted oil markets.

The Organization of the Petroleum Exporting Countries (OPEC) estimates that the oil industry will need about \$ 12 trillion in investments by 2045 to offset the cuts in capital expenditures caused by various factors, including the novel coronavirus pandemic.

Given the lack of adequate investment in oil in recent years, the rise in oil prices may surprise all skeptics and green energy fans. There are fewer and fewer oil fields that are cheap to extract, and even if the entire world switches to electric motors, it is unlikely to be able to do without refining and petrochemicals.

### Operating and financial results

Over the course of the 12 years, owing to M&As and new fields development Rosneft has been able to significantly increase its output. In 2020, complying with the OPEC+ decisions, Rosneft had to put a cap on production. However, as 2q21 results demonstrate the output has started to increase as the global economy moves out of the pandemic restrictions and demand for oils starts to outpace supply.



Source: Rosneft website

This improving dynamic is reflecting positively on the company's financials. Key financial indicators along with our estimates for 2<sup>nd</sup> half of 2021 are provided in the table below.

**Key operating indicators**

		2015	2016	2017	2018	2019	2020	2021П	1n2020	1n2021	2n2021
Production of hydrocarbons, incl.	barrel K/day	5 159	5 369	5 718	5 795	5 791	5 186	5 279	5 402	5 074	5 484
Oil and liquid hydrocarbons	barrel K/day	4 116	4 252	4 577	4 673	4 674	4 141	3 920	4 338	3 824	4 015
Nat gas	barrel K/day	1 043	1 117	1 141	1 122	1 117	1 045	1 360	1 064	1 250	1 469
Oil and liquid hydrocarbons*	barrel K/day	5 574	5 701	5 718	5 795	5 791	5 186	5 279	5 402	5 074	5 484
Oil refining	ton M	97	100	113	115	110	104	106	51	51	55

**Key financial indicators**

		2015	2016	2017	2018	2019	2020	2021П	1n2020	1n2021	2n2021
<b>Revenue</b>	<b>Rb'B</b>	<b>5 150</b>	<b>4 988</b>	<b>6 011</b>	<b>8 238</b>	<b>8 490</b>	<b>5 757</b>	<b>8 354</b>	<b>2 797</b>	<b>3 904</b>	<b>4 450</b>
export sale of oil, oil products, petrochemicals	Rb'B	3 888	3 586	4 248	6 148	6 461	3 862	6 069	1 919	2 801	3 268
domestic sale of oil, oil products, petrochemicals		995	1 087	1 414	1 694	1 770	1 526	1 777	706	877	900
sale of nat gas		188	214	215	234	259	240	331	116	139	192
Other		79	101	134	162	0	129	177	56	87	90
<b>EBITDA, млрд руб.</b>	<b>Rb'B</b>	<b>1 245</b>	<b>1 278</b>	<b>1 403</b>	<b>2 081</b>	<b>2 105</b>	<b>1 209</b>	<b>2 214</b>	<b>479</b>	<b>1 016</b>	<b>1 198</b>
Net profit	Rb'B	355	181	222	549	708	147	832	-113	382	450
Adj Operating Cash Flow	Rb'B	1 339	1 011	1 167	2 069	1 738	1 210	1 967	573	967	1 000
Capex	Rb'B	595	709	922	936	854	785	962	367	462	500
Free Cash Flow	Rb'B	744	302	245	1 133	884	425	905	206	405	500
Urals oil price	Rb' K/barrel	3,14	2,82	3,1	4,38	4,11	3,01	4,94	2,75	4,68	5,20
EBITDA margin, %		24,2%	25,6%	23,3%	25,3%	24,8%	21,0%	26,5%	17,1%	26,0%	26,9%

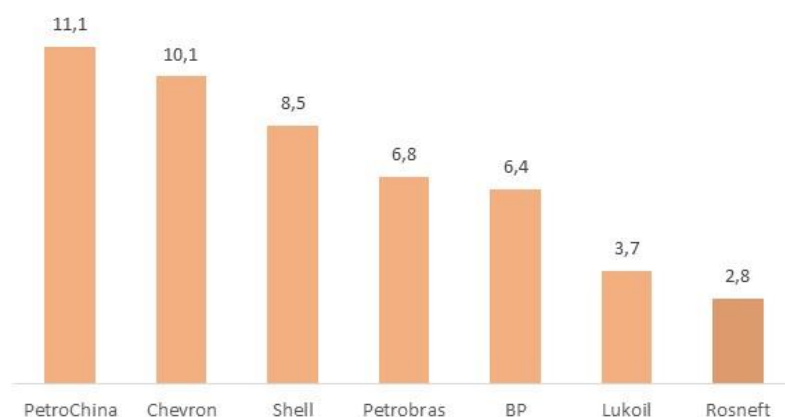
\* incl Bashneft

Source: Rosneft website, GiG estimates

In 1h2021 we see strong growth in both revenue and EBITDA as well as net profit. We believe the company will continue to increase output and top line and bottom line going forward as OPEC+ eases output curbs and oil price remains in the upward trend.

Rosneft remains one of the lowest-cost-per-barrel oil producers in the world with production costs significantly below its Western peers.

Rosneft O&G production costs, \$/barrel equivalent



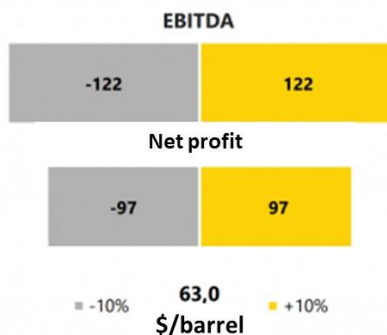
Source: Rosneft website

The company's EBITDA is quite sensitive to changes in the oil price but even more so to changes in Rub/\$ exchange rates.

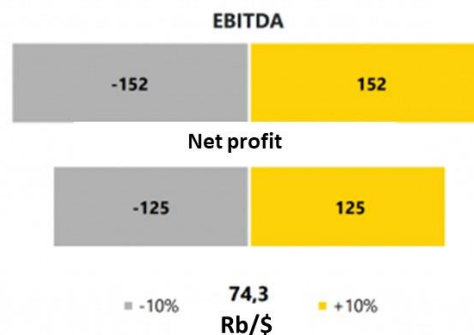
## Sensitivity Analysis

Sensitivity of EBITDA and net profit in the 1<sup>st</sup> half 2021

to a 10% change in Urals price, Rb B



to a 10% change in Rub/\$ Ex rate, Rb B



Source: Rosneft website

Our conservative forecast of revenue in 2q 2021 is based on the following assumptions:

- Average Urals oil price Rb 5200 per barrel (actual average price in 3q21) will not change in q4.
- Oil production will increase as OPEC+ is gradually increasing production.
- Gas production will also rise as Rospan, Rosneft's gas production arm, is ramping up gas output.

This should result in a record high EBITDA margin of 27%.

### New oil project - Vostok Oil

One of the main growth factors for Rosneft is the development of the Vostok Oil project. Vostok Oil is a large-scale project in the upstream segment scheduled to start production in 2024–2025, and peak, after 2030 at 2.3 million b/day, which is virtually half of what the company produces today.

Vostok Oil is a project with low unit cost of production, with a carbon footprint 75% lower than other major new oil projects in the world. Its resource base is over 6 billion tons of premium low-sulfur oil, which has a uniquely low sulfur content of 0.01-0.04%. The high quality of raw materials eliminates the need for separate installations at the refinery, which will significantly reduce the volume of greenhouse emissions of the project.

In June 2021, it was announced Rosneft would sign a deal with a consortium of Vitol S.A. and Mercantile & Maritime Energy Pte. Ltd. on the sale of a 5% stake in Vostok Oil. In a previous deal with the oil trader Trafigura for the sale of 10% stake in the project, the valuation of the entire Vostok Oil project is 70 billion euros. This valuation of the Vostok Oil project alone is a little less than the current market capitalization of Rosneft.

In mid-September there was a disclosure on Rosneft's corporate website that on September 17 a meeting of the Rosneft Board of Directors will be held to consider the issue on whether to sell a stake in one of the companies of the Group. It is very likely that the issue under consideration is Vostok Oil. Taking into account the September 1 meeting of the Minister of Oil and Gas of India and Rosneft CEO Igor Sechin at EEF-2021, it is very likely that we will also see a deal to exchange the share of a consortium of Indian investors in Vankorneft for a share in Vostok Oil, and possibly the purchase by the Indians of an additional share in the project.

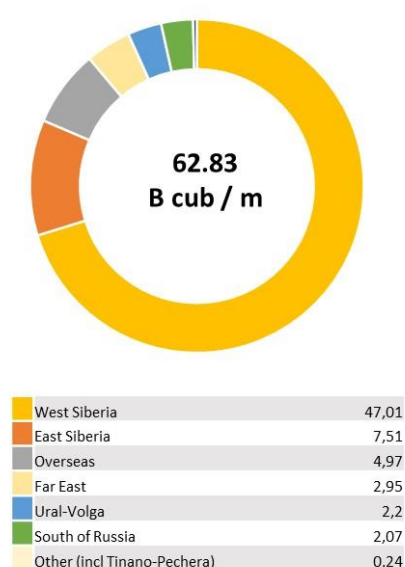
Rosneft has the intention to sell up to 50% stake in Vostok Oil and use the proceeds to finance capex.

## Gas

At the end of 2019, Rosneft was the third company in Russia in terms of gas production (after Gazprom with 500 billion cubic meters, and Novatek with 74.7 billion cubic meters). In 2019, Rosneft produced 67 billion cubic meters of gas, which amounted to about 8% of the volume of gas produced in Russia. In 2020, Rosneft produced 62.83 billion cubic meters of gas, of which natural gas 30.26 b cub/m and APG 32.57 b cub/m. Rosneft's long-term plans aim to take a 20% share of the Russian market through its Rospan and Kharampur gas projects, as well production of gas in Taimyr and Eastern Siberia.

Rosneft produces gas through its subsidiaries in Western and Eastern Siberia, Central Russia, Southern European Russia, the Far East, as well as Vietnam and Egypt.

Gas production by regions, B cub/m



Source: Rosneft 2020 Annual Report

Rosneft produces the bulk of gas in Western Siberia (70%) and is represented by JSC Sibneftegaz (~ 10-11 billion cubic meters per year with plans to increase to 15 billion cubic meters), JSC Rospan International (~ 6.5 billion cubic meters per year) and LLC RN-Purneftegaz (~ 4 billion cubic meters per year). APG is produced mainly at the fields of Samotlorneftegaz JSC (~ 6 billion cubic meters), RN-Yuganskneftegaz LLC (~ 5 billion cubic meters per year), RN-Purneftegaz LLC (~ 2 billion cubic meters) and PJSC Varyaganneftegaz (~ 4 billion cubic meters per year, sold in 2021).

Gas production in Eastern Siberia is carried out at the fields of the Vankor group (~ 6-7 billion cubic meters per year) - the largest in the region. The main production of the Far East region is APG and natural gas from fields located onshore and offshore Sakhalin Island. (~ 2.3 billion cubic meters per year, mainly RN Shelf-Far East JSC).

The bulk of gas production in Central Russia in 2018 was provided at the fields of JSC Orenburgneft, JSC Samaraneftegaz, LLC Bashneft-Dobycha.

In southern Russia, the main gas producing asset is LLC RN-Krasnodarneftegaz, which produces both natural gas and APG.

Rospan is currently Rosneft's largest gas investment project. The resource base is gas and gas condensate fields in the Vostochno-Urengoysky and Novo-Urengoysky license areas in the Yamalo-Nenets Autonomous District (Yamalo-Nenets Autonomous Okrug). The reserves are estimated at 1246 billion cubic meters of gas; 313 million tons of gas condensate, propane-butane mixture and oil. Rosneft in Rospan has a mineral extraction tax benefit (50% of the base). According to the plan, the project will allow Rosneft to produce 21 billion m<sup>3</sup> / year of gas and 6.3 million tons / year of gas condensate, oil and propane-butane mixture (+ 30% to the current gas production volumes of the entire Rosneft). An important feature of the project is that reaching the design capacity is achieved within 1 year. The launch of the 1st start-up complex took place in the 1st quarter of 2021. The launch of the 2nd start-up complex is scheduled for the 3rd quarter of 2021. In addition, it should be noted that the production of gas condensate and gas is not included in the terms of the OPEC + agreement.

Another interesting gas assets is Kharampurneftegaz (launch no earlier than 2022). Like Rospan, it is located in the Yamalo-Nenets Autonomous Okrug. The reserves of the field according to international PRMS standards amount to 735 billion cubic meters of gas, with more than 80% of gas reserves accounted for by hard-to-recover (TRIZ) Turonian deposits. Rosneft has a tax exemption for gas production in Kharampura. Rosneft is implementing the Kharampurskoye field development project jointly with BP. The implementation of the project involves 2 stages:

- 1st phase of the project will ensure gas production in the amount of 11 billion cubic meters per year,
- Phase 2 provides for the production of another 14 billion cubic meters of gas per year.

Rosneft moved the commissioning of Kharampura to 2022. Once the project is up and running it can produce up to 25 billion m<sup>3</sup> / year.

With Rospan and Kharampura up and running, by the end of 2022, Rosneft will have undergone an amazing transformation with gas sales accounting for circa 25% of total sales. Currently, revenue from gas is marginal for the company.

So, Rosneft may increase its gas production by 50 billion cubic meters per year, which is 80% from current levels.

### **Gas Ambitions – Export**

With this incredible growth in gas production the question comes as where to sell all this new gas.

The head of Rosneft Igor Sechin, having addressed with a letter to Russian President Vladimir Putin, asked to allow the company to export 10 billion cubic meters of gas a year through an agency agreement with Gazprom (MOEX: GAZP), the Kommersant newspaper wrote. Sechin proposes to pay a significantly increased tax on gas production on these volumes, which, according to the head of Rosneft, will allow the budget to receive an additional 37 billion rubles a year. In the coming days, the Ministry of Energy is to submit a report on the possibility of ensuring the export of gas by Rosneft through Nord Stream 2, Deputy Prime Minister Alexander Novak told reporters.

We keep in mind the pressing problems of Gazprom's Nord Stream-2. At the end of August, a court in Dusseldorf, Germany rejected an appeal by the Nord Stream 2 operator, who tried to challenge the decision on the pipeline's falling under the EU gas directive. Under this directive, Gazprom is deprived of the right to sell to the end consumer exactly half of the entire throughput capacity of the gas pipeline - 27.5 bcm / year. The Russian gas pipeline, according to the EU Gas Directive, after commissioning will be able to load only 50 percent of its capacity.

But with the Rosneft gas projects slated to come on line in 2022, Rosneft will be able to sell this gas not at domestic prices, but at European ones. This will provide such a solid cash flow that Rosneft is ready to pay an increased tax of up to 37 billion rubles per year.

Let's now try to estimate Rosneft's possible revenue from sale of this export gas:

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#### Rosneft Export Revenue Calculations

Volume, B cubic meters	10
Selling price, \$ per K cub meters	300
Rub \$ ex rate	73
<b>Revenue, Rub M</b>	<b>219 000</b>

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Source: BST Research estimates

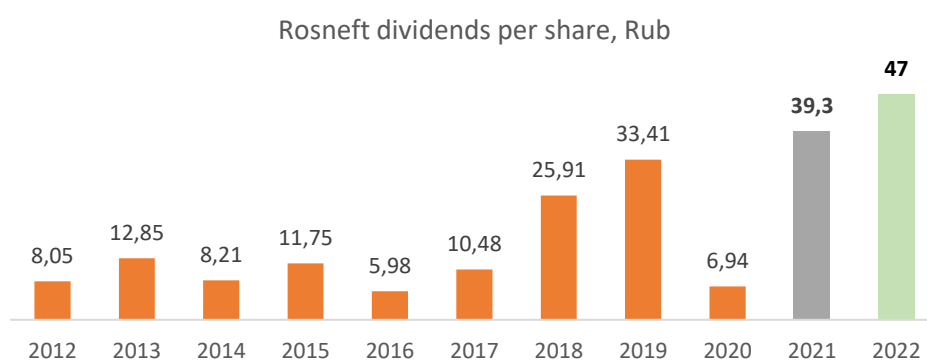
Even a 37 billion of mineral extraction tax, and lifting costs and transportation expenses, Rosneft may get a whopping 150 billion rubles in incremental EBITDA. For the first half of 2021, Rosneft showed an EBITDA of Rb 1 000 billion. So, in annual terms this should contribute circa 7% to EBITDA.

#### Dividends

The current dividend policy of Rosneft assumes the payment of 50% of its net profit under IFRS in the form of dividends. This is in line with a government decree that state-owned companies must allocate at least 50% of their net profit to dividends. At the same time, unlike many oil companies, Rosneft does not adjust its net income for exchange rate differences or impairments to calculate dividends. Considering that a significant part of the company's debt is denominated in foreign currency, this may reduce dividends in the event of an increase in the dollar exchange rate (as happened in 2020) and increase them during periods of strengthening of the ruble.

Given our 2021 forecast net profit of Rb 832 billion, total dividends for 2021 financial year may be Rb Rb 416 billion, which is the equivalent of Rb 39.3 per share, or 6.3% given today's price of Rb 620 per share (based on a total number of 10 598 177 817 shares outstanding). Given our forecast of 2022 dividends (assuming no change in oil price and the start of has export sales), the dividend yield for 2022 is 7.6%.

Rosneft dividend history and our forecast for 2021-2022 is provided in the table below:



Source: Rosneft website, BST Research estimates

We believe a fair dividend yield for a company the size of Rosneft is 6-6.5%. With this in mind, **the fair value of Rosneft shares is Rub 720-780.**

**Disclaimer:**

*This is not an investment recommendation!*

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