CEE oil & gas sector hit by global equity sell-off, but profitability still strong in 2008

24.09.2008

- Undervalued CEE oil and gas sector, most CEE stocks have Buy recommendation...
- ...however, the continued global sell off is now the crucial issue
- Outlook for 2008 and beyond: stable crude oil price in EUR terms and lower margins

Despite higher-than-expected crude oil prices, and the current negative mood and global sell-offs on equity markets, Erste Group analysts say CEE oil and gas sector profitability is even higher than 2007 figures. In fact, despite expectations of a slightly worsening macro environment (decreases in the price of crude oil and refining margins), current share prices are mostly well-below their valuations.

CEE stocks are traded with P/Es of 8.0x (but only 6.1x excluding INA) in terms of 2008 earnings and even 7.3x (6.2x excluding INA again) using 2009 estimated earnings, while the sector's European peers are traded at P/Es of 10.8x for 2008 and 9.8x for 2009. The undervaluation of the CEE oil and gas sector can also be seen in the EV/EBITDA for the coming two years, although the numbers are boosted by the high ratios of Petrom and, particularly, INA, which is supported by the MOL takeover bid.

Based on the current negative market sentiment, Erste Group analysts say the CEE oil and gas sector is trading not only below the values of its European peers at P/E, EV/EBITDA and EV/Sales levels, but also well-below its long-term average of 8-12x (at P/E level). "Both statements would make sense at the moment, as investors look at CEE stocks with high levels of risk - and the stock prices are under pressure thanks to the overall sell-off mood on the financial markets. However, the operating performance of the companies is very high", says Jakub Zidon, Oil & gas sector analyst and author of the report.

Most CEE stocks have Buy recommendation

- Given its large exposure to the upstream segment and plans to increase production, **OMV** remains top pick with a Buy recommendation and target price of EUR 55.0.
- Although with no potential growth drivers for the future, **MOL** is currently enjoying high diesel margins and delivering almost record quarterly figures at the operating level. Erste Group analysts change recommendation from Hold to Buy, while slightly lowering the target price to HUF 22,500.
- Polish refiners were strongly supported by huge revaluation gains in 1H08, but the outlook should be taken with caution (expected decrease in refining margins). Thanks to the significant drop in the share price, both **Lotos** and **PKN Orlen** are upgraded to Buy with 12M target prices of PLN 33.0 and PLN 45.0, respectively.
- **Unipetrol** was hit strongly by the longer than expected shut-down of its Litvinov plant and the significant decrease in petchem margins. Despite this, Erste Group analysts stand by their Buy recommendation, while substantially decreasing the valuation to CZK 250.
- **Petrom's** restructuring is still ongoing, but the results are not yet very visible, mainly due to increasing production costs. A slight increase in the valuation to RON 0.570 is attributed to the higher-than-expected crude oil price.

Erste Group analysts downgraded **INA** to Reduce, as the share price is supported by MOL's takeover bid at HRK 2,800, which is above target price of HRK 2,550. However, potential synergies with MOL could reach up to HRK

460 per share to justify the current stock price level.

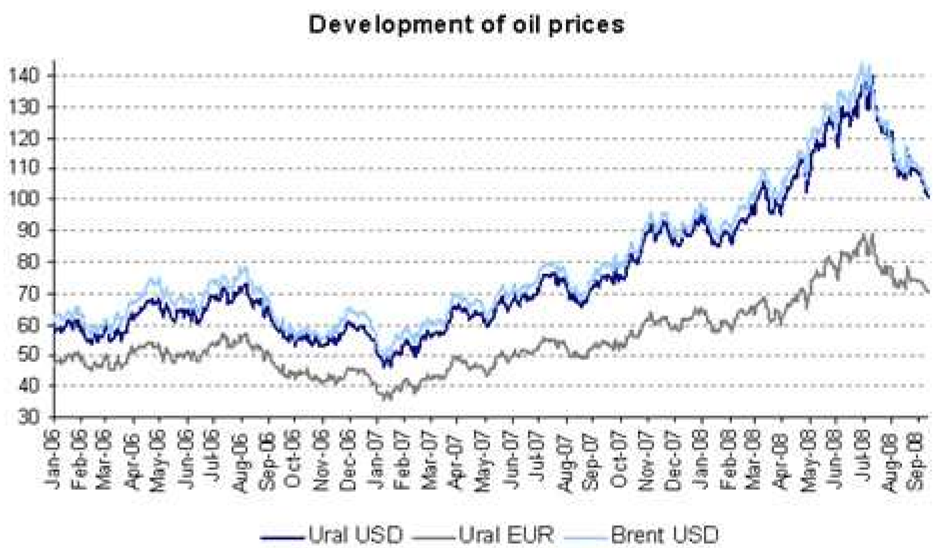
List of recommendations and target prices

Company	Previous recomm.	Current recom.	Previous target price	Current target price	Report released
Lotos	Accumulate	Buy	PLN 40.5	PLN 36.0	24/09/2008
MOL	Hold	Buy	HUF 24,125	HUF 22,500	24/09/2008
OMV	Buy	Buy	EUR 59.7	EUR 55.0	24/09/2008
PKN Orlen	Accumulate	Buy	PLN 44.6	PLN 45.0	24/09/2008
Unipetrol	Under review	Buy	CZK 358.0	CZK 255.0	24/09/2008
Petrom	Accumulate	Buy	RON 0.608	RON 0.570	24/09/2008
INA	Accumulate	Reduce	HRK 2,490	HRK 2,550	24/09/2008

Source: Erste Group

Outlook for 2008 and beyond: stable crude oil price in EUR terms, lower margins

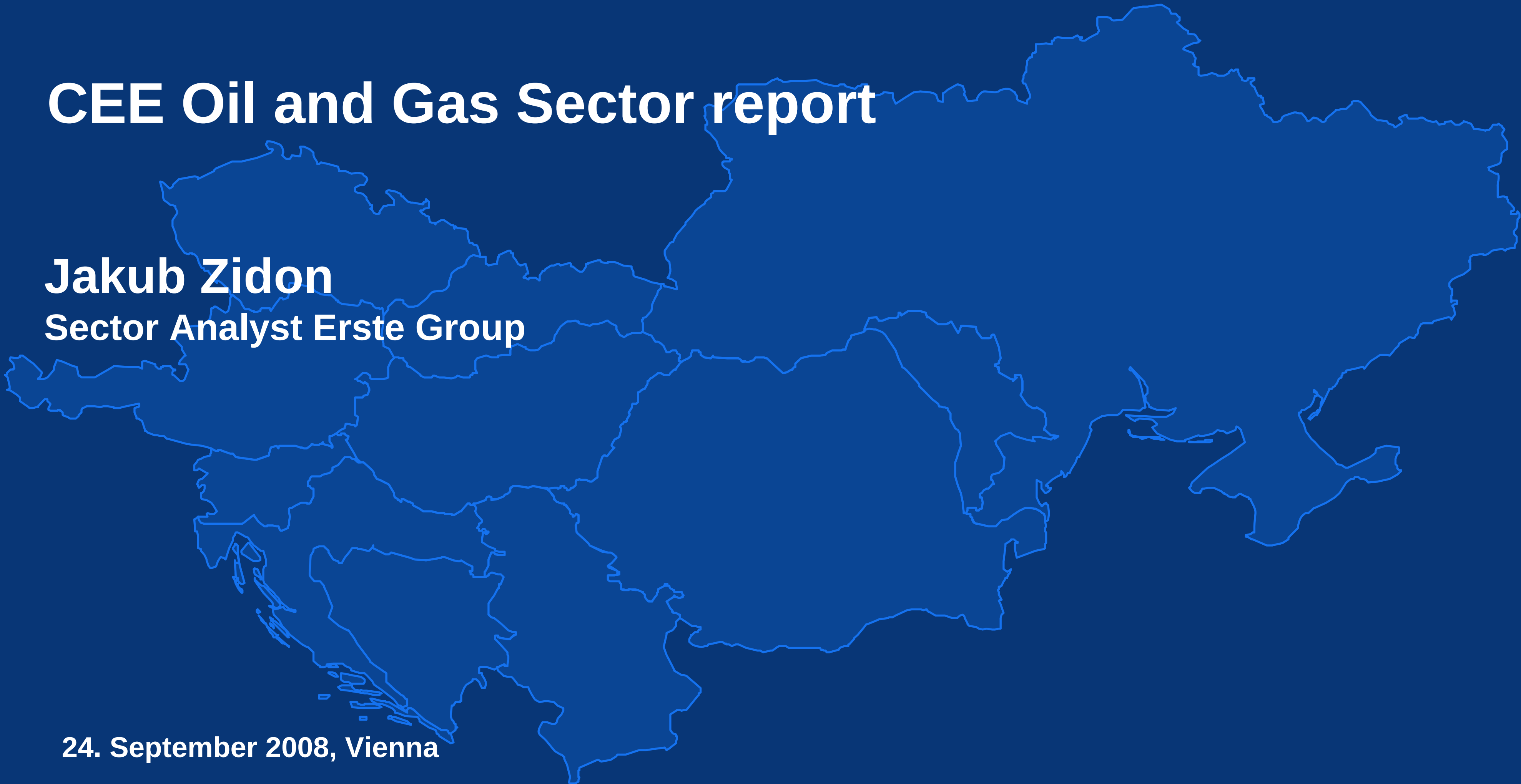
"We have increased our crude oil forecast for 2008 (to USD 105/bbl) and beyond (with a gradual decrease to USD 80 per barrel, which should be sustainable in the long-term) hand in hand with our EUR/USD forecast", says Jakub Zidon. "As for margins, we expect refinery margins to decline over the mid-term, due to pressure from bigger supply side, while petrochemical margins should see a slight recovery in the coming years, with decreasing naphtha prices. In terms of CEE companies, we still highlight upstream-exposed companies (OMV, Petrom) or refiners with a high share of middle-distillate production (MOL) in the short term", he concludes.



Consolidation to continue in coming years

Erste Group analysts believe that the consolidation wave in the oil and gas sector will continue, but over some time. Current global equity sell-offs destroy stock prices, making the relative valuation quite difficult. A merger between PKN Orlen and Lotos could be back on the table after the next general elections in Poland, while a merger between OMV and MOL is not likely in the long term from the current prospective. The third possibility, a MOL/PKN merger, is also unlikely at the moment, but is not unrealistic, in their view. The OMV/MOL project was rejected because of the really low synergy effect, while this merger a MOL/PKN merger could connect the north and south of the region without the merged entity being subject to asset divestment.

CEE Oil and Gas Sector report



Jakub Zidon

Sector Analyst Erste Group

24. September 2008, Vienna

Oil & gas sector report

Presentation Topics

1. **Valuation and recommendation summary**
2. Market development
3. Company highlights

Oil & gas sector report

Valuation and recommendation summary

Oil prices rebounded above USD 100/bbl…

CEE oil sector environment

- Strong increase of oil prices supports upstream players
- External environment was peaking in 1H 2008 – market likely to returned to mid-cycle
- We foresee downstream market to slightly decrease in 2009-11
- We are more bullish on upstream business than on outlook for downstream profitability
- We foresee gradual recovery in petchem segment outlook – limited potential upside of Unipetrol

…our top pick is therefore OMV

List of recommendations and target prices

Company	Previous recommen.	Current recommen.	Previous 12M target price	Current 12M target price	Report released	Current price
Lotos	Accumulate	Buy	PLN 40.5	PLN 36.0	24.9.2008	PLN 25.6
MOL	Hold	Buy	HUF 24,125	HUF 22,500	24.9.2008	HUF 14,900
OMV	Buy	Buy	EUR 59.7	EUR 55.0	24.9.2008	EUR 35.5
PKN Orlen	Accumulate	Buy	PLN 44.6	PLN 45.0	24.9.2008	PLN 33.7
Unipetrol	under review	Buy	CZK 358.0	CZK 255.0	24.9.2008	CZK 173.1
Petrom	Accumulate	Buy	RON 0.608	RON 0.570	24.9.2008	RON 0.40
INA	Accumulate	Reduce	HRK 2,490	HRK 2,550	24.9.2008	HRK 2,810

Source: Erste Group

Oil & gas sector report

Valuation and recommendation summary

- **Lotos – Poland – Buy – 12-month target price: PLN 36.0**
  - PKRT and modernization of Gdansk refinery could offer good growth story
  - But the program is highly risky at the moment and also upstream target would be hardly achievable
- **MOL – Hungary – Buy – 12-month target price: HUF 22,500**
  - Lack of long-term growth drivers is currently offset by the strong middle distillates share in product portfolio
  - Russian and INA relationship could offer better longer-term growth opportunities
- **OMV – Austria –Buy – 12-month target price: EUR 55.0**
  - Stock was hit by MOL merger talks, slower Petrom restructuring and relatively expensive Petrol Ofisi purchase
  - We believe investors overreacted to negative news; OMV now looks much more exciting, especially if crude oil remained at the these levels
- **PKN Orlen – Poland – Buy – 12-month target price: PLN 45.0**
  - Buying Lithuania's Mazeikiu fits well strategically, but uncertainty looms over supply
  - Purely downstream players worst-equipped to the current macro environment
- **Unipetrol – Czech Republic – „weaker" Buy – 12-month target price: CZK 250.0**
  - Longer than expected shutdowns hugely affected 2H 07 numbers…
  - …while petrochemical margins slumped in 1H 08
- **Ina – Croatia – Reduce – 12-month target price: HRK 2,550**
  - Very expensive compared to peers, but obviously supported by MOL's takeover bid
- **Petrom – Romania – „weaker" Buy – 12-month target price: RON 0.57**
  - Upstream assets waiting for efficiency improvement

Oil & gas sector report

Valuation and recommendation summary

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Peer group comparison

	EV/EBITDA			EV/Sales			P/E		
	2007	2008e	2009e	2007	2008e	2009e	2007	2008e	2009e
ENI SpA	4.5x	3.1x	3.0x	1.3x	0.9x	0.9x	7.8x	6.6x	6.5x
Repsol	4.3x	3.3x	3.2x	0.7x	0.5x	0.5x	8.2x	7.4x	7.4x
Royal Dutch Shell	4.9x	2.9x	2.9x	0.8x	0.4x	0.4x	7.8x	6.0x	6.1x
Total SA	4.8x	3.2x	3.1x	1.1x	0.7x	0.7x	8.4x	6.8x	6.5x
BP	6.6x	3.3x	3.2x	0.9x	0.5x	0.6x	9.7x	5.9x	5.9x
Norsk Hydro ASA	6.7x	4.6x	4.0x	0.9x	0.5x	0.5x	6.2x	9.5x	7.6x
Cepsa	12.9x	15.4x	12.5x	1.3x	1.2x	1.1x	26.0x	37.4x	29.9x
Statoil	3.2x	1.8x	1.7x	1.1x	0.7x	0.7x	10.1x	7.0x	6.8x
Hellenic Petroleum	7.2x	7.6x	8.4x	0.5x	0.4x	0.4x	10.2x	11.0x	11.2x
WE average	**6.1x**	**5.0x**	**4.7x**	**0.9x**	**0.7x**	**0.6x**	**10.5x**	**10.8x**	**9.8x**
MOL	7.3x	3.7x	3.9x	1.2x	0.5x	0.5x	7.1x	5.2x	5.8x
PKN	6.2x	4.7x	4.8x	0.5x	0.3x	0.3x	6.8x	6.6x	6.7x
Unipetrol	7.6x	3.2x	3.1x	0.7x	0.3x	0.3x	5.6x	10.2x	8.5x
OMV	6.1x	3.4x	3.1x	1.0x	0.5x	0.5x	6.6x	4.7x	4.6x
Petrom	8.3x	4.2x	4.2x	2.1x	1.1x	1.0x	12.2x	6.3x	6.8x
INA	13.8x	10.3x	9.1x	1.2x	1.1x	1.0x	28.7x	19.5x	14.0x
Lotos	5.3x	3.6x	3.8x	0.4x	0.3x	0.4x	4.2x	3.3x	4.6x
CEE average	**7.8x**	**4.7x**	**4.6x**	**1.0x**	**0.6x**	**0.6x**	**10.2x**	**8.0x**	**7.3x**

Sources: Erste Group, JCF, prices as of August 22

Oil & gas sector report

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Oil & gas sector report

Market development

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Crude oil markets: increasing demand, while rather lower supply

World Oil, Gasoline and Diesel Stocks (in mn barrels)

USA	Jul-08	Jul-07	y/y change
Crude oil	296.9	336.7	-11.8%
Gasoline	213.6	202.8	5.3%
Diesel	133.3	131.6	1.3%

EMU	Jul-08	Jul-07	y/y change
Crude oil	483.8	483.0	0.2%
Gasoline	128.2	121.1	5.9%
Diesel	358.7	377.2	-4.9%

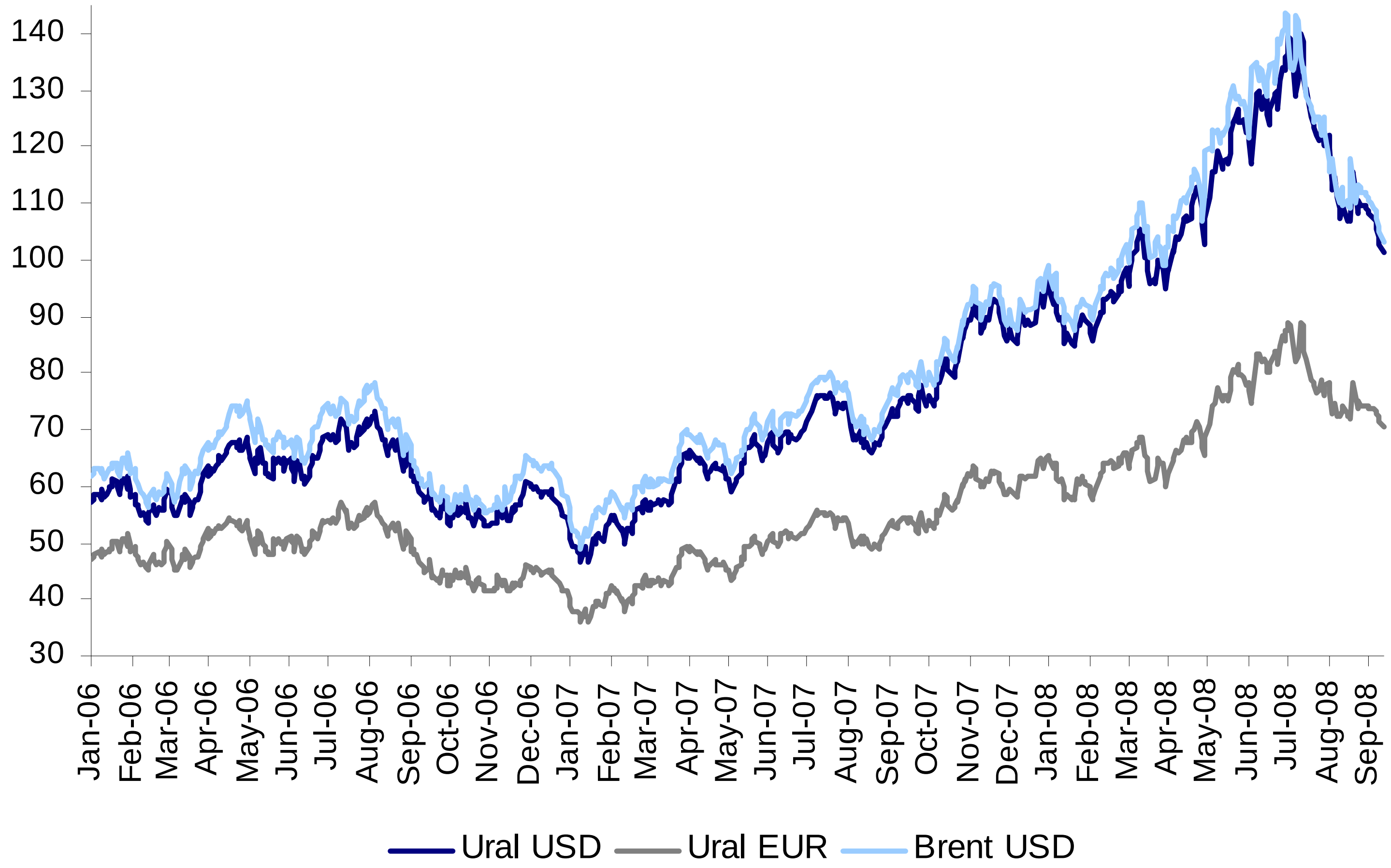
Japan	Jun-08	Jun-07	y/y change
Crude oil	101.1	110.2	-8.3%
Gasoline	13.2	12.3	7.3%
Diesel	28.4	31.4	-9.6%

Oil & gas sector report

Market development

Crude oil in EUR terms looks more stable than in USD

Oil price development in USD and EUR



Oil & gas sector report

Market development

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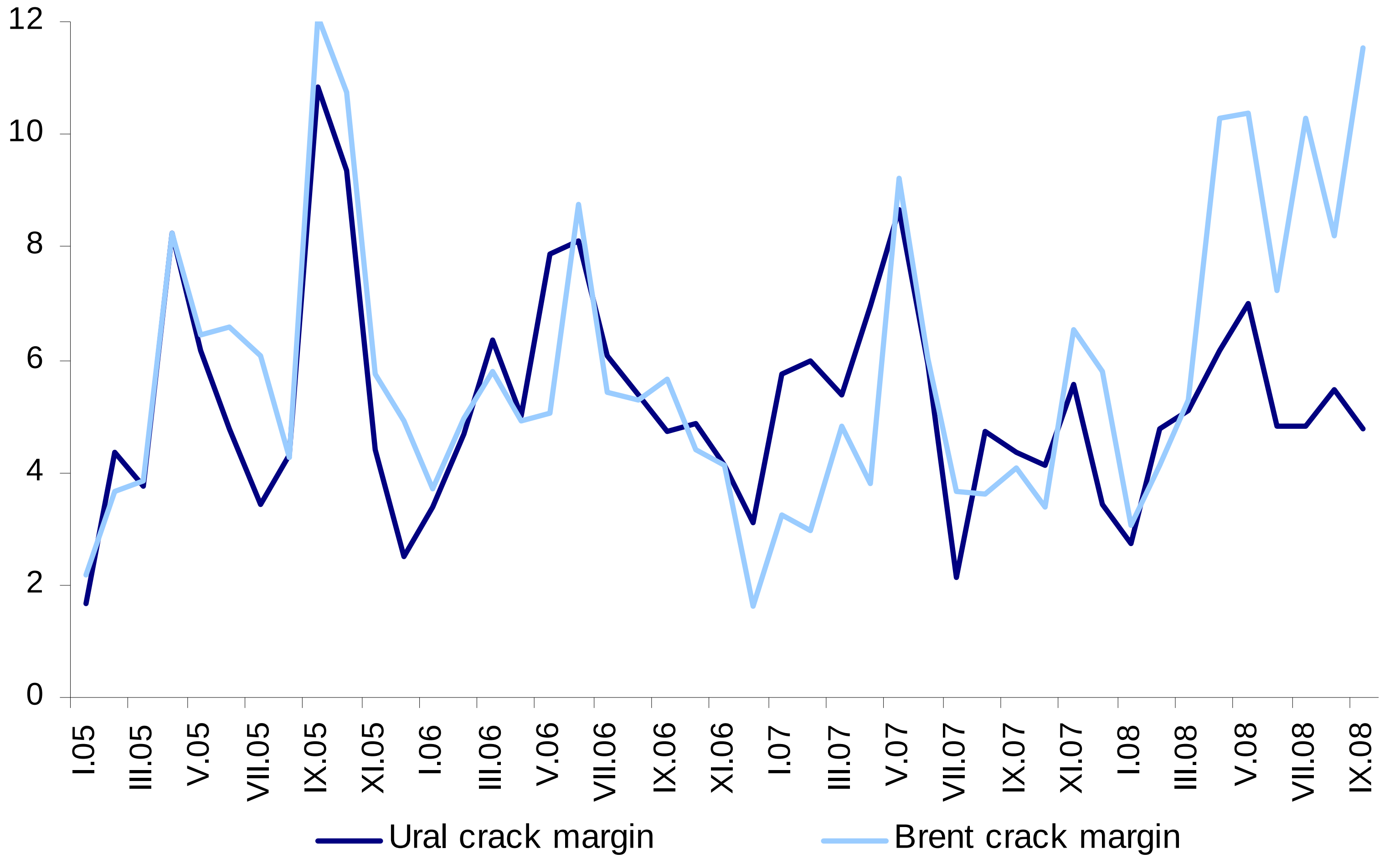
Refining margins – volatile, but even above level in 2007…

Development of Refining margins

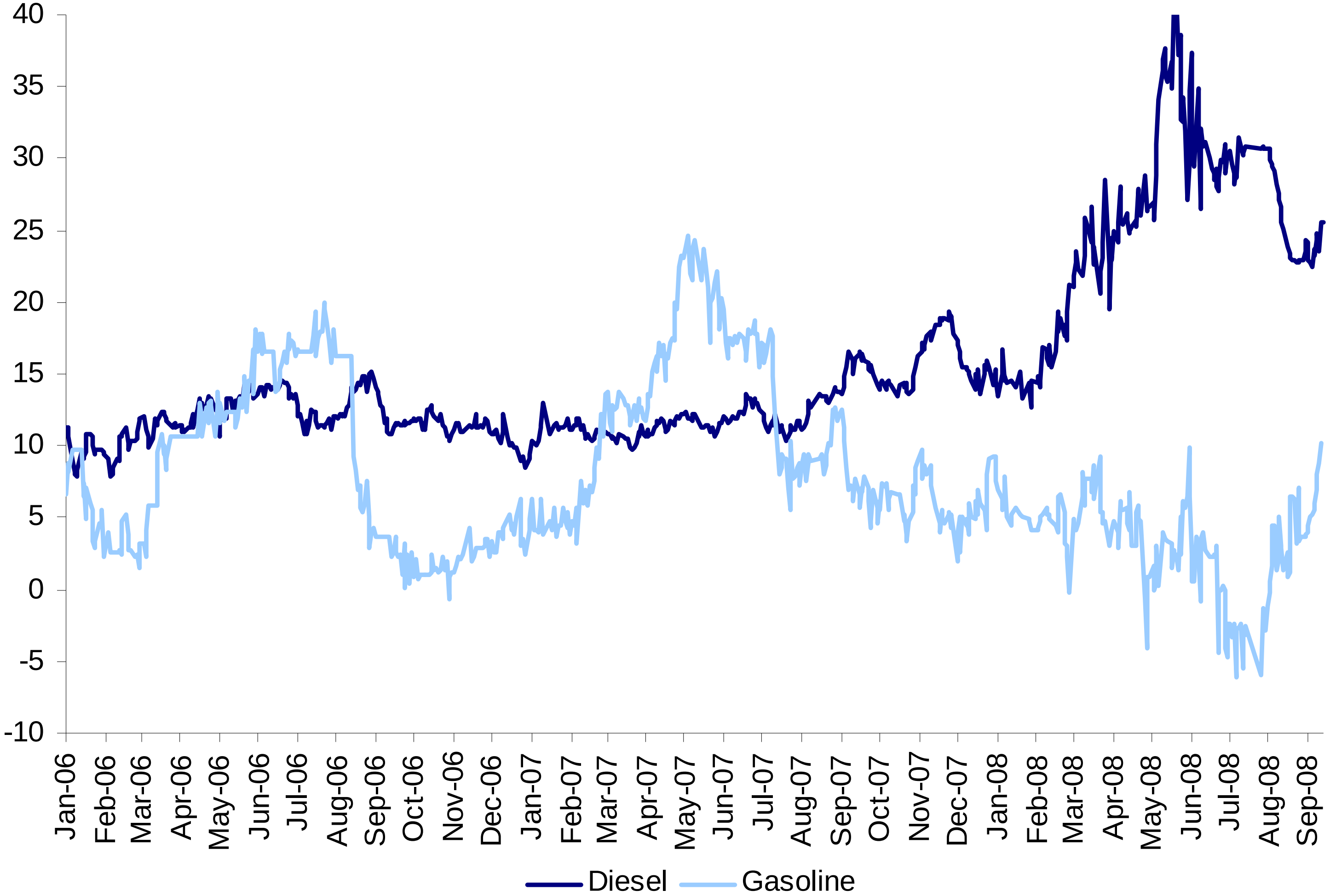


Oil & gas sector report

Market development

Diesel crack spreads well-above the gasolines' in Europe

Development of Diesel/Gasoline margins



Oil & gas sector report

Market development

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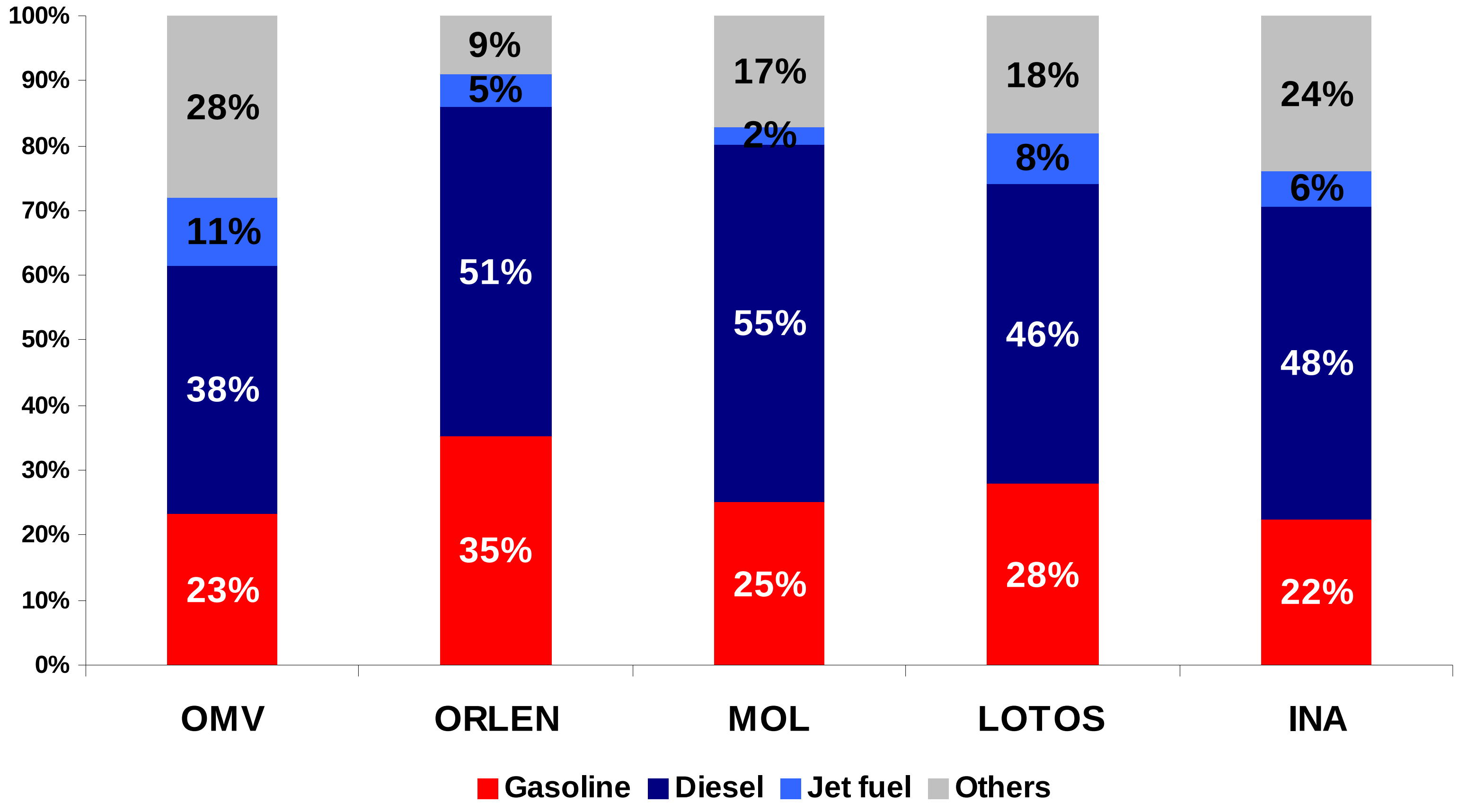
Refinery – product portfolio (1H 2008)



Oil & gas sector report

Market development

Downstream markets: list of CEE refiners with capacity and Nelson complexity

Refinery segment in CEE

CEE refineries

	Refinery	Refining capacity mmtpa	Nelson complexity
MOL	Duna	8.1	10.6
	Bratislava	6.0	12.3
INA - 25%	Sisak	3.9	4.1
	Rijeka	4.4	5.7
OMV	Schwechat	10.2	6.2
	Burghausen	3.5	7.3
	Bayernoil	12.8	8.0
Petrom - 51%	Arpechim	3.6	7.3
	Petrobrazi	3.4	7.3
PKN Orlen	Plock	13.8	9.5
Unipetrol -63%	Litvinov	5.5	6.7
Unipetrol	Kralupy	3.4	9.8
Unipetrol	Paramo	1.0	n.a.
	Mazeikiu	10.0	9.0
	Southern refineries	0.7	n.a.
Rompetrol	Petromidia	5.1	7.5
Lotos Group	Gdansk	6.0	11.1
NIS	Pancevo	4.8	4.9
	Novi Sad	2.8	4.6
Lukoil	Petrotel	2.4	9.7
	Burgas	10.7	8.0

Source: Erste Group estimation, PKN Orlen

Oil & gas sector report

Market development

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CEE oil sector environment: We definitely prefer upstream

- We are more bullish on upstream than on downstream profitability
- Oil price reached peak already in 1H 2008 (in USD terms), but should remain relatively high
- Downstream market tighter –refining margins likely to go down until 2011
- Petrochemicals depends on demand and Middle East supply and naphtha price

Key forecast factors		2005	2006	2007	2008e	2009e	2010e	2011e	2012e	2013e	2014e
Ural-crack refining margin	USD/bbl	5.3	6.0	5.0	5.0	4.5	4.0	3.8	4.0	4.5	4.5
European Brent price	USD/bbl	54.5	68.0	70.0	105.0	95.0	90.0	85.0	80.0	80.0	80.0
European Brent price	EUR/bbl	43.8	54.1	51.9	68.6	66.4	64.7	66.9	66.7	66.7	66.7
Complex petchem margins	EUR/ton	380.0	400.0	450.0	380.0	400.0	400.0	415.0	415.0	415.0	415.0
Ural-Brent differential	USD/bbl	4.1	3.0	2.5	2.5	2.0	2.0	1.5	1.5	1.5	1.5
HUF/USD average		199.7	204.8	183.8	163.4	175.0	181.8	180.8	184.0	187.5	183.3
PLN/USD average		3.23	3.10	2.77	2.29	2.36	2.39	2.34	2.36	2.42	2.42
HRK/USD average		5.95	5.83	5.36	4.84	5.19	5.49	5.56	5.78	6.03	6.03
RON/USD average			2.73	2.44	2.40	2.54	2.65	2.62	2.66	2.69	2.69
CZK/USD average		23.9	22.6	20.3	16.5	17.7	18.0	17.7	17.9	18.3	18.3
EUR/USD average		1.27	1.29	1.37	1.50	1.40	1.32	1.30	1.25	1.20	1.20

Source: Erste Group estimates & Bloomberg

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Oil & gas sector report

Company highlights

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Big potential upside lies in risky investments

Lotos

- **Profit could be driven by upgrade of Gdansk refinery and increase in production**
  - Long-term plans (refinery capacity increase and upstream growth) sound good, but are highly risky
  - Polish politics play crucial role - government may intervene at any time – diversification of crude oil supplies an issue
  - We increased our recommendation to Buy; while 12-month target price was lowered to PLN 36.0 per share
  - Top story at Lotos is company's 5-year development program, which focuses primarily on Lotos' main refinery asset in Gdansk (capacity increase by 80%!)
  - Lotos has postponed development of two fields in Baltic Sea that are estimated to have 16bn cubic meters of crude oil
- **Conclusion: We like Lotos' 5-year investment plan, as it should have a positive payback. But compared to the current size of the company, we think that company could have problem with financing.**

Oil & gas sector report

Company highlights

Current strong position in downstream, but lack of long-term growth drivers

MOL

- **Looking for growth opportunities**
  - MOL is eager to acquire more INA shares after IPO – we foresee growing chance that this action will take place this year or in 2009
  - Company is also looking for opportunities in upstream, particularly in Russia and former Soviet states, but the upstream production is rather decreasing
  - Improving Russian-Hungarian relationship helps MOL involvement in several oil and gas projects, including building of oil storage facilities in Hungary, extension of Blue Stream pipeline, etc.
  - We also increased our recommendation to Buy with new 12-month target price of HUF 22,500 per share
- **Conclusion: MOL is looking for new opportunities to maintain growth. At the moment, we do not see any major deals in the pipeline. INA would be the key deal to be signed, but this is still not enough for us.**

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Company highlights

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OMV – best-equipped to the current external environment

OMV

- **Looking at Turkey**
  - OMV's stock price was hit by the global sell-off mood, the unsuccessful attempt to takeover MOL and slow Petrom restructuring at the beginning of 2008, but strong upstream should offset that
  - OMV has the highest exposure to upstream with 70% stake at EBIT level, perfectly fit to the current macro environment
  - OMV is eyeing quickly growing Turkish market, which is among fastest growing countries in terms of fuel consumption (with 7% CAGR)
  - Restructuring of Romania's Petrom is going ahead, although no spectacular results are expected short-term
  - We have lowered our 12-month target price to EUR 55.0; while we maintain our Buy recommendation
- **Conclusion: Investors overreacted to the negative news in 1Q 08. We therefore have a Buy recommendation on the stock. The Turkish story could bring investors back to the stock, which could offer a new growth story.**

Oil & gas sector report

Company highlights

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Mazeiku is short-term driver

PKN Orlen

- **Mazeikiu deal may become driver**
    - After purchase of Lithuania's Mazeikiu Nafta the company again increased its downstream exposure
    - Mazeikiu deal was smart move strategically, but cut in Russian crude oil supply scared off investors
    - Unipetrol restructuring successfully implemented, but petchem margins hugely hit the profits
    - Polish politics continue to represent risk – fate of management depends on political changes in Poland
    - Due to the share price drop, we upgraded our recommendation from Hold to Buy and also slightly increased our 12-month target price to PLN 45.0 per share
- **Conclusion: PKN Orlen is facing a challenging time, the refining margin could go down. But we expect improvement from subsidiaries.**

Oil & gas sector report

Company highlights

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Petrochemical segment sent down the stock price

Unipetrol

- **Restructuring and solving corporate issues did not push profit up**
  - PKN Orlen restructured Unipetrol's business and streamline activities, which should push up earnings at Czech chemical holding
  - Unipetrol was divesting non-core subsidiaries, including PVC maker Spolana and specialty chemical producer Kaucuk; group focuses on retail, refining and mainly petrochemical businesses (from 70% at EBIT level)…
  - …and this is also the current biggest problem – environment was significantly affected by high crude oil price
  - Our valuation suggests that Unipetrol stock is attractively valued at current level; however, we significantly lowered our valuation to CZK 250 per share. Buy recommendation is maintained just on the back of significant drop in the share price.
- **Conclusion: Despite the attractive valuation, we would rather be cautious with buying Unipetrol, as we still expect negative newsflow in coming months.**

Oil & gas sector report

Company highlights

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Supported by MOL takeover bid at HRK 2,800

INA

- **Expensive, but upcoming privatization could be important**
  - INA is currently suffering from fuel and gas prices caps, but we expect both caps should be removed before the EU-entry
  - Potential growth drivers (upstream production increase of CAGR 10% in 2006-09, refinery upgrades at the Rijeka and Sisak plants and cost savings and improvement programs) are already priced in
  - Given the fact that MOL could become a strategic shareholder in INA, we would expect additional synergies from the merger to reach some USD 175mn per annum by 2014
  - Our valuation suggests that INA stock is still expensive to its peers at current level because of MOL‘s takeover bid support; we downgraded our recommendation from Accumulate to Reduce; our 12-month target price is HRK 2, 550 per share
- **Conclusion: INA is currently traded roughly 10%above our target price, however, the potential synergies between MOL and INA (of up to HRK 460/share) could justify share price level of HRK 3,000 per share.**

Oil & gas sector report

Company highlights

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Production costs diminish the potential profits in upstream

Petrom

- **Restructuring underway, but still not visible**
  - OMV, majority owner of Petrom, started to implement restructuring process, but quite high production costs still diminish profits from upstream
  - OMV decided to increase CAPEX in the company, but the improvement will not be visible this year
  - We decreased our 12-month target price to RON 0.57; while we increased our rating to Buy. This is, however, purely based on the recent drop in share prices due to global equity sell off.
- **Conclusion: Investors buying Petrom shares are mainly attracted to the huge potential for consolidation and efficiency improvement.**

Oil & gas sector report

Overall conclusions

- Given the global equity sell-off, most of CEE oil and gas companies are traded at very attractive valuations – the profitability remains stong
- OMV remains our top pick, with more than 70% exposure to the upstream segment
- As expected, MOL is enjoying current high diesel margins, although we do not see potential growth drivers for the future.
- Unipetrol‘s valuation significantly lowered on the back of very weak petrochemical environment. We decrease the target price from CZK 358 to CZK 250. Also Petrom‘s „Buy“ recommendation is weaker and mainly based on the recent share price drops.
- Consolidation of sector could continue, at least MOL will likely takeover INA

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Thank you for your attention!

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