

Rating: Buy
 S&P 500: 1227

Gazprom

The Ultimate Natural Gas Stock

<i>Symbol</i>	(OGZD) OGZPF	<i>Ebitda Next Twelve Months ending 9/30/06 (US\$m)</i>	14,900
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	0
<i>Price (US\$/sh)</i>	52.50	<i>Natural Gas and Oil Production/Ebitda (%)</i>	100
<i>Pricing Date</i>	9/14/05	<i>Adjusted Reserves/Production NTM</i>	22.0
<i>Shares (mm)</i>	2,043	<i>EV/Ebitda</i>	7.7
<i>Market Capitalization (US\$m)</i>	107,300	<i>PV/Ebitda</i>	12.8
<i>Debt (US\$m)</i>	6,500	<i>Undeveloped Reserves (%)</i>	71
<i>Enterprise Value (EV) (US\$m)</i>	113,800	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	4.51
<i>Present Value (PV) (US\$m)</i>	190,400	<i>Present Value Proven Reserves(US\$/boe)</i>	1.75
<i>Net Present Value (US\$/share)</i>	90	<i>Present Value Proven Reserves(US\$/mcf)</i>	0.29
<i>Debt/Present Value</i>	0.03	<i>Earnings Next Twelve Months (US\$/sh)</i>	3.46
<i>McDep Ratio - EV/PV</i>	0.60	<i>Price/Earnings Next Twelve Months</i>	15
<i>Dividend Yield (%/year)</i>	0.6	<i>Indicated Annual Dividend (US\$/sh)</i>	0.34

Note: Estimated cash flow and earnings are actual results reported for 2004.

The Russian government apparently intends to own 50% of the equity.

Summary and Recommendation

We initiate a buy recommendation of **Gazprom (OGZPF)**, the government-controlled company that produces about 90% of the natural gas in Russia, holder of some 27% of the world's reserves of the clean fuel. Long a major supplier to Europe, the company in recent days made its first delivery of natural gas to the U.S. The traditional major oil companies, discouraged from making oil investments in top producing countries, are likely to make large investments in natural gas instead. As the owner of the resource, Russia and Gazprom will get the best terms. At the same time, Russia is expected to encourage international investment in Gazprom shares by removing trading restrictions on domestic shares that currently are priced at a discount. We see 70% appreciation potential to nominally estimated present value of \$90 a share that is still just a fraction of the potential resource value. The availability of up-to-date financial information is limited and there is obvious political risk.

Invest Where the Resources Are

Part of the success of today's leading publicly-traded oil giants is that they have been willing to invest in almost any country. Political risk is controlled by not investing too much in any single political jurisdiction. In today's advanced capital markets investors have opportunities to apply the same strategy more directly. If it is a good idea for major oil companies to try to do deals with Gazprom, it may be a good idea for investors to buy Gazprom stock.

Russia Asserts Control and Invites Investment

After the conversion from state ownership to private ownership of Russian oil and gas resources there has been a swing back to more government control of the strategic industry. Whether that is good or bad depends on how those in charge act. We sense that President Putin realizes that an orderly development of Russia's oil and gas resources will maximize value on a long-term basis.

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Simply put, Russia does not have enough oil resources to export much greater volumes. The country ranks seventh in the world in oil (see table Global Leaders in Natural Gas and Oil Reserves, 2004). Higher oil exports today would simply borrow from Russia's future tomorrow.

Global Leaders in Natural Gas and Oil Reserves, 2004
 (billion barrels oil equivalent)

	Natural Gas		Oil		Total	
	Rank	Reserves	Rank	Reserves	Rank	Reserves
Russian Federation	1	282	7	72	1	355
Saudi Arabia	4	40	1	263	2	302
Iran	2	162	2	132	3	294
Qatar	3	152		15	4	167
Iraq	10	19	3	115	5	134
United Arab Emirates	5	36	5	98	6	133
Kuwait		9	4	99	7	108
Venezuela	9	25	6	77	8	102
Nigeria	7	29	10	35	9	65
USA	6	31		29	10	60
Kazakhstan		18	8	40	11	57
Libya		9	9	39	12	48
Algeria	8	27		12	13	39
China		13		17	14	30
Canada		9		17	15	26
Norway		14		10	16	24
Australia		14		4	17	19
Turkmenistan		17		1	18	18
Mexico		2		15	19	17
Azerbaijan		8		7	20	15
Total 20 Countries		916		1097		2013
World		1056		1189		2245

Source: BP Statistical Review of World Energy

In contrast, Russia is number one in the world in natural gas reserves. Moreover, the country's natural gas reserves are largely undeveloped with a reserve/production ratio of 67 years. Further, natural gas transportation is more highly capital intensive than oil transportation. There is a strong long-term world market for Russian natural gas. It makes sense for Russia to promote investment in natural gas for export and domestic consumption.

Russia can attract capital for natural gas in two promising ways. First, Gazprom can offer investment opportunities for partners. Second, Gazprom can tap the capital markets directly. Both approaches appear to be proceeding.

The best advantage Gazprom can have is a high stock price. That would convey credibility for the company in Russia and around the world. Indeed the stock has started to move apparently in anticipation of a broader market for shares with more financial disclosure and managerial focus. That may take time and there are likely to be ups and downs.

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Rich in Resources

Gazprom recently passed the \$100 billion market cap measure according to Bloomberg. Large as that may seem, it is still small considering the company's resources. The company quotes the respected U.S. engineering firm, DeGolyer and MacNaughton, as an auditor of most of the analysis that places Proven and Probable reserves at 653 trillion cubic feet (see table Natural Gas Reserves). Considering production of 19 trillion cubic feet in 2004, the proven part of the D&M estimate might be some 15 times, or about 300 trillion cubic feet. Gazprom's natural gas resource may have present value in a free market of a trillion dollars.

Gazprom Natural Gas Reserves

	<i>Reserves</i> <i>(tcf)</i>	<i>Production</i> <i>(tcf)</i>	<i>R/P</i>
World	6,337	95.0	67
Russia	1,694	20.8	81
Gazprom (A+B+C1)	1,020	19.2	53
Gazprom (Proven and Probable)	653		34

Financial Information Dated

Financial results in a standard format are available for last year, 2004, on the company's website www.gazprom.com. The company is also frequently covered in the financial media. On the basis of those sources we do a rudimentary analysis in our regular format (see table Operating and Financial Results). A brief press release also discloses some measures of first half 2005 results.

Though the company reports income by segment including natural gas transportation we have allocated all cash flow and earnings to natural gas production. If we understand the statements correctly and make an appropriate currency conversion, it looks like the company's total revenue was a low \$1.83 an mcf last year when the hub price of natural gas in Louisiana by comparison was more than three times that at \$6.15. Gazprom delivers large volumes thousands of miles to Western Europe, primarily Germany, where pricing is more competitive. At the same time it sells natural gas especially cheap in Russia where it heats most homes, factories and office buildings as well as generates half of the electricity. The company explains patiently on its website that artificially low price is not a good thing for Russia.

Oil production last year was primarily associated with natural gas. That appears to be changing as the company pursues oil acquisitions in 2005. Among other news stories, Gazprom, as an instrument of the Russian government, apparently acquired a prominent Moscow media company. Those are examples of how the investment outlook may be complicated.

The company controls more natural gas resources than any other publicly-traded entity on the planet. The stock price reflects only a fraction of the potential economic value. We believe it is the interest of Russia to encourage a higher price for "the ultimate natural gas stock".

Kurt H. Wulff, CFA

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Gazprom
Operating and Financial Results

	<i>Year</i> <i>2004</i>
Volume	
Natural gas (bcf)	19,242
Natural Gas (mmcf)	52,718
Oil (mmb)	84
Oil (mbd)	230
Total gas & oil (bcf)	19,746
Total gas & oil (mbd)	9,016
Price	
Henry Hub (\$/mmbtu)	6.15
WTI Cushing (\$/bbl)	41.44
Natural gas and oil (\$/mcf)	1.83
Natural gas and oil (RUB/mc)	51.18
Revenue (RUB billion)	1,011
Expense	589
Ebitda	422
Deprec., Deplet., & Amort.	111
Ebit	311
Interest	27
Ebt	284
Income Tax	83
Net Income (RUB billion)	201
Shares (millions)	2,043
Per share (RUB)	98.20
Ebitda Margin (E&P)	42%
Tax Rate	29%

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