European Markets

Lukoil Strives to Restore Confidence --- Use of U.S. Accounting Principles Expected to Please Investors --- Analysts Say Russian Oil Producer Still Could Improve on Candidness

By Andrea Chipman
Dow Jones Newswires
1,243 words
15 January 2001
The Wall Street Journal Europe
12
English

MOSCOW -- After spending much of the second half of last year as a corporate outcast, OAO Lukoil is trying to get back into the good graces of equity investors.

Russia's largest oil producer gave markets an early holiday gift the Friday before Christmas when it released the first of its long-awaited financial results under U.S. generally accepted accounting practices, or GAAP. And it has promised more GAAP results covering 1998-1999 by the end of January. While the moves have made Lukoil more transparent, analysts say more needs to be done.

"Releasing accounts in a format which allows us to compare apples with apples is very good," said David Herne, a portfolio manager with Brunswick Capital Management in Moscow, who said his firm had a significant stake in Lukoil. At the same time, he said the ownership structure of some of the company's subsidiaries needs to be clarified.

With corporate governance a sensitive issue in Russia, Lukoil's failure to publish its GAAP results in October, as expected, took a heavy toll on the reputation of a company generally considered one of the most investor-oriented in Russia.

As managers stalled, fears about what the Lukoil numbers might be hiding sparked the implosion of the company's share price, despite record oil prices. Lukoil stock slid from a high of about $17 (17.85 euros) on March 27 to a low of $7.90 on Dec. 21. On Friday, Lukoil lost 10 U.S. cents, closing at $10.70 on the Russian Trading System.

The company's shares remain undervalued but should continue to improve now that the company has provided a universally recognized measure for assessing its results, said Steve Allen, oil and gas analyst at Renaissance Capital in Moscow.

"GAAP accounting gives some certainty that when you buy a share of Lukoil you are getting most of the cash flow of all of the subsidiaries," Mr. Allen said.

Standard Russian accounting makes it difficult to clearly measure Lukoil's minority holdings, he added.

Analysts clearly liked the results, which showed an exponential jump in Lukoil's net profit to $1.45 billion in the first half of 2000 from $92 million a year earlier.

The results also led Renaissance to raise its rating on the company to buy from hold, and to increase its target price for Lukoil shares to $27.50 from $18. Other Moscow banks have followed suit.

"They've always told a pretty good story and one that investors believed," Mr. Allen said. "But the fact that they delayed publishing GAAP standards put them in the doghouse and this gets them out."

Indeed, the timing of Lukoil's first GAAP release hardly was coincidental, coming on the same day as an official announcement of plans for its Level-3 American depositary receipt issue, which is expected by the end of 2001.

The share issue, which will involve the privatization of a 6% government share in the company, makes Lukoil the first Russian oil company to submit to such scrutiny. The company produced 75.6 million tons of oil in 1999, just under a quarter of Russia's total crude output.

Lukoil trades at a premium to its Russian peers, with a price-to-earnings ratio forecast for 2000 of 2.5, compared with 2.3 for its next closest rival, Surgutneftegaz, according to a report by Moscow investment bank United Financial Group. Still, the report notes that Surgut -- which lacks GAAP financials -- and other Russian oil producers remain subject to higher corporate-governance risk.

Meanwhile, the ratio of Lukoil's enterprise value over production -- the company's market capitalization plus net debt -- in dollars per barrel of oil equivalent is $21.72, compared with $209.72 for ExxonMobil and $144.78 for BP Amoco PLC. With 2 billion tons of proven reserves -- the fourth-largest of any private oil company in the world -- Russian country risk remains Lukoil's main disadvantage in comparison with its non-Russian rivals.

Lukoil managers win overall praise from analysts and investors alike. Lukoil President Vagit Alekperov was even named manager of the year by a corporate-governance watchdog group comprising 23 of Russia's top portfolio investors.

But most are hoping Lukoil's new candidness will extend to other areas of the company's dealings that remain murky, including the autumn 1999 sale of a 9% stake in the company to Reforma Investment Ltd., a little-known offshore entity that some suspect is linked to Lukoil management. Equally unclear are elements of the company's corporate strategy.

"Management is quite strong, but there are some ambitious plans that aren't predictable or understandable to investors," said Konstantin Reznikov, senior oil and gas analyst at Alfa Bank in Moscow, which also recently raised its rating on Lukoil to buy from hold.

One strategy that was less than comprehensible to investors was Lukoil's $71 million acquisition last month of U.S. Getty Petroleum Marketing Inc.'s 1,300 gas-station network.

Although Lukoil initially will supply its Getty stations through swaps with other major international companies, it hopes within the next few years to ship crude from its oil fields in the northern Timan-Pechora region to the U.S. for refining and sale, Lukoil Vice President Leonid Fedun said in December.

"If we can begin operations using our own oil, then the (Getty) transaction will pay for itself in 2 to 3 years," Mr. Fedun said. At current prices, he added, exports of oil to the U.S. market could increase the Getty unit's profit by sixfold.

Oil tankers have already begun transporting small shipments of crude from Lukoil's new Russian sea terminal at Varandei Bay, north of Timan-Pechora.

The company is "actively looking at" possible U.S. refinery acquisitions for Getty, said Todd Gremillion, a Houston-based partner with Akin, Gump, Strauss, Hauer & Feld LLP, Lukoil's U.S. law firm. The timing of such a purchase, he said, is likely to "match the oil coming out of Timan-Pechora."

Others are more skeptical.

"It doesn't seem realistic to me," said Mr. Allen at Renaissance Capital. Although the U.S. is the world's biggest market of energy consumers, he said, "it's also the world's most competitive market and one of the world's regulated markets. It will be hard for them to make money off of that."

Mr. Herne of Brunswick Capital Management also said he was perplexed by Lukoil's plunge into an unfamiliar retail market at a time when it could profit elsewhere from the liquid market for crude oil.

Market participants said they will be watching closely for more details about Lukoil's plans for Getty as a sign of the company's commitment to corporate governance.

Still, few deny the potential of Lukoil's Timan-Pechora reserves, which are expected to produce up to 27 million metric tons of oil annually by 2007. Added to Lukoil's 500 million tons of potential reserves in the Northern Caspian, the assets make the company a formidable international contender.

"It's fair to say that if you look at Lukoil as a Russian company with huge reserves, you'd be misunderstanding it," Mr. Gremillion said.

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