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DAVY RESEARCH

Bloomberg: DAVY<GO> www.davy.ie

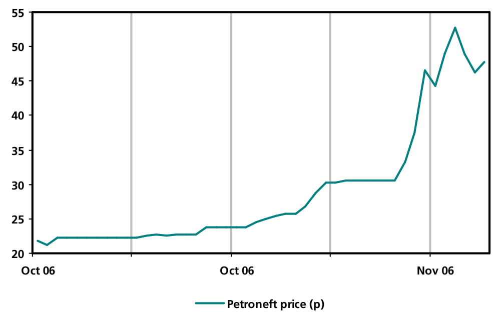
Institutional Equity Sales: +353 1 6792816

Job Langbroek
job.langbroek@davy.ie +353 1 6148914

Caren Crowley
caren.crowley@davy.ie +353 1 6148923

James McCullough
james.mccullough@davy.ie +353 1 6148921

Share Price Performance



Company data	
Reuters/Bloomberg/Xetra	PTR.L/PTR LN/P8ET
Sector	Resource
Shares (m)	176.6
Daily No. Shares Traded (m)	0.221
Free Float (%)	60
52 Week High/Low	52.75/21.25
Capital Structure	
Mkt. Cap (£m)	84.3
Net Debt/(Cash) (£m)	8
Deferred Consideration	N/A
Pref Shares/Non Eq Min	N/A
Equity Minorities	N/A
E.V. (£m)	78

Recent research and research resources

Recent research and financial data on [Petroneft]

Sector research and data on [Resource]

Equity Report: Company update

Petroneft Resources

Price: **48p**

A new opportunity to invest in a very good blend of Russian oil reserves and experienced management

The licence contains existing oil reserves and significant potential for more

- Former drilling campaigns in Licence 61 in the Tomsk region of Western Siberia established the presence of 33.5m barrels of 2P oil reserves.
- A development plan for these reserves will be finalised after completion of three new wells.
- Significant value leverage exists, with a further 100m barrels of relatively low risk oil targeted in the near term.

Management has much experience in Russia and industry

- Senior management members are veterans of Marathon Oil's Russian oil and gas business, including the first Sakhalin Island project and several major corporate actions in Russia.
- The management is also a substantial investor in Petroneft.

Valuation is now very much up with events but January drilling will again focus investor attention on upside

- Reflecting the tight capital base and anticipation of drilling activity, recent price gains mean that Petroneft is now valued (EV of $4.6/bl) well ahead of its nearest peer (EV $2.6/bl).
- However, the first of a three-well campaign is due to start in January. This includes a target that, if successful, would push the valuation significantly ahead of where it is today, even if we apply the lower EV rating of its peers.

Petroneft Resources – an opportunity seized

Petroneft Resources is a new E & P company with a significant Russian oil investment opportunity. This came about in early 2005 when Licence 61, which had been recently auctioned by the relevant authorities in the Tomsk Oblast, was introduced to senior management. The intrinsic value of the licence, which included proven and probable reserves and with a clear chain of ownership, was quickly recognised and the opportunity was secured.

In 2005 and the early part of this year, old seismic and drilling data were reprocessed, new seismic was acquired and a drilling and development programme was put in place. During this time, this activity and the business in general were financed through $14.6m of private equity funding.

Petroneft was floated on AIM and the IEX in September at a pre-cash market capitalisation of $50m. At the same time, $16m of new equity was raised. Since then the share price has grown steadily in value, reflecting a tight capital base and the approach of the first drilling season.

The main driving force behind Petroneft is CEO Dennis Francis. He was formerly head of business development for Marathon Oil in Russia and managed its involvement in the Sakhalin II project. Dr. David Sanders, formally lead negotiator for Russian projects in Marathon's business development group, is the company's Vice President and General Councel. The Board also includes David Golder as Chairman. Golder was formerly a Senior Vice President of Marathon. Collectively, they have over 40 years' experience in the Russian oil and gas business.

Other directors include Tom Hickey, Chief Financial Officer with Tullow Oil, and Des Burke, who has been involved with a number of quoted resource stocks in the past. Russian director Vakha Sobraliev, who has a near-15.0% stake in the company, is also General Director of Tomskburneftegaz, one of the largest drilling companies in the Tomsk region, and has access to drilling rigs and related services.

Petroneft operations are managed out of Tomsk by senior Russian management members who were formerly involved with various natural resource state agencies.

Licence 61 - a relatively simple oil play

The company's primary asset is a 100% equity position in Licence 61, which is located on the eastern side of the Ob river in the Tomsk Oblast in Western Siberia, a very prolific oil and gas basin. Historically, activity was focussed in the western and northern regions of the basin resulting in the discovery and development of several world-class fields.

However, as the overall basin play matured, oil and gas exploration and development shifted to second and third order targets and prospects.
Licence 61 in particular contains two oil fields that were discovered by early seismic and exploration drilling in the block. However, this work did not lead to a development as the focus was still on much larger scale oil accumulations.

Nonetheless, these targets still represent substantial amounts of oil, especially in the context of smaller companies and when higher oil prices are taken into account.

Since Petroneft acquired the block, further seismic has been completed and a modern drilling programme will shortly commence.

Both fields contain low risk reserves with excellent potential for further additions

There are two established oil accumulations on the block, the Tungolskoye Field and the Lineynoye Field. Taken together, these two fields have 2P reserves of 33.5m barrels. These reserves have been audited by Ryder Scott and are based on discovery wells drilled by the local government organisations in the 1970s.

Table 1: Licence 61 reserve inventory (barrels million)

	P1	*P2*	*P3*	*P4*	*Total P1 and P2*
Tungolskoye Field	2.7	15.6			17.9
Tungolskoye +10% recovery			7.4		
Tungolskoye West Lobe			23.1		
Lineynoye Field	2.2	13.4			15.6
Lineynoye + 10%			6.6		
West Lineynoye target			66.6		
Existing fields inventory	**4.9**	**28.7**	**103.7**		**33.6**
Other structures confirmed by seismic data			187.0		
Prospects and leads (P4)				99.9	
Total Licence 61 inventory	4.9	28.7	290.7	99.9	33.6
Cumulative		33.6	324.3	424.2	

Source: Ryder Scott report

Table 1 summarises the reserve position in the group. The important point to note is that while the 2P reserve figure does include water flooding, it represents only about 25% of the oil originally in place.

- **Licence 80, operated by Imperial Energy, is located immediately to the East of Licence 61. Two early wells on Licence 80 established the presence of the Kiev-Eganskoye field located just next to the eastern boundary of Licence 61. Recently, DeGoyler and MacNaughton estimated substantial P3 reserves and resources for this field. These are at the same geological horizon as those present in Licence 61. Petroneft's two fields are located to the north and central part of Licence 61, and most of the prospect inventory is located in the western part of the licence. The Imperial estimate may suggest that heretofore unknown prospectivity exists in the eastern part of Licence 61.**

The following comments are relevant:

- These recovery rates are conservative but are believed to be appropriate at this stage of the project.
- However, in general, similar type fields in the West Siberian basin will recover over 35% (with water flooding).
- Based on efficient water flooding, infill drilling, future technology, oil price increases, etc. an extra 10% recovery should also be possible in the case of the Tungolskoye and Lineynoye fields.

Ryder Scott ascribes this additional 10% recovery to P3 reserves of 14m barrels (7.4m and 6.6m barrels) associated with the two fields. Even though we view these as fairly low risk P3 reserves, they still represent a 40% increase on the 2P reserve estimate.

In addition to this, a further 90m barrels of reserves, or three times the existing amount, is believed to be present in structural highs close to the two oil fields (West Lineynoye Target and Tungolskoye West Lobe).

Significant upside is also present in several other ways

- The existing fields should be more productive than the discovery flow rates suggest. This is due to:
  - more modern drilling practices and completions;
  - improved structural positioning of the well locations, resulting in more oil filled reservoir sand to be accessed by the well.

- Improved structural interpretation following reprocessing of old seismic and new seismic acquisition.
  A good example is the West Lineynoye Prospect with 66m barrels of estimated P3 reserves. However, an oil water contact is present and the structure is mapped on new seismic. Consequently, risk has been decreased significantly. In fact, Ryder Scott attributes an 83% chance of success to this target. This target will be the third well drilled in the upcoming drilling programme.

- Additional targets in Licence 61.
  Up to now, the search for oil has been focused on the Upper Jurassic Bazhenov oil system. However, a second oil system, which is lower in the geological column, has been shown to be present in Licence 59 immediately to the west. This may also be present in block 61.

If we take the above into account, an additional 104m barrels of oil can be identified. While these reserves are classified as P3, they are arguably much lower risk than would normally be associated with P3 reserves.

Table 2: Development metrics

Capital costs per barrel	$4.9
Peak output b/d	15,400
Decline rate	
Year 1	60%
Year 2	30%
Recovery rate	25%
Operating cost per barrel	$4.4
Pipeline tariff	
Domestic sales	65%
Export per barrel	$3.3
Domestic per barrel	$0.6

Source: Ryder Scott report

Fiscal terms
The Russian fiscal regime consists of a mineral extraction tax (NPRT), a profits tax at 24%, a property tax and VAT at 18%.
Furthermore, an export tariff applies to exported oil.

Under the base case Ryder Scott model for the development of the 2P 33.5m barrels, the total tax take is 52% of revenue.

- **The Lineynoye No. 6 well will start in January**
- **A second rig will then be employed which will start the Tungolskoye No. 4 well in early February**
- **A well on the West Lineynoye prospect will start in early March**

Development plan

Even though the licence has been in the hands of Petroneft management for a relatively short space of time, a development plan has already been instigated.

The results of the drilling programme on both existing fields will do two things.

- They will confirm the results from the former drilling activity on the licence.
- They will also provide modern data to assess the reservoir flow rates and characteristics. Such data will be required for any debt package associated with the project financing.

The capital cost to develop the 2P reserves in Lineynoye and Tungolskoye is currently estimated at $154m. This assumes a pipeline option crossing the Ob River to the south. The ultimate debt and equity financing structure to provide this capital still has to be resolved. However, the development plan is based on the development of the 33.5m barrels of 2P reserves only. This means that any additional reserves added to the project will have a very low incremental cost.

It is also important to note that the above project becomes self funding and that the cumulative negative cash flow is only about $75m. Overall, project timing is tight, with significant expenditures expected to begin in late 2007 and 2008.

At present there is sufficient funding in place to drill three wells, acquire an additional 500km of seismic data and complete the feasibility study. However, while management is investigating potential debt funding options, further equity issues are likely as the project moves towards development.

Schedule

The Lineynoye No. 6, the first well in the group's Siberian operations, is scheduled to start in early January 2006 and should be completed by March.

This will be followed by the Tungolskoye No. 4 well in early February. These are both appraisal wells. The first proper exploration well on the West Lineynoye Prospect will utilise the same drilling rig as the Lineynoye No. 6 well and will commence following a rig move in March. While road transport will begin to be an issue as the weather improves, once the rig is on site the programme can continue without difficulty into the summer months.

- **The drilling of the third well is a very important event for Petroneft. This well will target a structure containing an estimated 66m barrels. Normally, such a P3 estimate is based solely on seismic but in this case an oil and water contact has already been established. This should reduce the risk for investors and could explain in part the recent very strong price gains.**

The result of this exploration well will have an important role in understanding the upside in the licence and the capital required to develop the oil and gas endowment on the block. However, even if only the 33.5m barrels are developed, the return is sufficient to justify the development as envisaged.

Timing for this development plan is very tight and envisages a feasibility study being completed by the middle of 2007. By inference, this assumes that the two appraisal wells and the 66m barrel West Lineynoye prospect are completed on schedule because information from these wells will have to be included in the design and permitting process.

First oil from the project under this timetable is envisaged by the end of 2008.

Valuation

- **There are two ways to look at a valuation of Petroneft. One is through a discounted cash-flow model and the other is by way of peer comparison.**

The competent person report for the recent IPO was prepared by Ryder Scott. This stated that the NPV generated from the baseline working model for the development of the 33.5m barrels of proven and probable reserves in Licence 61 was $107m. This is equivalent to $3.3 per barrel. The baseline study assumes that export oil is sold at $53 per barrel and domestic oil is sold at $29 per barrel.

The current market capitalisation is ahead of this baseline valuation. This suggests that the market is either:

– discounting a higher oil price or
– assuming more than 33.5m barrels will be developed.

We suspect the latter.

We can also compare Petroneft to its peers as outlined in Table 3.

The current most appropriate valuation comparison is with Imperial Energy, which amongst others in the Tomsk region, holds Licence 80 immediately to the east of Licence 61. The recent strong price performance means that the EV/barrel is comfortably ahead of Imperial Energy.

The obvious assumption is that the market has begun to discount some of the P3 reserves into the P2 category. While there is comfort in the fact that there are considerable low risk P3 reserves in the Petroneft inventory, as in the case of the recovery factor for the two existing fields, such a conversion cannot be properly assumed until the appraisal wells are drilled and/or the field is in production.

The table also shows that EV per barrel is higher when production is achieved as in the case of West Siberian Resources and Urals Energy. This obviously reflects the fact that capital costs per barrel are sunk and included in the value. However, the effect of gearing and reduced execution risk should also mean that equity has a greater value when reserves are developed and oil is flowing.

- **The table shows how the recent price rise in Petroneft has increased the EV per barrel rating. It also shows how existing production will result in a higher EV per barrel multiple. Western Siberian Resources currently has production of close to 25,000 barrels per day and also has the highest EV per barrel number.**

Table 3: Peer group valuation metrics

	Enterprise value ($m)	*Reserves 2P*	*Enterprise value ($/2P) reserves*
Urals Energy	845	226	3.74
Imperial Energy	652	250	2.61
Western Siberian resources	14547	279.2	5.18
Dragon oil	1036	323	3.21
Aurelian Oil & gas	44	0	0.00
Petroneft	153	33.5	4.6

Source: Davy

Summarising the investment case for Petroneft

- **Ryder Scott estimates that the West Lineynoye well has an 83% chance of success**

- A near-term drilling campaign has a very high probability of converting P3 reserves to P2 reserve status. This will result in a higher nominal valuation on a simple EV/barrel calculation.
  - If the West Lineynoye well is successful, it will add 66m barrels, twice the current 2P inventory, with obvious implications for value gains.
  - An additional 37m barrels of low risk P3 reserves are also easily identifiable.
- Once in production, the value of equity should increase to reflect gearing and reduced execution risk

Due to the surge in the share price in recent weeks, Petroneft is currently ahead of its nearest peer comparison and the IPO baseline NPV calculation. We believe that this reflects the low-risk nature of the first P3 reserves that will be drilled.

- **Note that even if we use the EV per barrel metric inferred by the nearest peer company, the West Lineynoye target size would, if successful, push the valuation significantly ahead of where it is today**

Table 3: Enterprise value matrix using current EV and peer EV

Reserve status (cumulative effect)	*Million barrels of reserves added*	*EV based on current market capitalisation if reserves added*	*EV based on peer market value if reserves added*
Current 2P	33.5	$153m	$87m
+ West Lineynoye prospect	66.6	$458m	$260m
+ Tungolskoye West lobe	23	$561m	$320m
+ Increase in recovery	14	$625m	$356m

Source: Davy

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Davy, Research Department, Davy House, 49 Dawson St., Dublin 2, Ireland.