Petroneft

Buy

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Coverage Initiation

Analyst: Brian Gallagher

Previous Close: 54p   Price Target: 118p

Tuesday 19th April 2011

Investment Case

We are initiating coverage of Petroneft with a Buy recommendation and a price target of 118p per share. We feel the Siberian based E&P company is significantly undervalued versus our NAV valuation and that the recent miss in production guidance is distorting the market's evaluation of the company. Petroneft commands a 96 million barrel 2P reserve base and is utilising it to develop a steep production profile that will leave the company highly cash generative by 2014. We also believe that there is scope for the company's existing reserve base to be materially increased this year with Petroneft drilling 5 wells that will target 152 million barrels of oil equivalent (mmboe) on a gross basis

Steep Production Profile

One of the primary reasons why we believe Petroneft represents value is the fact that it is backed by a steep production profile that will provide a platform off which to fund its existing operations and facilitate expansion. In the next three years the company will drill approximately 60+ new production wells that are designed to raise production from 3,000 barrels of oil per day (bopd) to over 12,000 bopd. This will dramatically increase cash-flow, move the company away from its current debt/equity funding position and allow Petroneft to look at new opportunities within Siberia. We also feel that the year end guidance miss has deflected the market's attention from Petroneft's long term prospects creating a good entry level.

Exploration Upside

Petroneft is in a strong position to deliver a material reserve uplift this year as it drills 5 new wells targeting over 152mmboe (gross). 3 of these wells are located in close proximity to existing production facilities that will allow economic and speedy commercialisation. Furthermore, the wells will test pay horizons that have already proved prospective. Petroneft spuds the first of five wells in the coming days with continuous exploration/appraisal activity scheduled from now until November.

Valuation

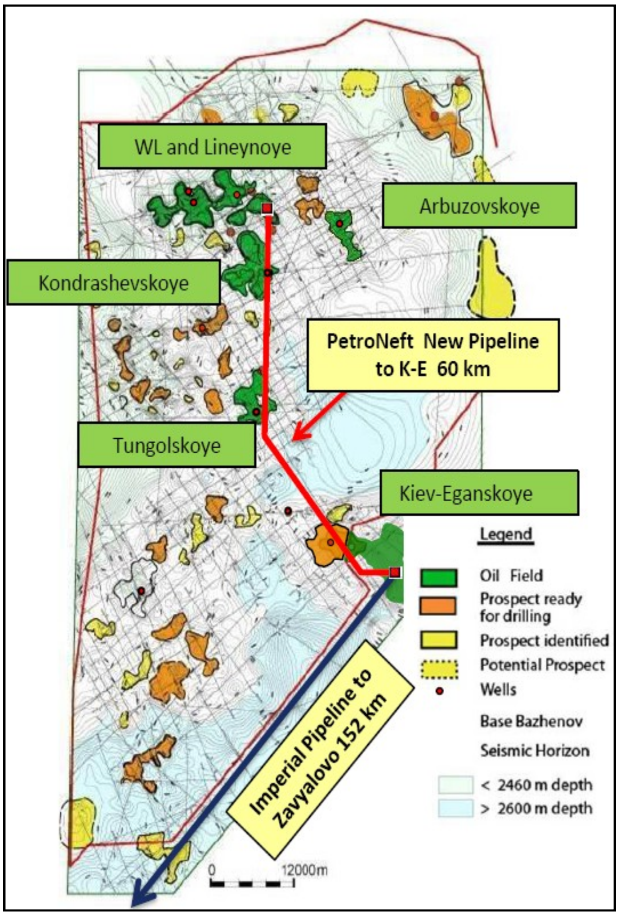
Based off a long run oil price of $100 a barrel (Brent) we value Petroneft on a risked basis at 118p per share. This valuation equates to approximately 120% of upside from current levels and clearly demonstrates the stock's potential. Using a discounted cashflow analysis we value existing reserves at $571mln. We also attribute $286mln of value to Petroneft's exploration portfolio. We have discounted at a rate of 12.5% which we believe is consistent with Siberia and relative to more geopolitically stable regions such as Western Europe where we would utilise a discount factor of 10%. There is also the added possibility of a NAV uplift from new Russian legislation that would create tax incentives for small oil fields. As the legislation is yet to be passed we have not integrated a value into our NAV however a successful passing into law in its proposed form would add circa 21p to our current valuation.

Maket Data	
Market Cap	£224.63mln
Shares Outstanding	415.98mln
52 Week High	73.5
52 Week Low	28.5

Largest Shareholders	
JPMorgan	12.02%
Macquarie Bank	6.16%
Sobraliev Ali	5.53%
Dennis Francis	5.43%
Bluegold	4.84%

Source: Bloomberg

Fig 1.1 Licence 61



Source: Company Website

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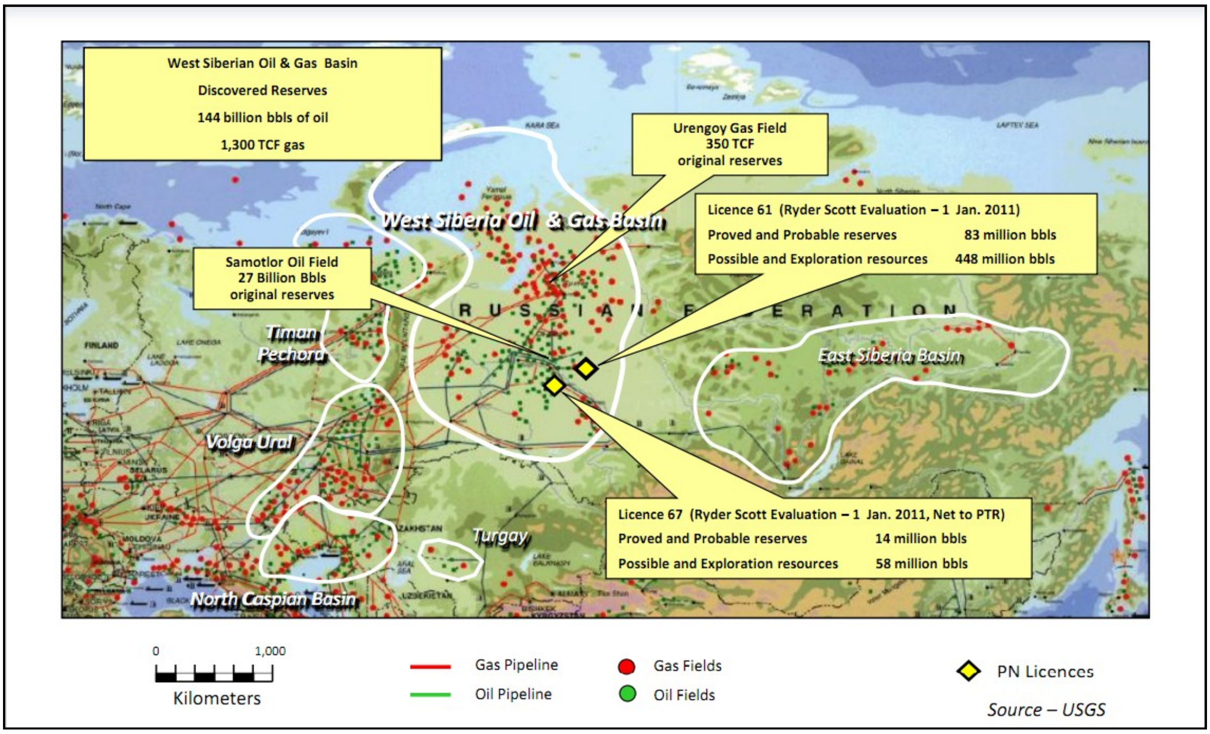
Asset Overview

Petroneft Resources in its current form was established in 2005. It owns and operates interests in two licenses that cover 7,438sqkm in Western Siberia. The strategy of the company is to develop small producing fields that were passed over in the 70s by Soviet engineers who at the time viewed the fields as too small for development. Today the economics of these fields have dramatically improved as global oil demand has risen and new technology has emerged. As a result, Petroneft's interests carry relatively low exploration risk meaning that it can add value through the delivery of incremental reserves & well efficiency. It does not target rank wildcat objectives and to date has only operated licences that have shown prior proof of hydrocarbons.

Both of Petroneft's Russian licences (61 and 67) are located in one of the world's best established petroleum basins. The West Siberian Oil & Gas Basin contains over 144 billion barrels of oil and 1300 trillion cubic feet of gas. It also includes two of the world's largest oil and gas discoveries. The Samotlor oil field is estimated to contain over 27 billion barrels of oil and the Urengoy gas field is believed to hold 350 trillion cubic feet of gas. The northern part of the basin is more gas prone while the southern part is more oil prone. Petroneft's licences are located to the south east and the basin includes the necessary infrastructure required for international exports.

Fig 2.1 West Siberian Oil Basin



Source: Company Website

Licence 61

Licence 61 is Petroneft's primary asset and accounts for the majority of our NAV. The company is the operator on this licence with a 100% interest which is not expected to be reduced. Licence 61 was acquired through the acquisition of Stimul-T in 2005 who previously acquired it through an auction process in November 2004.

Like Licence 67, Licence 61 is located in the Tomsk Oblast in Western Siberia. The licence covers a 4,991sqkm area and contains 4 oil fields; Lineynoye/West Lineynoye, Tungolskoye, Kondrashevskoye and Arbuzovskoye. These fields hold light oil with an API level of approximately 44. Tight reservoirs are characteristic of this region and can create challenging recovery conditions. The area's operating environment also provides challenges as severe cold weather in winter and swamp like conditions in summer makes the transportation of equipment difficult. As a consequence, heavy machinery must be moved during the winter months when the ground is hard leaving Petroneft little margin for error with regards logistical scheduling.

In 2010 Petroneft completed a 60km pipeline that connected Licence 61 to an adjacent field allowing the sale of oil into the local market last August. This pipeline facilitates the sale of crude into international markets. 2010 also saw Petroneft drill 9 wells and one water source well while also completing the construction of processing and storage facilities. Current production from this licence is 3,000 barrels per day (bopd).

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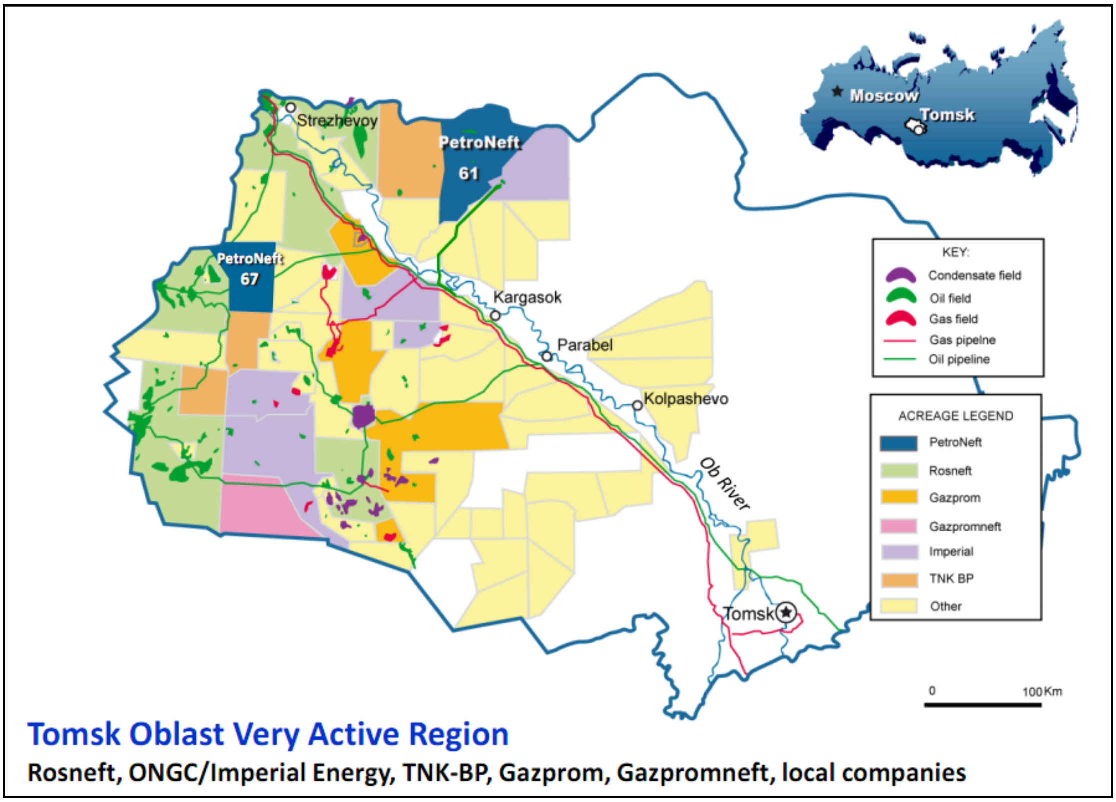
Licence 67

As can be seen from figure 3.1, Licence 67 is located on the Western side of the river Ob. Petroneft holds a 50% interest in this licence and is the operator. Arawak Energy who holds a 3.8% equity stake in Petroneft, owns the remaining 50% of Licence 67. The 2,447sqkm licence was acquired at state auction in December 2009 for $1.39mln. Like licence 61, this acreage experiences the same severe weather and reservoir conditions however unlike licence 61, it is less remote and will require lower infrastructural build to get oil to market. Currently there are two pipelines running through the acreage and the licence can also be accessed by an all weather road.

Fig 3.1 Tomsk Oblast Region



Source: Company Website

<u>Reserve Estimates</u>

On the 10th of March the results of a Competent Persons Report completed by Ryder Scott examining Petroneft's reserves at year end 2010 was released to the market. On a gross basis the report stated that Licence 61 (Operator 100% Interest) holds 11.8mmboe 1P reserves, 82.9mmboe 2P reserves and 120.0mmboe 3P reserves. Also on a gross basis, Licence 67 (Operator 50% Interest) holds 1.5mmboe 1P reserves, 14mmboe 2P reserves and 17.4mmboe 3P reserves. The report illustrates that Petroneft already has material reserves and that it has been successful in delivering reserve growth in 2010. A similar review of the Petroneft reserves was completed in 2009 and since then Petroneft has added 25.99mmboe of 2P reserves. We anticipate Petroneft's 2P figure to grow again this year as outlined later in the note.

Fig 3.2 Ryder Scott Resources Estimates

	1P (MMBOE)	2P (MMBOE)	3P (MMBOE)
Lineynoye L61	5.154	22.735	28.472
West Lineynoye L61	2.713	23.32	29.224
Kondrashevskoye L61	0.611	8.122	26.129
Tungolskoye L61	1.381	15.483	19.628
Arbuzovskoye L61	1.953	13.244	16.555
Ledovoye L67	1.538	14.024	17.418
Total	13.35	96.928	137.426

Source: Ryder Scott

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Steep Production Profile

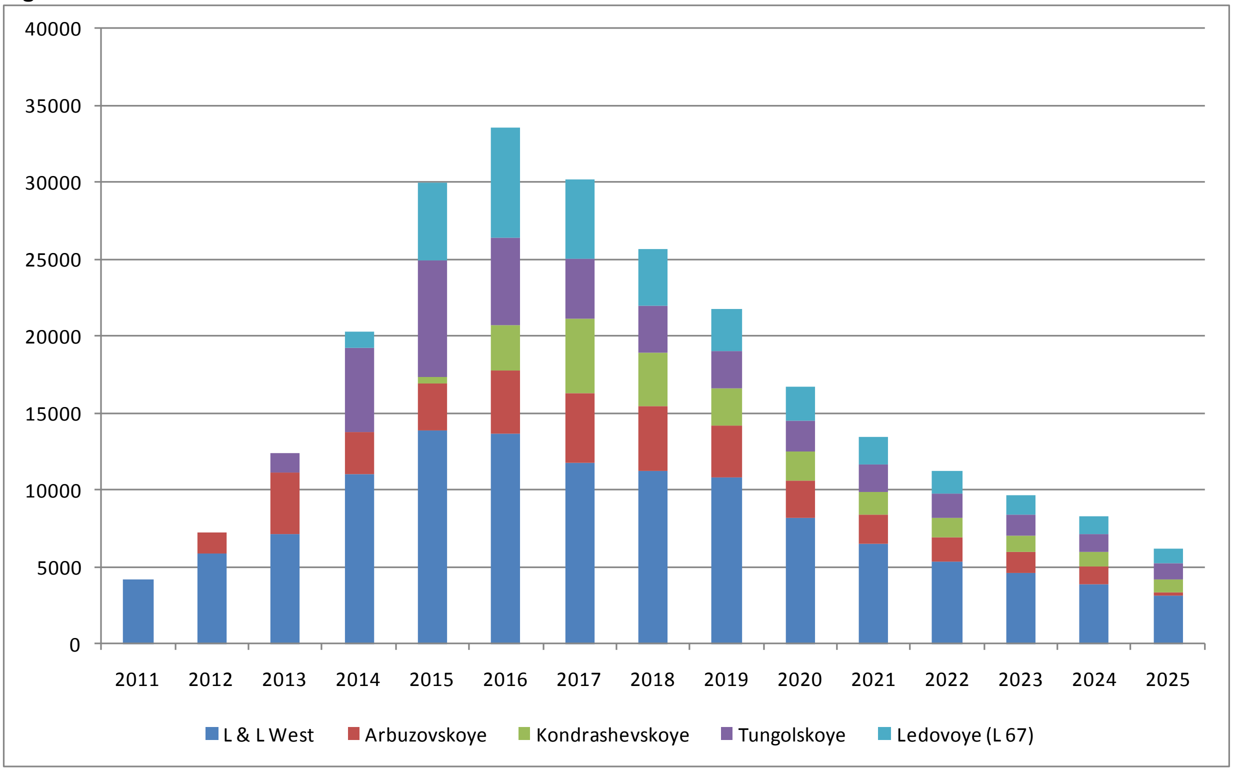
One of the primary reasons why we believe Petroneft represents value is the fact that it is backed by a production base that will provide a workable platform off which to fund its existing operations and facilitate expansion. This is rare for such a young company and differentiates Petroneft from many of its peers who are heavily dependent on equity funding. Our estimate on Pertroneft's production profile is graphed in figure 4.1. It is constructed using Petroneft's existing 2P reserves and highlights the quantity of oil the company is about to bring onstream and the acceleration in volume. The shape of the production profile is not typical with no clear plateau every forming. This reflects the tight reservoirs characteristics that are predominant in the Tomsk region.

Petorneft has recently disappointed the market in terms of production, missing its 2010 year end target of 4,000bopd by some way. The company explained the miss by greater than expected formation damage resulting from the drilling and completion process. Current production from 9 of 11 wells stands at 3,000 bopd. The two wells that are offline (Lineynoye 1 and Lineynoye 6) have been shut down for operational reasons. Lineynoye 1's casing is too small to accommodate an submersible pump and a bespoke screw pump has been ordered for the well. Once installed the well should reach a production levels of 275bopd. Lineynoye 6's casing was damaged during drilling however a repair has been completed. No production guidance has been given for this well by Petroneft.

As a result of the tight reservoirs, Petroneft has employed fraccing to enhance flow rates. This process involves the high pressure injection of water and particles into the reservoir in order to increase the spacing between the rock. In mid January Petroneft begun a fraccing campaign and has reported that it is satisfied with results of this programme. The successful completion of the programme is an advantage to Petroneft going forward as this process is not without risks and in some cases can have a detrimental effect on the efficiency of a well. The understanding of the geology and the reservoir gained from completing the programme will allow the refinement of the time of fracc and optimise the time taken to return a well to production.

This summer Petroneft will utilise "heli-fracc" crew to implement a second programme of fraccing that will aim to enhance flow rates for 9 of the 17 new wells the company plans to drill in the 2011. The necessary equipment for this programme has already been moved to location by winter road. Petroneft also recently announced the purchase of new workover that it feels will help improve speed and quality of well performance. Once 2011's 17 new wells have been completed, production is expected to reach between 7,000 bopd and 8,000bopd by Q1 2012. This figure will also include the first production from the Arbuzovskye field. Year end 2011 production is expected to be between 6,000bopd and 7,000bopd.

Fig 4.2 Estimated Production Profile



Source: Dolmen Estimates

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Exploration Upside

Figure 3.2 highlighted Petroneft's current reserves at the end of 2010 according to an independent assessor (Ryder Scott). The same independent assessor also estimates that across Licence 61 and Licence 67 Petroneft there could be as much as 503mmboe of oil still be found. In Licence 61 this includes 23 prospects in the upper Jurassic, 10 in the Cretaceous and another 11 in the lower to middle Jurassic. Licence 67 has 8 prospects in the upper Jurassic and 3 in the lower to middle Jurassic. In addition, to the exploration upside, Ryder Scott estimate a further 137mmboe of possible reserves in its 5 existing oil fields.

The well program that Petroneft has drawn up for 2011 will test some 152mmboe of this upside. In total, 5 wells will be drilled across to the two licences; 3 wells at Licence 61 and 2 wells at Licence 67.

The first well in this program **Kondrsahevkoye** is an appraisal that Petroneft intends to spud later this month. The aim of well is to delineate the field brining an additional 12mmboe into play. This field is located directly to the south of Petroneft's main producing field (Lineynoye-L61) which means a quick and low cost tie back into the facilities located there. Results of this well are due in May.

The exploration target **Sibkrayevskaya** located in Licence 61 is expected to be spudded in May with results due in June. This is a upper Jurassic prospect targeting 44mmboe of exploration upside. This propounded structure lies on the north eastern boundary of Licence 61 is believed to a large accumulation however it will take longer to tie back to the existing facilities.

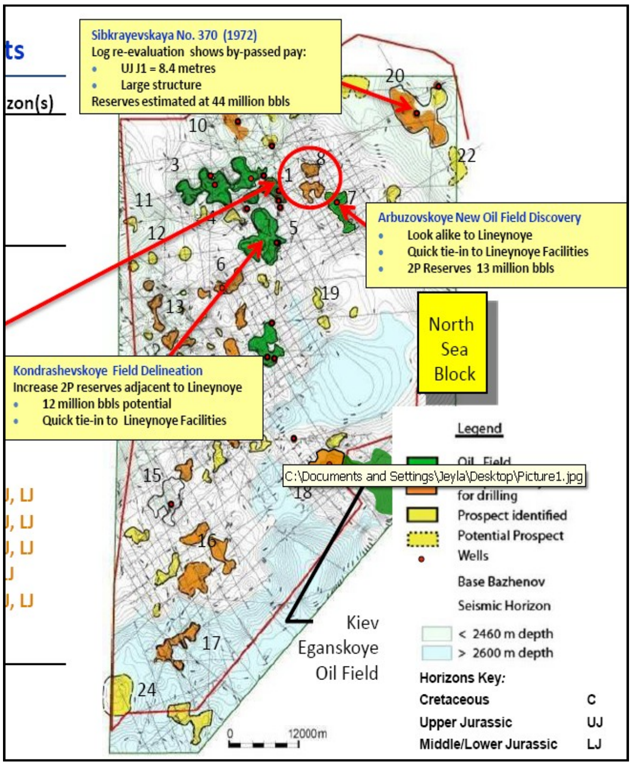
The next well Petroneft will drill is the exploration prospect, **North Varyakhskaya**. The well here will target upper Jurassic sands like Sibkrayevskaya with a spud date set for June with results expected in July. The size of the prospect is estimated at 5mmboe with reservoir and pay quality expected to be high.

Drilling activity moves across to Licence 67 in the second half of 2011 when Petroneft test the largest prospect of the campaign at **Cheremshanskaya.** This well is testing three plays across three horizons; upper, middle and lower Jurassic. The well is expected to be spudded in August with results due in September. The prospect is believed to be in the region of 60mmboe however Petroneft only owns 50% of Licence 67. Costs will also be split 50:50 with Arawak Energy at Cheremeshanskaya**.**

The final well of the 2011 campaign is also located in Licence 67. The **Ledovoye** field lies on the northern boarder of the licence and Ryder Scott already recognises 14mmboe of 2P reserves net to Petroneft here however the company believe that based of the reinterpretation of log data from an existing well that additional 30mmboe of gross pay is present at this location. Note again that Petroneft has a 50% interest in this prospect. The spud date for Ledovoye is expected to be in September with results in November.

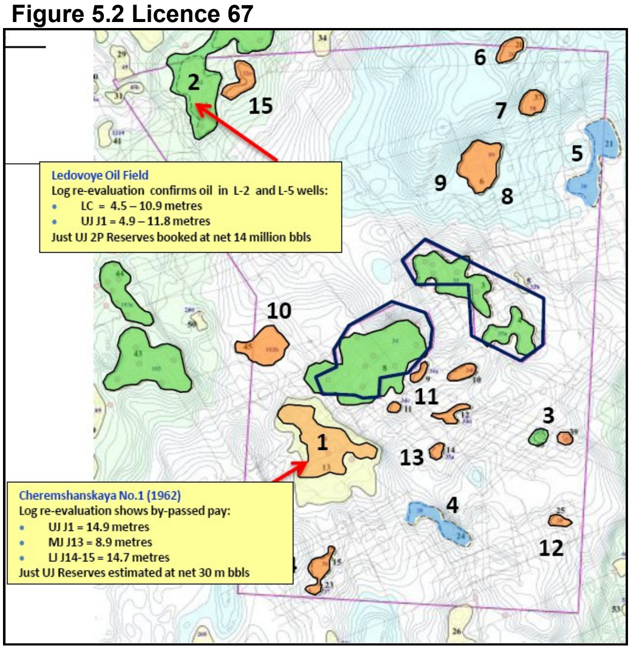
As can be seen later in our NAV we have attributed a conservative chance of success for these prospects but we believe that given the drilling schedule outlined above that there is significant scope for further reserve upgrades come next year.

Fig 5.1 Licence 61



Source: Company Website

Figure 5.2 Licence 67



Source: Company Website

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Valuation

We have used the following assumptions in the completion of our valuation of Petroneft:

- Long run oil price of $100 a barrel (Brent)
- Operating expenses of $6 a barrel
- Discount rate of 12.5%
- Internal production estimates
- Reserve estimates taken from Competent Person's Reports completed by Ryder Scott
- Exploration estimates formulated by Ryder Scott
- Capital expenditure of $370mln over 10 years to achieve commercialisation of existing reserves

As can be seen from Figure 6.2, we attribute a risked valuation of 118p per share to Petroneft. We believe that our risk weighting are conservative as we have only attributed a 16% chance of success (COS) to Petroneft's exploration upside despite all future targets being located in close proximity to already producing fields. Furthermore our risking of the upper Jurassic is very conservative particularly given the prior prospectivity of this horizon in Petroneft's 5 existing fields. We have risked 1P reserves at 100% COS, 2P at 66% COS and 3P at 25% COS.

Our valuation of Petroneft does not include the possibility of a change in Russian legislation relating to Minerals Extraction Tax (MET). The amendment to this tax is designed to encourage the development of fields less than 5 million tonnes or approximately 35mmboe. The proposed tax break expected to work on a sliding scale with smaller fields receiving more relief than larger fields. If the legislation passes in its anticipated form, 4 of Petroneft's 5 existing fields would qualify for relief. We estimate that passing of the amendment to the MET would add 21p to our Petroneft NAV however without full details of the legislation this calculation is largely subjective and has been excluded from our valuation.

Fig 6.2 Petroneft Valuation

	1P (MMBOE)	2P (MMBOE)	3P (MMBOE)	Interest	Risked (MMBOE)	Valuation ($)mln
Lineynoye L61	5.154	22.735	28.472	100%	27.28	126.50
West Lineynoye L61	2.713	23.32	29.224	100%	25.41	117.84
Kondrashevskoye L61	0.611	8.122	26.129	100%	12.50	57.99
Tungolskoye L61	1.381	15.483	19.628	100%	16.51	76.55
Arbuzovskoye L61	1.953	13.244	16.555	100%	14.83	68.79
Ledovoye L67	1.538	14.024	17.418	100%	15.15	70.25
	13.35	96.928	137.426		111.68	517.93
Exploration Upside			(MMBOE)	Interest	Risked (MMBOE)	Valuation ($)mln
L61			410.71	100%	65.71	257.50
L67			92.55	50%	7.40	29.01
						286.52
Total Risked NAV						804.45
Net Debt						2
Sub Total						802.45
Prev FX Rate	1.63					
£ Subtotal						492.30
Shares Outstanding (mln)	415.975					
Risked NAV						**£1.18**

Source: Company Website

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Funding Position

In the past Petroneft has used a combination of debt and equity to fund its operations. We now expect a lower reliance on both of these forms of financing as the benefits from existing production and the ramp of new production bolster operational strength. Depending on capital expenditure we estimate that by 2013 Petroneft will have the option of funding itself entirely from its production base should it choose to do so. The cashflow created by the projected 6,000 - 7,000bopd by 2011 year end will play a heavy role in this move to an operationally funded company. Furthermore, the rising production profile will provide greater access to credit and limit the need for equity raises.

In October last year Petroneft completed a placing of 63,125,000 at 43p per share. The gross proceeds from the corporate action were $43mln and by the end of 2010 $25mln was left at the disposal of the company.

Petroneft has also put in place a $30mln debt facility with Macquarie Bank out of which $11mln has been drawn down. This coupled with a cash position of $9mln leaves the explorer on a net debt position of $2mln. We anticipate that Petroneft will continue to draw down from this facility throughout the year however this dependence will drop as the production ramp up gains pace.

Executive Directors & Key Management

CEO - Dennis Francis

Francis has been Chief Executive Officer and an Executive Director of the Company since its formation in 2005. He has over 37 years experience in the petroleum industry and was with Marathon for 30 years who have and have had extensive operations in Russia. He has a BSc degree in geophysical engineering and an MSc degree in geology both from the Colorado School of Mines. He has also completed the Program for Management Development at Harvard University.

CFO - Paul Dowling

Mr. Dowling joined Petroneft in October 2007 and was appointed to the Board of Directors in April 2008. From accounting background, he has 17 years experience in various form of finance. Most recently he was a Partner in the firm LHM Casey McGrath located in Dublin. Mr. Dowling has worked in a number of industries and has significant experience in the Natural Resources sector. He is a fellow of the Association of Chartered Certified Accountants (ACCA) and a member of the Irish Taxation Institute.

Vice President - David Sanders

Dr. Sanders has been Vice President, General Legal Counsel, Executive Director and Company Secretary of the Company since its formation in 2005. He is an attorney of law and has over 35 years experience in the petroleum industry, including 18 years of doing business in Russia and three years in the oil and gas litigation division of the law firm of Fulbright & Jaworski LLP. In 1988, Dr. Sanders joined Marathon where he analyzed and reviewed joint venture agreements for worldwide production until his assignment in 1991 to the negotiating team for the Sakhalin II Project in Russia. He is a member of the State Bar of Texas and of the American Bar Association.

Managing Director of Stimul-T - Alexander Frenovsky

Mr Frenovsky was a former general director and chief engineer of JSC Tomskneftegazgeologia, the former Russian state enterprise that discovered and delineated essentially all of the oil and gas fields in the Tomsk Region. Mr Frenovsky has over 34 years experience in the oil industry and has received a state medal For Development of the Subsurface and Oil and Gas Complex of West Siberia and the Merited Worker of Geological Exploration badge of honour. He participated in the discovery of fields in the Tomsk Region and took part in the development of over 15 of the oil fields.

Chief Geologist & Geophysicist of Stimul-T - Nikolay Karapuzov

Dr Karapuzov was chief geophysicist/chief geologist of JSC Tomskneftegazgeologia. He worked for JSC Tomskneftegazgeologia for 35 years and directly participated in the discovery of 17 oil fields in the area and has been awarded the title of Honourable Geologist of Russia by the Russian government for his contribution to the development of the subsurface in Tomsk Region. Dr Karapuzov graduated from Voronezh State University in 1970.

General Director of Stimul-T - Alexey Balyasnikov
Mr Balyasnikov has over 32 years experience in the Russian oil and gas industry. He worked for Marathon in various capacities, including as head of Marathon's representative office in Moscow, from 1990 to 2004. Most recently he has worked for Petroneft LLC on numerous projects including under contract to Foster Wheeler Energy LTD as Russian Project Manager of a large due diligence project for TNK-BP in Western Siberia. Prior to joining Marathon, Mr Balyasnikov was a senior geophysical researcher for the Moscow Research Institute. Mr Balyasnikov has a degree in geophysics from St. Petersburg University. .

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