Oil and Gas
Nostrum Oil and Gas

Review of 9M2016 results

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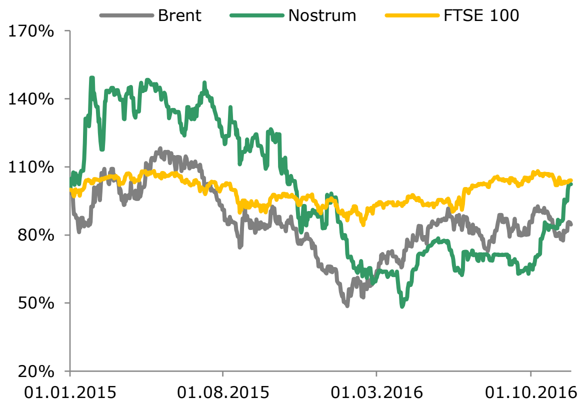
Ticker	NOG LN
Recommendation	**Sell**
Current price, GBp/ share (19.12.2016)	423
12M target price, GBp/share	351
Upside/Downside	**-17%**
No. of ordinary shares (mn)	188
3M av. daily turnover ($ mn)	298
Free float	57%
Market capitalisation ($mn)	816
Major shareholders	
MaiFair Investments	26%
Clarement Holdings	13%
Baring Vostok Co.	10%

Financials ($mn)	2015A	2016F	2017F
Revenue	449	327	589
EBITDA	229	152	356
Net profit	-94	-85	94
Equity	774	823	917
Net debt	781	845	861
EPS ($)	-0.5	-0.5	0.5
Valuation	**2015A**	**2016F**	**2017F**
Net debt/EBITDA (x)	3.4	5.5	2.4
Debt/Equity	0.4	0.4	0.4
EV/Sales	4.3	6.1	3.4
EV/EBITDA (x)	8.4	13.1	5.7
P/E (x)	n/a	-13.5	12.3
P/B (x)	1.5	1.4	1.3

Share price performance	Abs.	Rel. FTSE 100
1M	6%	2.3%
3M	57%	53.8%
12M	4%	-10.9%
52-week high	467	
52-week low	203	

Source: Company data, Bloomberg, HF estimates

Рис 2. Return dynamics Brent oil, shares of NOG, FTSE 100 Index.



Source: Bloomberg

Since our last report on October 5, share price of Nostrum Oil and Gas (NOG, Nostrum) increased by 65%. The impressive growth in the value of shares in the absence of triggers allows us to consider a more optimistic scenario in the oil price forecast. Meanwhile, transition to cost saving drilling restrains our expectations about achieving minimum production levels planned by Company. Counting on the growth of oil price, we raise our target price to GBP351/share. However, on December 13 the NOG's shares updated yearly highs, closing at GBP467/share. Given the sharp and unjustified shares increase, we believe it is appropriate to take profits at current levels and therefore recommend to "SELL" Nostrum's shares.

9M2016 financial results review. Due to the fall of the average price of oil by 16% (yoy) and a decrease in average daily production by 12% (yoy), Nostrum's revenue for 9M2016 decreased by 35% (yoy) and amounted to $245m The Company halved its export sales, while revenues from sales in the domestic market increased by 2.8 times (yoy). Ratio of export sales and domestic sales was 70/30.

Costs decreased by only 1% (yoy). In the same time the Company was able to significantly optimize other operating costs. However, the effect of the cost reduction was leveled by loss on derivative financial instruments ($47m). As a result, by the end of 9M2016 the Company recognized a net loss of $64m, which exceeds the 9M2015 loss by 3.5 times. Excluding the loss on derivatives, net loss was $14m.

Average daily production for 9M2016 decreased over the year by 12% and amounted to 38.9 ths. bopd, mainly due to the transition to a more economical type of drilling.

Current production capacity exceeds 44 ths bopd despite the fact that the projected level of production for the whole 2016 continues to be 40 ths. bopd.

At the end of 9M2016 total liabilities of the Company amounted to $1 408m of which 67% are long-term loans and 24% deferred tax liabilities.

Production and prices estimates. Taking into account updated consensus forecast data by Bloomberg in our model we increase oil prices forecast for 2016-2020 period by an average of 15%. As a result, our target price is GBP351/share, which higher than the previous target price by 11%, but lower than the current price by 17%. Despite the increase in the forecast for oil prices, the profitability of the Company is still under the pressure of falling production volumes as a result of the transition to an inclined type of drilling. Based on current results, in 2017 we do not expect a significant improvement in financial performance, which, in our opinion, justified by the continuing low oil prices at which the Company will be costly to adhere to the planned completion of the GTU-3 and achieve the declared production levels.

Recall that the Company planned completion of GTU-3 in 2016, but due to low oil prices and adjusting capital expenditures on drilling and construction of GTU-3, the completion of GTU-3 will not happen before 2017-2018.

Fig. 3. 9M2016 financial results

$ m	9M2016	9M2015	yoy
Revenue	245	375	-35%
Cost of sales	(146)	(147)	-1%
Gross profit	**99**	**228**	**-57%**
General and administration expenses	(28)	(37)	-24%
Selling and transportation expenses	(56)	(75)	-26%
Finance costs	(32)	(36)	-9%
Finance costs - reorganization	-	(1)	n/d
Employee share option plan fair value adjustment	2	1	237%
Foreign exchange loss, net	(1)	(15)	-95%
Loss on derivative financial instruments	(47)	24	n/d
Interest income	0.4	0.2	60%
Other income	7	9	-24%
Other expenses	(6)	(16)	-59%
(Loss) / profit before income tax	**(60)**	**84**	**n/d**
Income tax expense	(4)	(102)	-96%
(Loss) / profit for the period	**(64)**	**(18)**	**257%**

Source: Company data

Fig. 4. Extraction and oil prices forecasts in 2016-2022

	2016п	2017п	2018п	2019п	2020п	2021п	2022п
Brent, $/barrel, HF	43	50	55	62	64	67	70
Brent, $/barrel, Bloomberg	50	55	62	62	65	68	70
LPG ($/tonne)	336	353	410	509	529	550	573
Natural Gas ($ / ths BTU)	2.3	2.9	3.0	3.0	3.1	3.3	3.4
Production (ths bopd), HF	38	50	60	80	90	100	110
Production (ths bopd), Nostrum min	40	40	60	90	110	-	-
Production (ths bopd), Nostrum max	40	60	90	100	110	-	-

Source: Company data, HF estimates

Hedging contract. Hedging contract has a validity period of 24 months, maturing in December 2017 and the product of cash payments on a quarterly basis. Put options purchased within the framework of the hedging contract at the end 9M2016 not implemented and excluding loss on derivatives, net loss was $14m. In case of excess of the price of oil at $49.16 per barrel at the time of implementation of the put option, we note the high probability of a significant loss.

Increase of 12M target price to 351 GBp/share, SELL recommendation. Given the adjusted Bloomberg consensus forecast for oil prices, which exceeds our expectations by an average of 15%, we raise our target price to GBP351/share. Taking into account the resent sharp increase in share price and retaining our expectations about the elusive Company plans, we recommend to "Sell" NOG shares. We also believe that credit risk will act as a deterrent: the Company has debt maturing in 2019 in the amount of $960m.

Fig. 5. Valuation

		2016F	2017F	2018F	2019F	2020F	2021F	2022F
Revenue		327	589	782	1 043	1 230	1 430	1 619
Operating cost		302	353	398	488	544	604	667
EBIT		25	235	383	555	686	826	952
-	Other taxes	-26	-44	-61	-81	-93	-110	-123
+	Fin. income	0	1	0	0	1	1	1
-	Income taxes	-1	-68	-114	-178	-219	-269	-318
+	Depreciation	128	121	122	132	142	152	164
-	Capex	-172	-258	-254	-269	-327	-332	-386
-	ΔNWC	-22	-33	-24	-21	-47	-60	-3
Free cash flow		-69	-46	52	138	142	207	286
WACC		13.7%						
PV (FCF)		439	(42)	42	98	89	114	138
PV (Terminal value)		1 201						
EV		1 640						
Net Debt estimates		777						
Capital		954						
FX rate GBP/$		1,3						
12M Targer price (GBp)		**351**						

Source: HF calculations

Sensitivity analysis. At the announcement of operating results for 9M2016, Nostrum management stated that the completion of the UPG-3 is planned for 2017. In addition, the Company continues to pursue ambitious plans, considering the likelihood of achieving minimum and the maximum possible average daily production levels (Fig. 4).

Provided the Company will achieve the maximum targeted results, the potential target price could reach GBP747/share (see Appendix 2).

Given that the Company to date has not yet reached the desired level of extraction at 2016 we feel the need to put in the model the lower limit of the target range.

Thus, subject to the Company achieving minimum levels on the average daily production, our target price may rich GBP604 / share.

Risks and growth prospects. The main risk for Nostrum Oil and Gas is price changes in the market, because pricing on the entire volume of crude oil, condensate and natural gas liquids are directly or indirectly dependent on oil prices.

The hedging transaction also leans on the result from the oil price. If at the time of sale of a put option on the price of oil is above $49.16 per barrel, the Company is exposed to the risk of substantial loss, which as in the case with the results 9M2016 may adversely affect the financial results.

Credit risk. At the end of 9M2016 the Company's total debt remains at $960m and net debt – about $867m.

Additional risks are country risks, regulatory risks. In particular, the Company is exposed to the risk of disputes with the Government of Kazakhstan on its efforts to comply with the requirements or subsoil contracts for subsoil use.

Attachment 1. Proforma financial statements of NOG, mn $, except for GDR

Income Statement	2015A	2016F	2017F	2018F	2019F	2020F	2021F	2022F
Sales	449	327	589	782	1 043	1 230	1 430	1 619
Cost of sales (incl. depreciation)	(187)	(189)	(205)	(227)	(272)	(305)	(338)	(374)
Gross Profit	262	138	384	555	770	925	1 091	1 245
G&A expenses	(49)	(39)	(45)	(46)	(46)	(46)	(47)	(48)
S&Oil Transportation	(93)	(74)	(104)	(126)	(169)	(192)	(218)	(245)
Operating income	120	25	235	383	555	686	826	952
Depreciation	109	128	121	122	132	142	152	164
EBIT (without royalties)	229	152	356	505	687	828	978	1 116
Interest expense	(44)	(42)	(42)	(47)	(49)	(70)	(68)	(61)
Amortization of discount	(1)	(1)	(2)	(2)	(3)	(4)	(4)	(5)
Derivatives gain	37	(41)	-	-	-	-	-	-
FX losses	(21)	(7)	-	-	-	-	-	-
Other tax expenses	(15)	(13)	(21)	(30)	(41)	(46)	(55)	(61)
Other nonoperating income	13	8	14	19	26	30	35	40
Othe Net Income	(17)	(13)	(23)	(30)	(40)	(48)	(55)	(63)
Pretax income	72	(84)	161	292	448	549	678	803
Income tax expenses	(167)	(1)	(68)	(114)	(178)	(219)	(269)	(318)
Net income	(94)	(85)	94	178	270	330	409	485
Return/GDR	(0.5)	0.3	0.5	0.9	1.4	1.8	2.2	2.6
Dividends/GDR	-	-	-	0.2	0.3	0.4	0.4	0.5

Balance sheet	2015Ф	2016П	2017П	2018П	2019П	2020П	2021П	2022П
Cash and cash equivalents	166	100	100	100	120	130	145	160
Current investments	-	102	-	17	21	26	34	47
Trade receivables	31	24	40	51	57	101	118	133
Inventories	29	21	30	37	50	58	69	75
Derivatives financials	54	-	-	-	-	-	-	-
Prepayments and other current assets	27	23	35	46	60	61	100	97
Income tax prepayment	27	20	35	47	63	74	86	89
Total current assets	334	290	241	299	372	450	551	601
PP&E, net	1 606	1 685	1 842	1 996	2 155	2 340	2 520	2 742
Goodwill	32	32	32	32	32	32	32	32
Exploration and evaluation assets	37	35	42	56	63	70	77	77
Restricted cash	5.4	5	5	5	5	5	5	5
Advances for noncurrent assets	131	136	163	217	245	272	299	299
Derivatives financials	43							
Total assets	2 188	2 184	2 326	2 606	2 872	3 169	3 484	3 756
Current portion of long term borrowings	15	-	-	-	-	-	-	-
Trade payables	41	30	44	55	73	85	97	109
Other current liabilities	52	15	21	27	36	41	47	53
Total current liabilities	109	45	65	82	109	126	144	163
Long term debt	936	942	966	1 044	1 044	1 044	994	844
Deferred tax liabilities	348	348	348	348	348	348	348	348
Other long terms liabilities	22	26	30	38	42	46	50	50
Total liabilities	1 415	1 360	1 409	1 511	1 543	1 564	1 536	1 404
Share capital, net of treasury	1	1	1	1	1	1	1	1
Retained earnings and reserves	772	822	916	1 094	1 328	1 604	1 947	2 351
Share capital and reserves	774	823	917	1 095	1 329	1 606	1 949	2 352
Total equity and liabilities	2 188	2 184	2 326	2 606	2 872	3 169	3 484	3 756

Cash Flow Statement	2015Ф	2016П	2017П	2018П	2019П	2020П	2021П	2022П
Cash Flow from Operating Activities:	153	268	110	215	350	395	471	646
Cash Flow from Investing Activities:	(245)	(275)	(156)	(272)	(273)	(331)	(340)	(399)
Cash Flow from Financing Activities:	(116)	31	(45)	57	(57)	(54)	(116)	(232)

Source: Company data, HF estimates

hhnAttachment 2. Sensitivity analysis

Share price sensitivity to scenario of various oil prices and production volume in 2017.

Production, kboepd	Brent oil price, $/barrel							
	40	50	47	49	50	55	53	57
20	269	275	273	274	275	277	276	278
30	289	297	295	296	297	301	299	303
40	309	319	316	318	319	325	323	327
50	328	342	338	341	342	351	347	354
60	350	370	364	368	370	380	376	384
70	374	397	390	395	397	409	404	413
80	399	425	417	422	425	438	433	443
90	423	452	443	449	452	467	461	473
100	447	480	470	477	480	496	490	503
110	471	507	496	504	507	525	518	533

Source: HF calculations

The sensitivity of the target price at achieving lower production boundaries

Production, kboepd	Brent oil price, $/barrel							
	40	50	47	49	50	55	53	57
20	669	682	689	698	701	705	708	715
30	693	710	718	729	732	737	742	751
40	717	737	747	761	765	770	776	786
50	790	819	834	855	861	870	879	893
60	802	833	849	871	877	886	896	911
70	814	847	863	886	893	903	913	929
80	826	861	878	902	909	919	930	947
90	838	874	893	918	925	936	947	965
100	850	888	907	934	941	952	964	983
110	863	902	922	949	957	969	981	1001

Source: HF calculations

The sensitivity of the target price at achieving higher production boundaries

Production, kboepd	Brent oil price, $/barrel							
	40	50	55	62	64	67	70	75
38	581	593	599	607	610	613	617	623
40	585	598	604	614	616	620	624	630
50	609	625	633	645	648	653	658	666
60	633	652	662	676	680	686	692	702
90	705	735	750	770	776	785	794	809
100	730	762	779	802	808	818	828	845
105	742	776	793	818	824	835	845	862
110	754	790	808	833	840	851	862	880
115	766	804	823	849	857	868	879	898
120	778	817	837	865	873	884	896	916

Source: HF calculations

Attachment 3. NOG summary

Nostrum Oil and Gas is an independent oil and gas company engaging in the production, development and exploration of oil and gas in the pre-Caspian Basin of Kazakhstan.

NOG has four licensed assets, and currently NOG operates at Chinarevskoe oil field with an area of 274 square kilometer (this license is valid until 2031-2033). Currently NOG has 21 oil and 18 gas wells.

NOG probable and proved (2P reserves) as per the latest 2015 update from Ryder Scott are at 470 mm boe, 80% of which belong to Chinarevskoe field. As per the report, 2P reserves at Chinarevskoy field comprised from 38.4% of crude oil, 13.6% of LPG and 48% of natural gas. Daily average production in 2015 was at 40.4 kboepd, and maximum production of 46.2 kboepd NOG reached in 2013. NOG exports 85% of crude oil, 100% of oil condensate, 100% of LPG and 75% of natural gas. As per the company data, average price discount to the local market is 50%.

The main strategic goal of the company is to increase the production to 110 kboepd, largely due to an increase of number of producing wells and a completion of third unit of the gas treatment facility (GTU-3). The third unit is expected to increase the operating capacity and production of liquid hydrocarbons up to 4,200 mmcm per year. Current processing capacity of the first two units is 1,700 mmcm per year. Construction of the first two units was carried out for the processing of gas condensate from its wells and associated gas from oil treatment unit into a mixture of stabilized condensate, LPG and dry gas.

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