ASSET CAPITAL PARTNERS

EPISODE III: Myths and Reality in the Russian Oil Sector

MERGERS, ACQUISITIONS AND LICENCING
IN THE RUSSIAN OIL AND GAS INDUSTRY

New realities and opportunities for growth of Russian and international companies

3rd Annual International Conference

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Vladimir Matias, Managing Partner

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1. **Myths and Reality in the Russian oil sector**
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Myths and Reality

There are generally three different groups of myths associated with the Russian oil sector:

- The first group of myths relates to the ability to acquire oil assets in the Russian Federation (see myths No. 1-5). It seems questionable to many potential western investors whether Russian oil assets can be acquired at all or can be subject to a joint venture

- The second group of myths relates to the attractiveness of the assets (see myths No. 6-8). Even if it is admitted that assets can be acquired they seem not be worthy an acquisition for several reasons

- The third group of myths relates to the implementation of an acquisition (see myths No. 9-10). Even if the possibility of acquiring oil assets and their respective attractiveness are not put into question it sometimes appears doubtful whether an acquisition can be implemented successfully

Many of the myths presented in this paper have some foundation in reality. Most do, however, not reflect the rapid changes in the Russian economy generally and the Russian oil industry in particular

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Myth No. 1

Myth:

- The Russian oil industry has a monopolistic structure and is state controlled

Indicators:

- The Russian state is still important in the gas sector with a majority shareholding in Gazprom, the largest integrated gas company in the world
- The Russian state fully owns the transportation companies Transneft (responsible for crude oil transportation via pipelines) and Transnefteproduct (responsible for oil products transportation via pipelines)
- Important oil companies are fully owned by the Russian state (e.g. Rosneft)

Reality:

- The Russian oil industry underwent a period of structural reforms and privatisation in the 1990s
- Most large Russian oil producers are now privately owned (e.g. Lukoil, Surgutneftegas, Sibneft, TNK-BP, Tatneft)
- There have also been a number of important investments by foreign private oil companies in the Russian oil sector (e.g. the joint venture between BP and TNK, the acquisition of KMOC by Marathon Oil, Shell and Wintershall with Gazprom etc.)
- In recent years the large Russian oil producers have developed or are in the process of developing into private, vertically integrated oil companies
- Quite to the contrary to the prevailing myth, the Russian oil sector is particularly diverse and offers endless opportunities to interested buyers

Myth No. 2

Myth:

- The Russian oil industry is controlled by the "oligarchs", a group of super-wealthy Russians and foreign individuals who dominate the oil sector both economically and politically

Indicators:

- A World Bank study published (for reference see www.worldbank.org.ru) confirmed that 23 individuals or groups control more than a third of the country's industry as measured by sales, 16% of employment and hold 17% of all banking assets

Reality:

- Despite the fact that the so-called group of "oligarchs" is particularly important in the Russian oil industry, a large sector of Russian small to mid-sized oil independents has emerged; there are currently more than 150 independent Russian oil companies and many more assets held individually
- Small and mid-sized investments have also proven to be of interest to foreign small to mid-sized independent oil companies
- Like in western countries assets of a certain size fit only companies of a corresponding size; hence, there is active optimisation of portfolios ongoing with Russian large and mid-sized oil companies. This offers opportunities to interested buyers

Myth No. 3

Myth:

- Russian oil reserves will run out in the near future

Indicators:

- The Russian Federation is currently producing at an annual rate of 443 million tonnes (in the year 2004); total oil reserves are estimated to be 60 billion bbl (BP Statistical Review of World Energy, June 2003) or 5.7% of worldwide oil reserves

Reality:

- Russian oil reserves are reported in a very conservative way in most reserve reports; it should be noted that Russian oil reserves characteristically have a significant (and geographically extensive) proved-undeveloped (PUD) component; hence the haircut between SEC- and SPE-measured reserves is significant, because of the SEC's more stringent classification of PUD reserves
- According to Renaissance Capital the SPE-measured proved oil reserves of Lukoil, Yukos, Surgutneftegas, TNK, Sibneft, Tatneft, Rosneft and Gazprom alone would have been an estimated 71.6 billion bbl
- According to BP's Statistical Review of World Energy, the estimated reserve-to-production (R/P) ratio at year-end 2002 was 21.7 years for Russian oil reserves (which compares with 40.6 years for the world as a whole and 9.7 years for OECD oil reserves). Excluding OPEC, Russia's reserves are very large indeed
- It is also important to note that Russia's largest oil groups replaced 325% of the oil and gas they produced in the five-year period spanning 1998-2002. Even eliminating acquisitions, the drill-bit reserve replacement was 138%
- Potential buyers, therefore, must not be worried about the reserve base of the Russian oil sector

Myth No. 4

Myth:

- Russian oil companies do not welcome foreign investments and are now financially able to make reserve acquisitions or investments in very costly infrastructure projects themselves

Indicators:

- Russian oil companies have indeed earned well during the past years due to high oil prices

Reality:

- Many of the successes in the Russian oil sector can be explained only if one understands the influence of western technological know how and investment; even „oligarchs" have often involved western investors alongside themselves and have greatly benefited from advanced western technologies such as horizontal drilling
- There are prominent examples where foreign investors were able to make sizeable investments (BP-TNK, Marathon Oil-KMOC, Sakhalin assets, Wintershall with Gazprom), but also smaller like Urals Energy, Harvest etc.
- The investment universe of potential western investors is large and very diverse. It is, hence, dangerous to make any generalisations
  - There are many Russian independent oil companies which welcome foreign investment if it comes with access to western technological know how
  - They are also often interested in sharing capital expenditures with foreign partners, in particular if they pursue a clear growth strategy
  - There are also infrastructure investments which small to mid-sized players owning larger assets cannot finance themselves
- All these situations offer interesting investment opportunities to foreign investors

Myth No. 5

Myth:

- I want to enter the Russian oil market; however, I will only buy a large asset and will expand from an already sizeable base

Indicators:

- Western investors often have thresholds for their investments with respect to minimum production amount and minimum reserve base

Reality:

- Large developed oil assets are rare in the Russian oil sector
- However, there are a great number of quickly growing Russian oil independents which can achieve attractive production numbers and reserve amounts within a reasonable period of time
- It is probably a better strategy to associate with a Russian oil independent with a proven track record of growth than to shoot for white elephants which may never appear

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Myth No. 6

Myth:

- Russia is hardly able to become an alternative to the OPEC countries in supplying the USA and Western Europe

Indicators:

- OPEC is dominating the world oil markets (in terms of reserves and production) and Russia is not a member of the oil cartel

Reality:

- In the 1960s and 1970s, OPEC's market share was as high as 73 % while today it has fallen to 40% and is expected to continue falling
- OPEC's success in controlling oil markets in the 1970s and 1980s was linked to the specific features of the world order in the second half of the 20th century, in particular to the Cold War. This epoch is now history; in the new world order OPEC's influence is declining and will continue to decline
- By the end of the decade Russia and other CIS countries (in particular the Caspian region) will be able to play an important role in bringing energy supplies to the USA and Europe; their importance will be enhanced by the political instability in the Middle East

Myth No. 7

Myth:

- The Russian oil sector is unattractive compared to other hydrocarbon rich regions in the world (in particular the Middle East, North Africa and West Africa) if measured by the netback achievable

Indicators

- The harsh climate necessitates high exploration and production expenses
- Reserves are located remotely with respect to transportation infrastructure ("land-trapped") as well as with respect to the their main offtake markets (Western Europe, North America, Asia)
- Russian oil is characterised by a low oil quality (in particular a high sulphur content)

Reality:

- The climate is not worse than in Canada or even in the North Sea
- New transportation routes are rapidly developed. Regions believed unaccessible or land-trapped (i.e. the Caspian area, Siberia, Sakhalin, the Far East, Yamal) are now de-bottlenecked
- The sulphur content, where it exists, is priced into the "Urals basket" which is traded at discount to Brent or WTI; many European but also US refineries can process such oil (sometimes after a blending process). In addition, oil products produced from Russian oil are less expensive than e.g. syncrude produced from Venezuelan heavy oil
- On a more general level, investments in the Russian oil sector seem attractive since they offer a new opportunity for a regional portfolio balancing of oil companies operating internationally, plus provide for great returns if foreign technical know-how is united with local expertise
- It should also be noted that the returns on equity for investors can be increased by acquiring developed assets (thus eliminating finding costs)
- Russian oil assets are still relatively cheap (US$ 2-3/bbl vs US$ 5-8/bbl in USA)

Myth No. 8

Myth:

- Investments without the umbrella of a production sharing agreement ("PSA") are unattractive

Indicators:

- A PSA offers investors legal and tax stability including (i) guaranteed rights to natural resources assets, (ii) fixed negotiated tax rates and royalties, (iii) granting of approvals and licences, (iv) granting of export rights and (v) permission of maintaining offshore accounts.

Reality:

- Although in theory a very attractive tool for investors, there have so far only very few PSAs been granted
- This is, however, no major impediment for investors in the Russian oil sector. The general subsoil licence taxation regime provides for a sufficiently predictable investment framework
  - All Russian oil companies and joint ventures are operating in this environment (SeverTEK, a joint venture between Lukoil and Fortum can serve as an example for a successful oil mid-size company)
- The PSA regime may resurface in future. There are discussions on senior political level with a view to introducing this legal instrument for difficult oil fields and regions

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Myth No. 9

Myth:

- Russia has no legislative framework for foreign investments in the oil sector

Indicatros:

- There are plenty of stories which describe the pitfalls of the Russian legal system. Many describe the difficult 1990s where investors made many a bad experience with their investments in the Russian Federation

Reality:

- Russia has undergone an almost unprecedented overhaul of its legal system. A new civil code has now been tested in practice already for several years. The court system has been improved. There is a favorable tax legislation in place and the oil sector has received particular attention by the legislator
- There are still pitfalls in the Russian legal system which have mainly to do with the fact that many pieces of legislation have no long history. However, the pricing of Russian oil assets seems to compensate for these uncertainties (which are no longer of fundamental nature) more than probably asked for
- International oil players are used to work in far less developed legal environments!

Myth No. 10

Myth:

- The performance of Russian oil companies' is hampered by poor management

Indicators:

- Given high R/P ratios and the limited exploration undertaken in the 1990s, the Russian oil industry tended to deliver subdued reserve replacement during most of the past decade. Also production efficiency was low due to the use of outdated technology

Reality:

- The Russian oil industry has undergone significant changes in the 1990s which is indicated by (i) the remarkable reserve replacement performance (see already myth No. 3) as well as its astounding increase in total production (from 303 million tonnes in 1996 to 450 million tonnes currently)
- Modern exploration and production technologies have become common-place in the Russian oil industry
- It should also be noted that the Russian oil industry has a large pool of highly qualified personnel at all levels of responsibility. The hydrocarbon industry is one of the main pillars of the Russian economy as a whole

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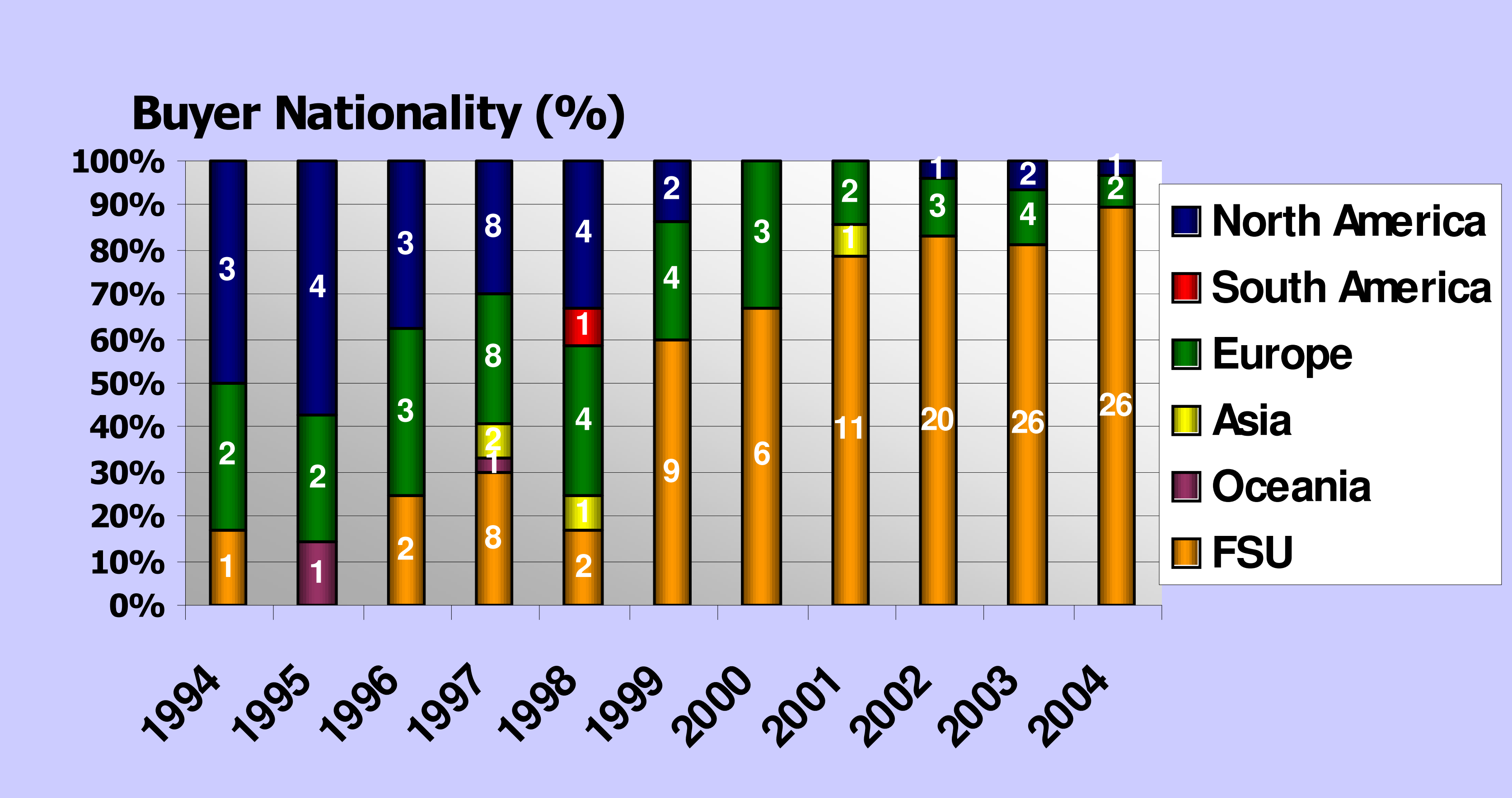
Recent trends in mergers and acquisitions

- High market activity, increasing seller‵s bargening power due to high oil prices, weak dollar, significant financial resources accumulated by industrial players
- The volume of M&A deals in CIS increased from US$ 17 bn in 2003 to US$ 26,5 bn in 2004. However, the share of oil & gas deals reduced from 68% to 59%*
- Decrease of M&A transactions between large companies and increase of the role of mid-size businesses
- M&A market players use more actively debt financing from Russian and foreign capital sources, inter alia, based on improvement of the Russian country rating
- Political nature of transactions. Increasing role of the Russian government. The YUKOS case impact

* Данные Ernst & Young

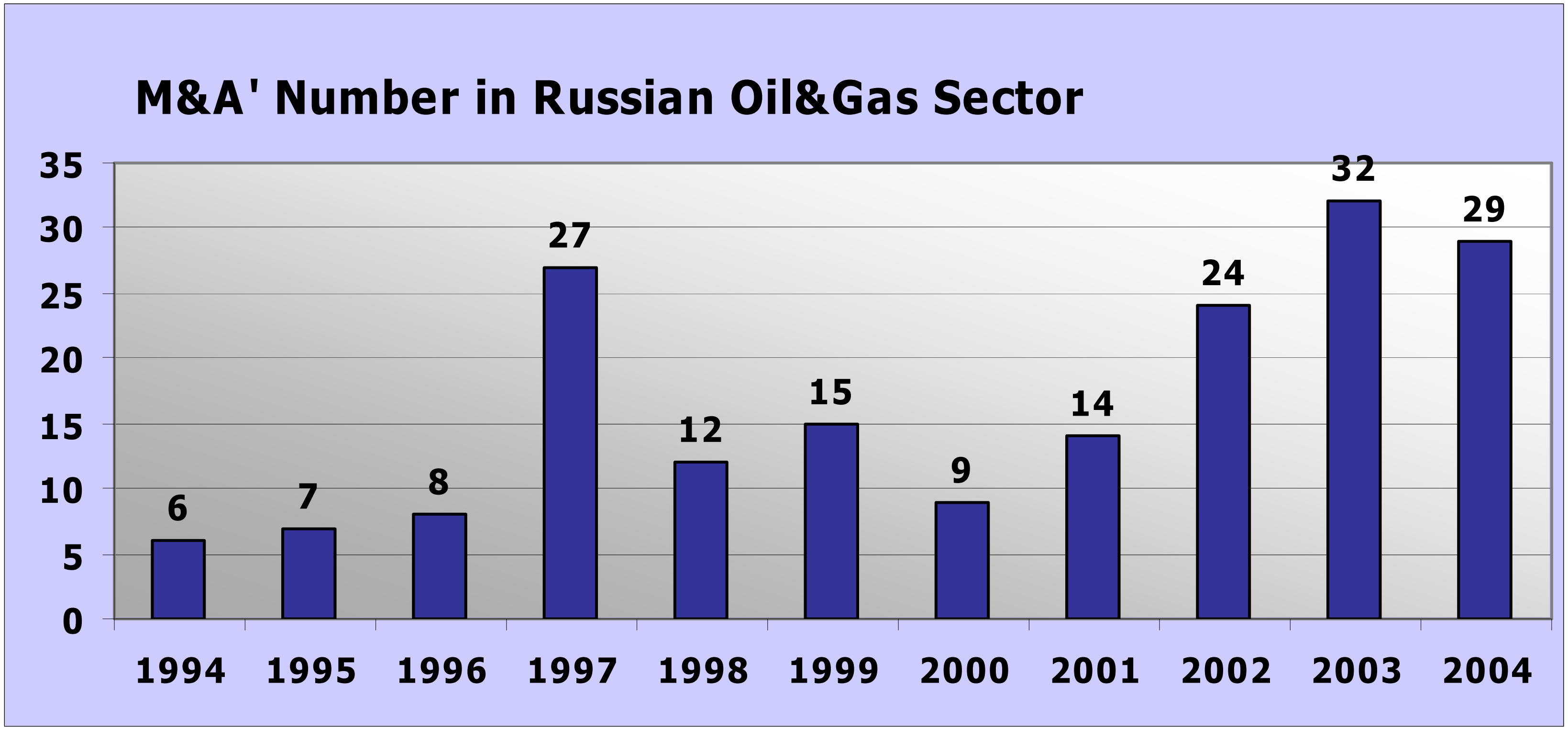
Strong local buyers

M&A facts in the Russian oil sector



M&A facts in the Russian oil sector

Growing number of deals



M&A facts in the Russian oil sector

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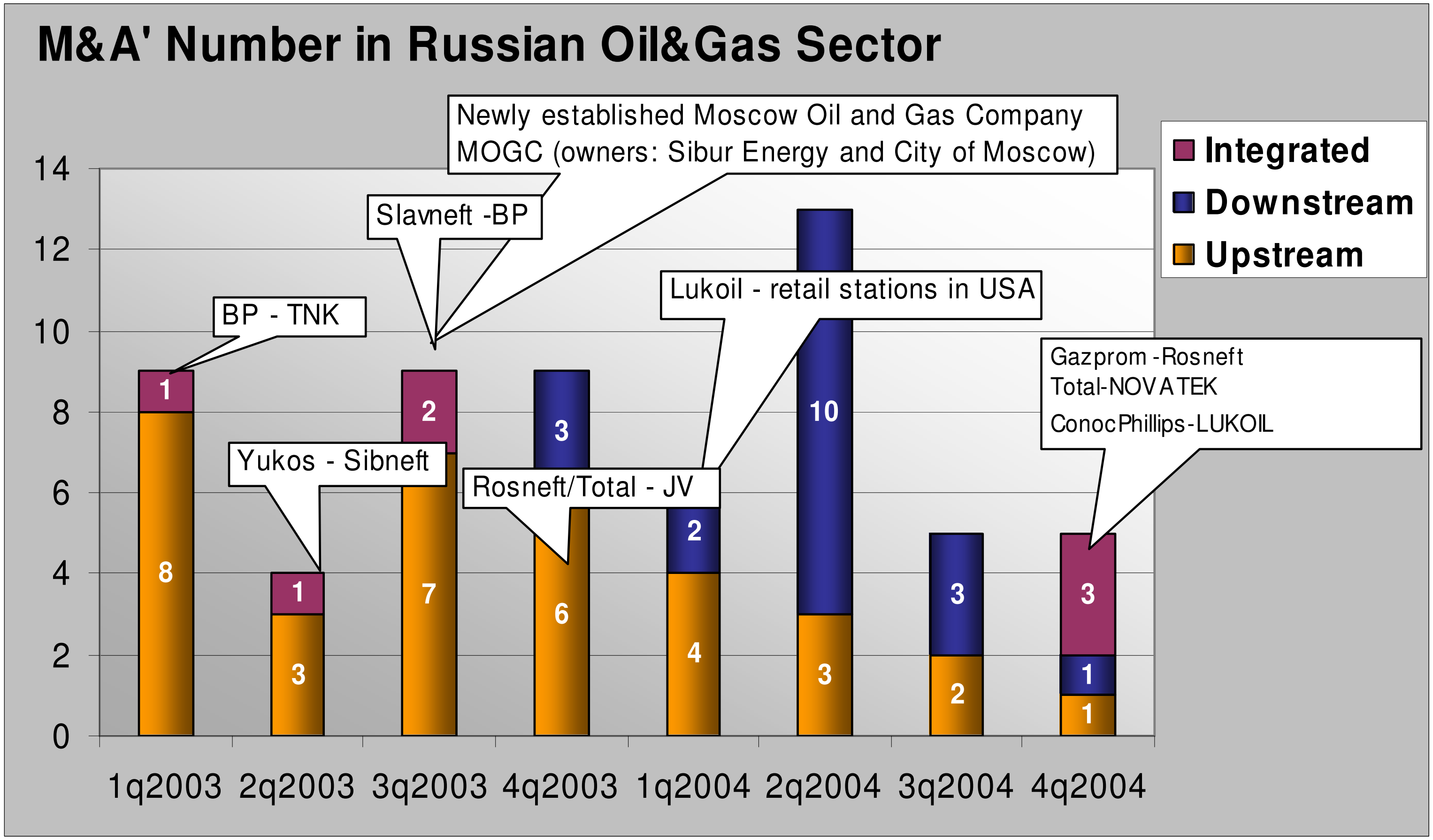
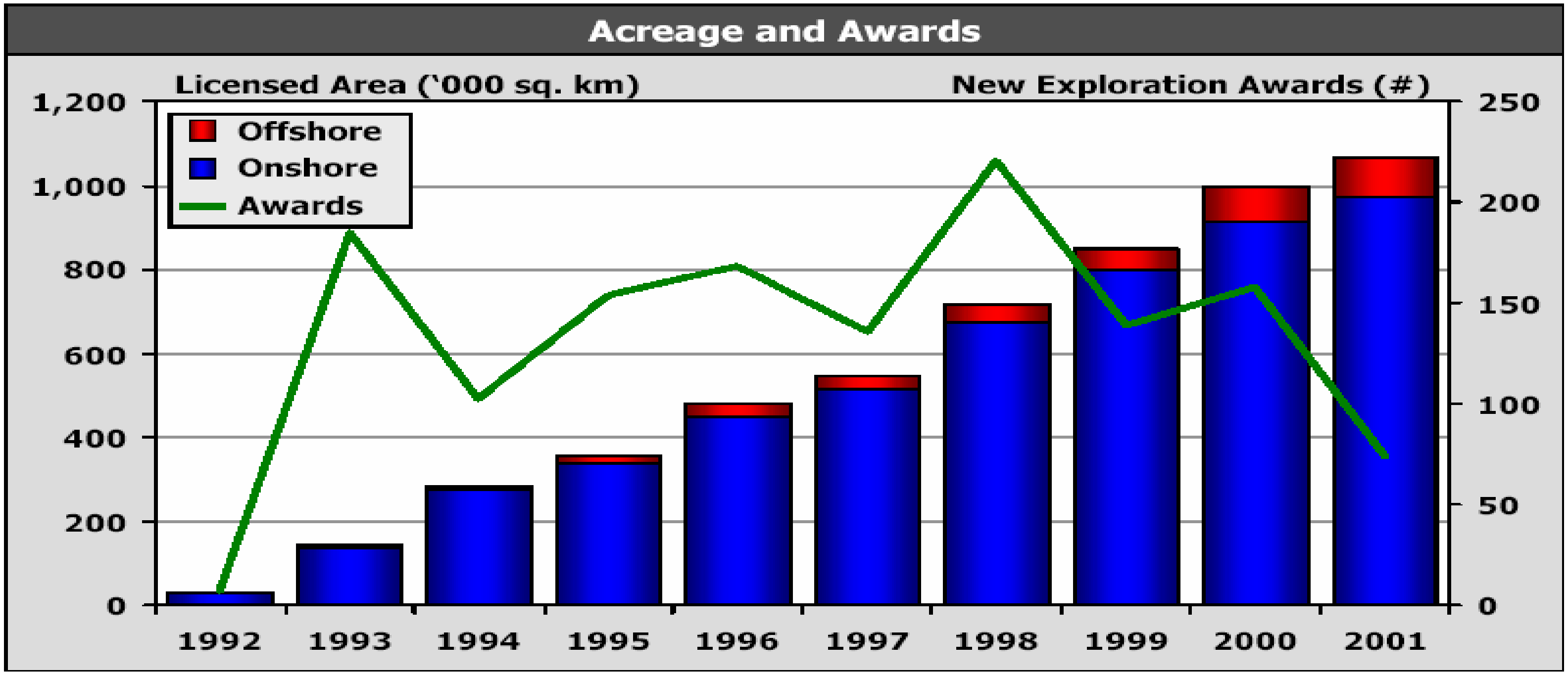


M&A facts in the Russian oil sector

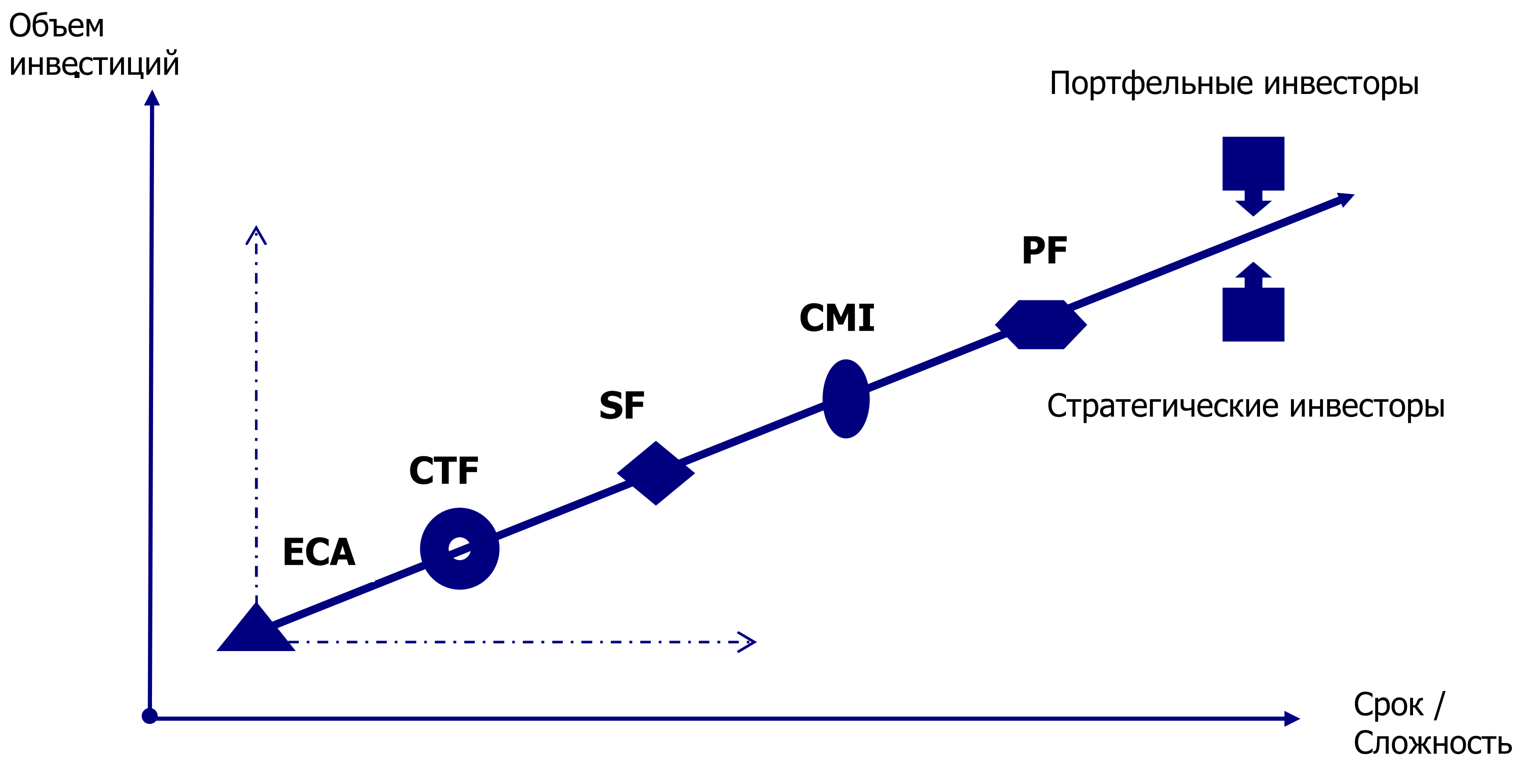
Market trends

- Revitalising of awards of new licences
- Moving into challenging regions, e.g. offshore (Prirazlomnoe, Shtokman, Sakhalin, Arctic region)



Source: IHS Energy

Эволюция долговых финансовых инструментов в России



ECA – Экспортно-кредитное агентство
CTF – Торговое финансирование
SF – Структурированное финансирование
CMI – Инструменты фондового рынка (облигации, векселя)
PF – Проектное финансирование

M&A facts in the Russian oil sector

Market trends: financing issues

- Almost all transactions financed via equity from companies' own financial resources or as a full recourse corporate financing (quick decisions and actions required in a tender and acquisition process)

- Emerging debt financings based on acquisition target's assets and cash flow

- Possible refinancing / leveraging of implemented transactions

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Focus

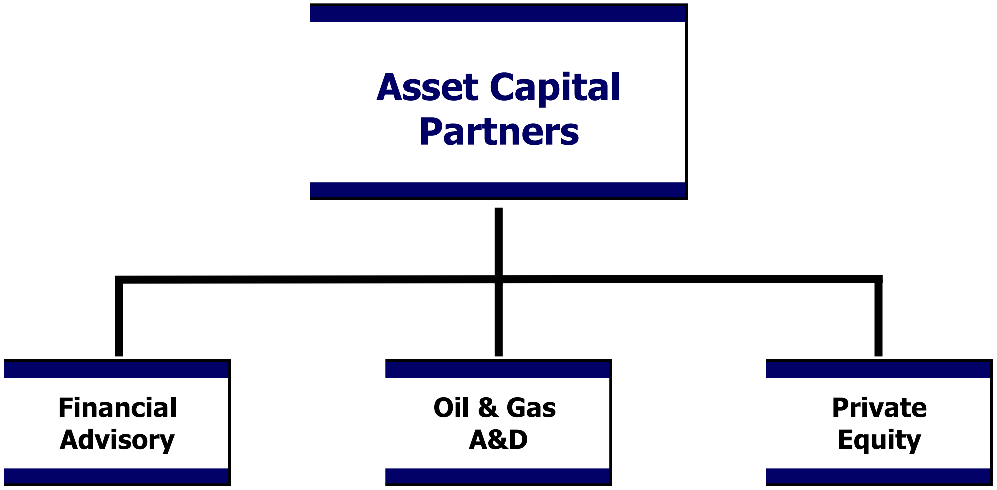
Introduction to Asset Capital Partners

- **Asset Capital Partners** is a globally operating investment banking firm based in Munich and Moscow

- Given the partners' proven track record **Asset Capital Partners** has a special focus on Russia and other CIS countries
- **Asset Capital Partners** provides investment banking and private equity services for asset based industries, particularly the oil & gas, mining, power and infrastructure sectors

Introduction to Asset Capital Partners (cont'd)

- **Asset Capital Partners** offers a wide range of investment banking services:
  - Financial advisory with regard to debt, mezzanine and equity
  - Acquisitions and divestiture (A&D) services in the oil and gas sector
  - Private equity services, including fund management and direct equity investments



Introduction to Asset Capital Partners (cont‛d)

Founders

- **Asset Capital Partners** was established as a spin off from the private equity and corporate finance division of HVB Group, one of the leading European banks
- The company‛s founders Hansjörg Gonser, Vladimir Matias, Jan-Hendrik Röver and Marc Wallenstein have successfully worked as a team for more than 8 years and have a combined financing and industry experience of almost 40 years
- All founders are executive partners of **Asset Capital Partners**

Experience

- The partners' expertise covers the whole spectrum of financing solutions from equity over mezzanine to senior debt
    - Thorough senior debt know how and track record as well as unique investment track record and reputation in Russia and other CIS countries, resulting inter alia in the No. 1 arranger position in 2002 and „Deal of the Year" awards in 2001 and 2002
    - Quasi-equity financing experience in the form of asset based mezzanine investments
    - Substantial private equity know how and track record as the partners represented the first institutional fund-of-funds-investor exclusively focused on asset based investments

Contact details

Asset Capital Partners GmbH

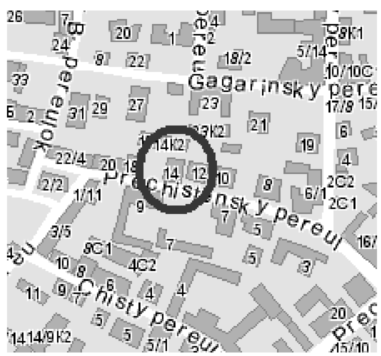
Wagmüllerstrasse 23

80538 Munich, Germany

p: +49 89 242 246 910

f: +49 89 242 246 990

roever@assetcapitalpartners.com



Asset Capital Partners GmbH

Prechistensky per. 14/1

119034 Moscow, Russia

p: +7 095 981 0791

f: +7 095 981 0792

matias@assetcapitalpartners.com