ERSTE GROUP

Press release 24. September 2008

CEE oil & gas sector hit by global equity sell-off, but profitability still strong in 2008, say Erste Group analysts

- **Undervaluated CEE oil and gas sector, most of CEE stocks with Buy recommendation...**
- **...however, the continuation of global sell off is now the crucial issue**
- **Outlook for 2008 and beyond: stable crude oil price in EUR terms and lower margins**

Despite higher-than-expected crude oil prices, and current negative mood and global sell-offs on equity markets, Erste Group analysts say CEE oil and gas sector profitability is even above 2007 figures. Moreover, despite expectations of a slightly worsening macro environment (decreases in the price of crude oil and refining margins), current share prices are mostly well-bellow their valuations.

CEE stocks are traded with P/Es of 8.0x (but only 6.1x excluding INA) in terms of 2008 earnings and even 7.3x (6.2x excluding INA again) using 2009 estimated earnings, while the sector's European peers are traded at P/Es of 10.8x for 2008 and 9.8x for 2009. The undervaluation of the CEE oil and gas sector can also be seen in the EV/EBITDA for the coming two years, although the numbers are boosted by the high ratios of Petrom and, particularly, INA, which is supported by the MOL takeover bid.

Based on the current negative market sentiment, Erste Group analysts say the CEE oil and gas sector is trading not only below the values of its European peers at P/E, EV/EBITDA and EV/Sales levels, but also well-below its long-term average of 8-12x (at P/E level). "*Both statements would make sense at the moment, as investors look at CEE stocks with high levels of risk and the stock prices are under pressure thanks to the overall sell-off mood on the financial markets. However, the operating performance of the companies is very high*", says Jakub Zidon, Oil & gas sector analyst and author of the report.

Most of CEE stocks with Buy recommendation

- Given its large exposure to the upstream segment and plans to increase production, **OMV** remains top pick with a Buy recommendation and target price of EUR 55.0.
- Although no potential growth drivers for the future, **MOL** is currently enjoying high diesel margins and delivering almost record quarterly figures at the operating level. Erste Group analysts change recommendation from Hold to Buy, while slightly lowering the target price to HUF 22,500.
- Polish refiners were strongly supported by huge revaluation gains in 1H08, but the outlook should be taken with caution (expected decrease in refining margins). Thanks to the significant drop in the share price, both **Lotos** and **PKN Orlen** are upgraded to Buy with 12M target prices of PLN 33.0 and PLN 45.0, respectively.
- **Unipetrol** was hit strongly by the longer than expected shut-down of its Litvinov plant and the significant decrease in petchem margins. Despite this, Erste Group analysts stand by their Buy recommendation, while substantially decreasing the valuation to CZK 250.

- **Petrom**'s restructuring is still ongoing, but the results are not yet very visible, mainly due to increasing production costs. A slight increase in the valuation to RON 0.570 is attributed to the higher-than-expected crude oil price.
- Erste Group analysts downgraded **INA** to Reduce, as the share price is supported by MOL's takeover bid at HRK 2,800, which is above target price of HRK 2,550. However, potential synergies with MOL could reach up to HRK 460 per share to justify the current stock price level.

List of recommendations and target prices

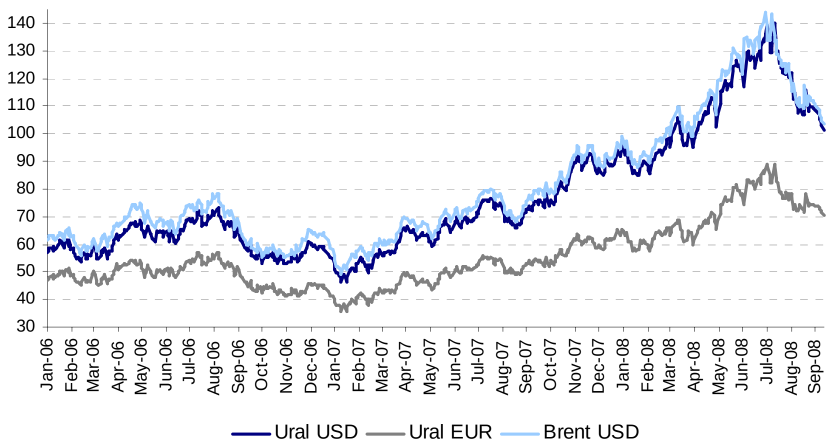
Company	Previous recomm.	Current recom.	Previous target price	Current target price	Report released
Lotos	Accumulate	Buy	PLN 40.5	PLN 36.0	24/09/2008
MOL	Hold	Buy	HUF 24,125	HUF 22,500	24/09/2008
OMV	Buy	Buy	EUR 59.7	EUR 55.0	24/09/2008
PKN Orlen	Accumulate	Buy	PLN 44.6	PLN 45.0	24/09/2008
Unipetrol	Buy	Buy	CZK 358.0	CZK 255.0	24/09/2008
Petrom	Accumulate	Buy	RON 0.608	RON 0.570	24/09/2008
INA	Accumulate	Reduce	HRK 2,490	HRK 2,550	24/09/2008

Source: Erste Group

Outlook for 2008 and beyond: stable crude oil price in EUR terms, lower margins

"We have increased our crude oil forecast for 2008 (to USD 105/bbl) and beyond (with a gradual decrease to USD 80 per barrel, which should be sustainable in the long-term) hand in hand with our EUR/USD forecast", says Jakub Zidon. "*As for margins, we expect refinery margins to decline over the mid-term, due to pressure from bigger supply side, while petrochemical margins should see a slight recovery in the coming years, with decreasing naphtha prices. In terms of CEE companies, we still highlight upstream-exposed companies (OMV, Petrom) or refiners with a high share of middle-distillate production (MOL) in the short term",* he concludes.

Development of oil prices



Consolidation to continue in coming years

Erste Group analysts believe that the consolidation wave in the oil and gas sector will continue, but over some time. Current global equity sell-offs destroy stock prices, making the relative valuation quite difficult. A merger between PKN Orlen and Lotos could be back on the table after the next general elections in Poland, while a merger between OMV and MOL is not likely in the long term from the current prospective. The third possibility, a MOL/PKN merger, is also unlikely at the moment, but is not unrealistic, in their view. The OMV/MOL project was rejected because of the really low synergy effect, while this merger a MOL/PKN merger could connect the north and south of the region without the merged entity being subject to asset divestment.

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