

Press release

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CEE Oil & Gas sector: the upstream segment to become attractive again

- Crude oil prices should gradually increase to above USD 65/bbl at year-end
- Downstream profitability expected to drop, upstream is on the rise
- Positive valuation for upstream players – OMV and Petrom are top picks

The significant drop in the crude oil price in 2H08 had two major consequences for the CEE Oil & Gas sector. On the one hand, it determined a fall in the profitability of the upstream segment and a huge negative revaluation of oil stocks. On the other hand, refining margins were very strong last year. However, Erste Group analysts expect that 2009 will bring a stabilization of the crude oil price, followed by an increase to above USD 65/bbl at year-end. This should bring about a 40% decrease in refining margins compared to 2008. Although new capacities and lower cost inputs are to be delivered to the market in the next 2-3 years, both refining and petrochemical products will face a significant drop in demand. This is the main factor that will generate an expected drop in downstream profitability in the upcoming period.

Crude oil prices should gradually increase to above USD 65/bbl at year-end

After a steep and prolonged decline in 2H2008, the crude oil price has stabilized in the range 40-47 USD/bbl. The price is depressed mainly because of the deteriorating global economy and consequently weak demand. In terms of demand, a decline of oil consumption of 1.6mn bbl/d is expected for 2009 compared to 2008. That is why Erste Group analysts expect OPEC to further cut production capacities so as to stop the decline in oil prices, as long as the oil price is traded below USD 75/barrel. The majority of oversupply on the global market should be gone by mid-2009. *“We expect the oil price to be in the range 55–65 USD/bbl during this year’s summer and in the range 60-75 USD/bbl at the end of the year,”* Jakub Zidon, Oil & Gas sector analyst and author of the report pointed out.

While so far the focus has been mainly on the demand side, it is expected that in the long run the supply side will clearly determine the future price development. Production is becoming increasingly cost-intensive, a large part of the infrastructure has to be replaced by 2020 and numerous oil fields are past their peak production. All these factors are expected to lead to higher prices in the long run – Erste Group analysts maintain a long-term price forecast of USD 80 per barrel.

Downstream profitability expected to drop, upstream is on the rise

For the first half of 2009, analysts envisage weaker refining margins in 1Q, due to lower overall demand for refining products (because of the winter season), while production is expected to remain relatively stable. This trend should also continue in the second quarter of this year, as margins will be slightly supported by the start of the driving season. Overall, the short-term margin expectation is USD 4.0/bbl.

Despite the expected contraction in refining margins, Erste Group analysts believe the situation will not be too grim for refiners in CEE. They point out that CEE companies’ level of refining complexity is above the global average, which gives them higher flexibility to market changes. Therefore, the expected

decrease in refining margins should not be very visible in the CEE region. Furthermore, the companies have better prospects to survive this negative scenario.

Based on the current negative market sentiment, Erste Group analysts say the CEE Oil & 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 10x (at P/E level). Both statements make sense at the moment, as investors perceive CEE stocks as having high levels of risk and the stock prices were additionally under pressure due to the overall sell-off on financial markets. As the companies in the CEE region are mostly refiners (excluding OMV and Petrom, with major exposure to upstream), the expected drop in refining margins for this year is included in the valuations. However, Erste Group analysts explain: *“despite the expected decrease in the refining margin, the profitability of CEE companies should not worsen in absolute terms in the coming years, as we do not expect such huge one-off items as in 3Q and 4Q08.”*

- OMV remains the top pick, with a Buy recommendation, despite the announced lower production targets and lower valuation (EUR 39/share). Its strong exposure to the upstream segment looks to be an advantage, due mainly to the expected increase in the crude oil price in the coming months.
- MOL is downgraded to Accumulate (from Buy) and the 12M target price is lowered to HUF 13,000. Despite the still positive recommendation on the stock, Erste Group analysts recommend cautiousness with buying MOL, due to its heavy exposure to the worsening economic environment in Hungary.
- Polish refiners have been strongly hit by huge revaluation losses, but investors have also been startled by their increasing indebtedness. Share prices do not have too much room for further decreases, but recovery may take a long time, especially in the case of the smaller and more vulnerable Lotos. Both Lotos and PKN Orlen are downgraded to Reduce and Hold, respectively, with 12M target prices of PLN 15.5 and PLN 27.
- Unipetrol was hit strongly by the collapse in the petchem segment. On one hand, the environment almost could not be worse. However, the Polish owners could use its strong balance sheet, which remains a big uncertainty for the company’s future strategy. As a result, Erste Group analysts lower the target price to CZK 120, with a Reduce recommendation.
- Despite the not-yet visible results of restructuring, analysts highlight Petrom, due to its strong exposure to the upstream segment. As a rise in the crude oil price is expected, the recommendation on Petrom is Accumulate, with a target price of RON 0.17.

Valuations and recommendation summary

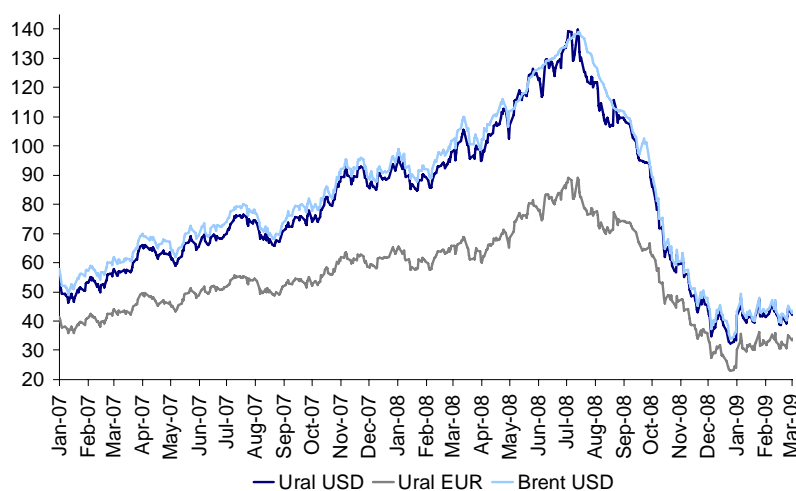
	Valuations derived from:		12M target price (50%-50% weights)	Recommendation
	DCF model	P/E multiples		
MOL (in HUF)	11,500	14,500	13,000	Accumulate
PKN (in PLN)	27.5	26.5	27.0	Hold
Unipetrol (in CZK)	120	120	120	Reduce
OMV (in EUR)	42.0	35.6	39.0	Buy
Petrom (in RON)	0.20	0.14	0.17	Accumulate
Lotos (in PLN)	17.0	14.0	15.5	Reduce

Source: Erste Group calculation

Outlook for 2009 and beyond: stable crude oil price in EUR terms, lower margins

1H09 will be unfavourable for the upstream business, as the average crude oil price will likely remain below USD 50/bbl. After a peak at USD 140/bbl at the end of June, the crude oil price dropped below USD 40/bbl in 2H08. Erste Group analysts have therefore decreased the crude oil forecast for 2009 (to USD 58/bbl) and beyond (with a gradual increase to USD 80 per barrel, which should be sustainable in the long term), hand in hand with the EUR/USD forecast. As for margins, they expect refinery margins to decline over the mid term, due to pressure from the greater supply side and economic slowdown, which should mainly result in lower middle distillates margins. The biggest “victim” of the ongoing economic crisis is definitely the petrochemical segment, as a slight recovery or stabilization around the current low levels can be expected. In terms of CEE companies, they still highlight OMV, due to its heavy exposure to the upstream segment, where they expect a recovery in the coming quarters. Also, its refining part should profit from the increasing gasoline margins.

Development of oil prices in last 2 years



Source: Reuters

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