Russia

OIL & GAS REVIEW

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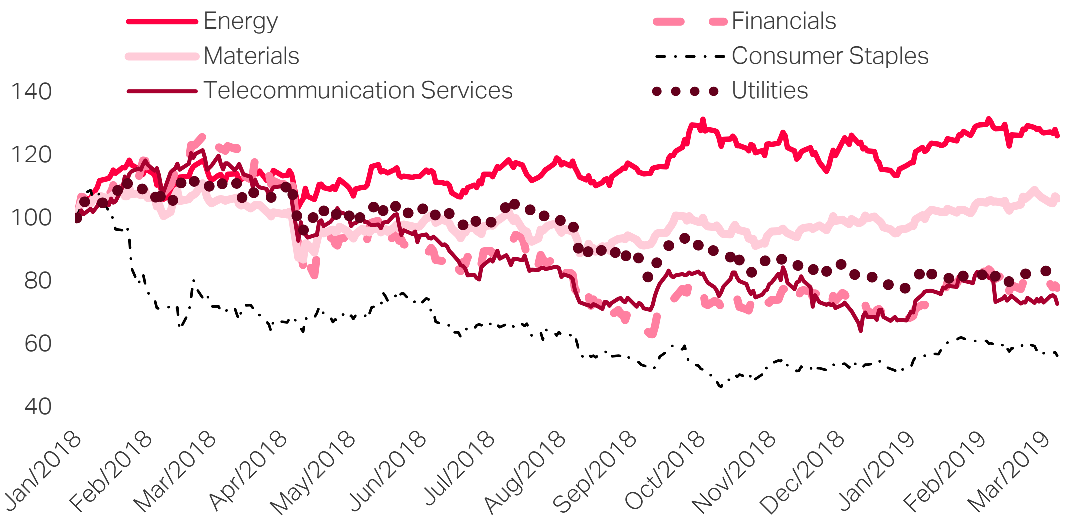
Novatek is the only Russian blue chip affected by the Norwegian SWF oil and gas sell-down. The company is also in the new US sanctions frame. Other top-down drivers besides sanctions rule out a repeat of last year's outperformance of Russian oil and gas stocks relative to the wider Russian equity market. Corporate governance performance could outweigh these top-down headwinds: Lukoil and Gazprom are the stocks to watch here.

Relative sector performance in Russia MSCI since January 2018



Source: Bloomberg

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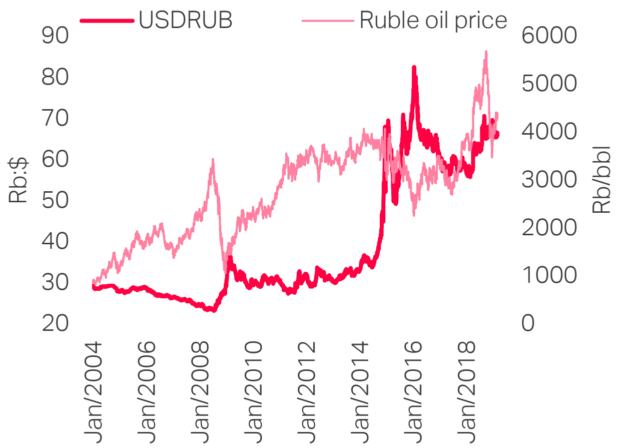
Oil and gas

The Norwegian GPFG's announcement on Friday of a $7.5bn reduction in its oil and gas holdings provides a timely prompt to assess the outlook for Russian oil and gas stocks. It is not that this decision by Norway's sovereign wealth fund is a powerful standalone driver for the Russian market. It turns out that vertically integrated companies escape the Norwegian cull on grounds of relative environmental impact. So the only Russian blue chip on the divestment list is Novatek. The downward pressure on the company's share price from GPFG off-loading its position – around $150mn-worth of stock (0.3% of the company's present market capitalization) – should be absorbed without causing excessive turbulence.

The negative story does not end with this Norwegian move, however. An optimal combination of top-down drivers underlay last year's impressive outperformance of Russian oil and gas stocks relative to the rest of the Russian market shown in the chart above. The mix of a high global oil price and weak ruble (hence an even higher oil price in ruble terms) was perfect for earnings.

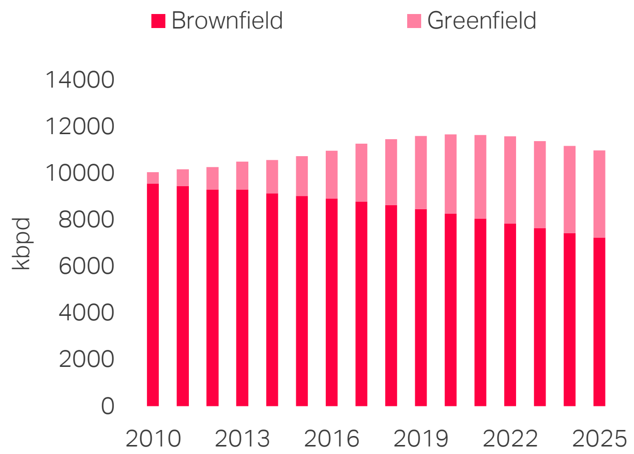
- **The favourable exchange rate trend is over.** This was a feature of the whole year thanks to the introduction in early 2018 of a change in the formula for determining the scale of the FX market interventions under the fiscal rule (FXFR). That change almost doubled the extent to which FXFR strips out the effect of a higher oil price in strengthening the ruble. The ruble then weakened further on the back of the US sanctions shock in April 2018 – and the threat unveiled in August of yet more serious sanctions. An important detail is that neither of those sanctions hits directly targeted the oil sector (in the frame instead were first Rusal and then sovereign debt and state banks).
- **As for last year's high oil price story, it did not even entail volume sacrifices.** On the contrary, the high oil price held up – at least until the December sell-off – despite the decision of OPEC+ last June to lift its output restraint first introduced in November 2016. Rising oil output was therefore the main contributor to Russia's overall industrial production growth last year.

Rb/$ exchange rate and ruble oil price



Source: Bloomberg

Crude output: actual and forecast



Source: TS Lombard estimates

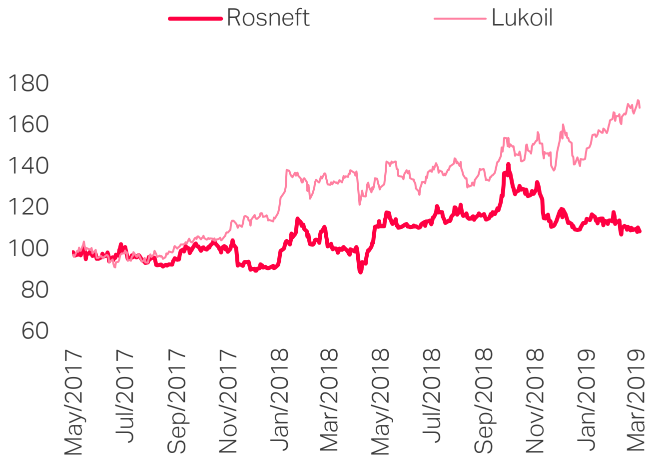
All those positive factors are now slipping away.

- **The global slowdown and buoyant US shale oil output has already depressed the oil price** and makes it unlikely that in Q2/19 OPEC+ will reverse its renewed output restraint announced last December. The negative base effect for Russian oil production will therefore kick in from mid-year.
- **Meanwhile, the ruble will not be so helpful.** Already sharply down from last year's record peak of Rb5,600/bbl, the ruble oil price is therefore unlikely to regain those heights (see left-hand chart above). The above-mentioned change in the FXFR formula a year ago was a one-off boost. True, the FXFR volumes held over from the last months of 2018 are now being executed to the tune of Rb2.8bn per day over the next three years. But the ruble would have been much weaker – i.e. advantageous for the oil companies – than it is now had that the programmed $33bn been purchased on schedule in August –December 2018 (the delay was designed to cushion the turbulence caused by the latest US sanctions threat). In any case, these catch-up FXFR operations would most likely be paused again in the event of renewed heightened volatility on the back of sanctions.
- **On this sanctions subject, the new US sanctions bill, unlike last August's draft, has the oil and gas sector in its sights.** The practical effect of the proposed ban on US persons investing in Russian oil projects would be limited since existing projects are excluded. Nevertheless, the progress of this bill through Congress will probably weigh on market sentiment on Russian oil stocks. A relevant factor here is the medium-term prospect of higher capex being required to support output. Last year's output increase merely tapped already available volume growth potential based on capex carried out by the middle of this decade; but, as shown in the right-hand chart above, this ready-made potential will be peaking next year. New US sanctions targeting the oil and gas sector would not halt the sector's development, but would probably nudge up its cost of capital.

Another new target in the latest US sanctions bill is Russia's new LNG export business – competing with the US. As we pointed out in our recent detailed analysis of this bill, Novatek is therefore in the frame. Its status as the market favourite – with a premium valuation relative to its Russian peers – is well deserved what with good corporate governance, the partnership with Total in the LNG business, and the successful launch of the Yamal LNG project. At the same time, this makes the stock seem more precarious in the face of the new sanctions threat. The Russian government would likely fill any sanctions-driven gap in the financing of Novatek's investments in its LNG export operations outside Russia (Norway and Germany being the most sanctions-sensitive locations) – which are the specific target of the new sanctions bill. Once again, however, this sanctions prospect does not look good for sentiment.

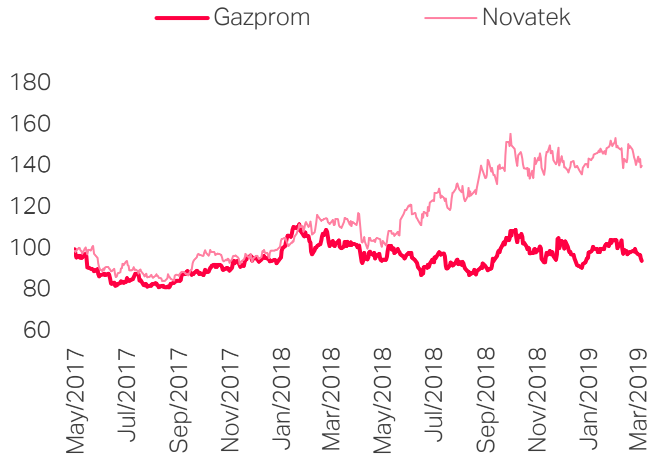
This negative outlook for the main top-down drivers of oil and gas companies' share price performance could be offset in specific cases by improved corporate governance. The power of the corporate governance driver is exemplified by the market valuing Lukoil on a par with Rosneft despite its crude oil output being less than half Rosneft's. Lukoil's shares should remain in demand thanks to the company's signal last week that it was planning a further share buy-back to follow on from the existing $3bn programme due to be completed next year. This news briefly pushed Lukoil's market cap above that of Rosneft, and the company had also pleased the market by announcing the prompt cancellation of the repurchased shares, thereby enhancing the future dividend outlook.

Lukoil vs Rosneft share price since May 2017



Source: Bloomberg

Novatek vs Gazprom share price since May 2017



Source: Bloomberg

While Lukoil should therefore maintain its lead over Rosneft, this same corporate governance driver could help Gazprom close the gap with Novatek. These relative share price performance stories are captured in the charts above. The upside in Gazprom's case is that it is one of the few hold-out SOEs that, until now, have managed to avoid compliance with the government's 50% dividend pay-out ratio norm. That resistance will continue to be beaten down this year and next. Brightening dividend prospects at Gazprom depend not only on government pressure (which is always up against Gazprom's lobbying clout), but also on the impending completion of the company's major pipeline projects – Power of Siberia, Turkstream and Nordstream-2. New government initiatives to tighten control of SOE capex should also be good for shareholder value. Finally, Increased exposure to Gazprom makes sense given the increasing share of gas in global energy consumption (good for specialized gas companies) and the chance during this political cycle of more radical – and value-enhancing – restructuring of the company through export liberalization and the unbundling of its businesses.

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