Petroleum Industry of Serbia (NIIS)

The Petroleum Industry of Serbia (NIS) posted record business results in the first three months, primarily due to the continued upward trend in crude oil price, which reached levels last seen during the global financial crisis. A stellar financial result would have been even better if the state had not approached regulating fuel prices after the start of the Russian-Ukrainian war which further escalated retail prices of oil derivatives.

June, 9th, 2022

Financial results

RSD 000	Q1 2021	Q1 2022	change
Revenues	48.178.285	98.034.987	103,48%
EBITDA	9.358.475	25.375.547	171,15%
margin	*19,42%*	*25,88%*	
EBIT	3.084.859	19.015.531	516,41%
margin	*6,40%*	*19,40%*	
Net income	1.525.429	15.640.145	925,29%

In Q1, NIS doubled its revenues to RSD 98.0b, predominantly due to a 67% jump in the crude oil price and an increase of 23% in sales volume. EBITDA bounced 2.7x to RSD 25.4bn with a margin of 25.9%, a record level in the 1Q, due to the upward trend in crude oil price. A record level of EBITDA came equally distributed among downstream (research and production) and upstream (processing and marketing) segments. Net profit was RSD 15.6bn (10.3x growth), partly due to a slowdown in the increase of depreciation expenses.

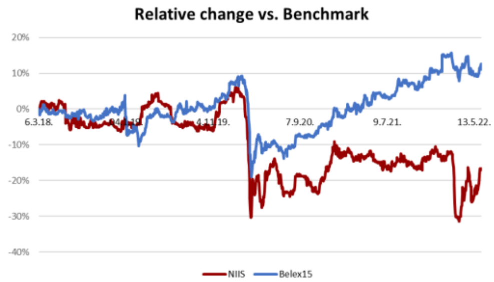
¤ **Operating results** – Domestic oil and gas production, supported by elevated crude oil price, were retained at last year's level of 292.1th, following a downward trend for a while. Refining reached 904.9th tonnes (+20%), while sales volume increased 23% to 958.6th tonnes, almost equally distributed among retail and wholesale.

¤ **Sanctions** – Given the majority of the ownership was a Russian state-owned company, NIS faced potential EU sanctions over the supply of crude oil through the Adriatic pipeline. The threat, which could have come into force on May 15th, led to a change in the company s ownership – Gazprom Neft lowered its stake to 50%. The new package of sanctions, however, will prevent Russian crude oil imports from December 1st, and the decision will affect the company certainly since Russian crude oil on the market is cheaper than alternatives. Last year, Rafinerija Pančevo processed only 16% of Russian crude oil, but because of a more favorable price mix, its percentage of total imports this year increased significantly.

Share price		597 RSD
Change	3m	19,40%
	12m	-1,81%

RSDbn

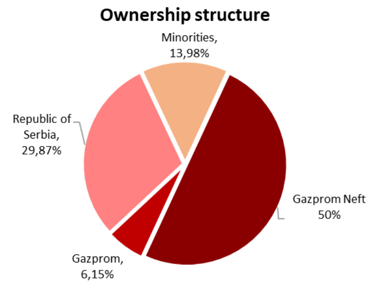
Size	Q1 2022	2022e
Capitalization	97,3	-
Enerprise Value (EV)	143,8	135,7



Valuation	Q1 2022	2022e
P/E	2,76	2,49
EV/EBITDA	2,08	1,73
P/S	0,28	0,25
P/B	0,35	0,35
Net debt/EBITDA	0,77	0,52

u RSD

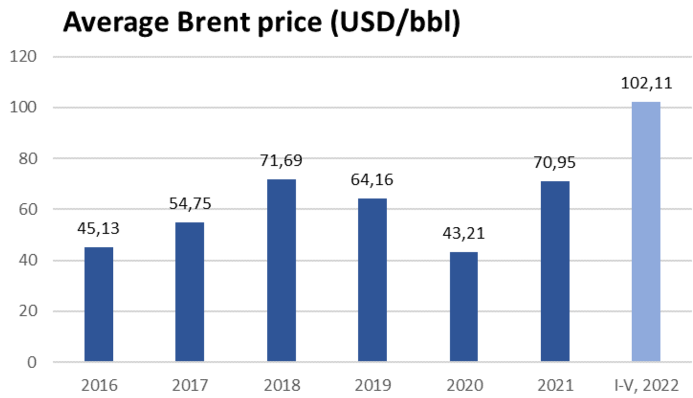
Dividend policy	2021	2022e
Dividend per share	35,46	59,95
Yield	5,94%	10,04%
Payout ratio	25,00%	25,00%



¤ **Ownership structure -** To prevent the suspension of crude oil imports, Gazprom bought a 6.15% stake of the company on May 6th on the Belgrade Stock Exchange from Gazprom Neft, lowering the stake of its dependent company to 50%. The transaction was worth RSD 7.2bn and executed at an RSD 717 level. Although this transaction only makes cosmetic changes to the ownership structure, the company's board expects that this will not only potentially avoid new sanctions but neutralize some business restrictions, primarily the one on funding that has been in place since 2015.

¤ **Dividend** – After the company paid a tiny dividend of RSD 6.14 per share to the shareholders last year, the management returned this year to the traditional dividend policy under which the company pays dividends in the amount of 25% of its unconsolidated profits. The company recommended a dividend of RSD 35.46 per share (dividend yield of 6%), while a dividend day was determined to be June 19th. The AGM, where this proposal is likely to be approved, will be held on June 29th. The parent company, Gazprom, has continued its dividend policy of paying half of its profits in dividends and announced a record payout in the company's history this year. There is still no indication that this could be the case with NIS.

¤ **Crude oil** - The price of crude oil posted a strong recovery in Q1, continuously trending upwards. The average price of Brent in Q1 was USD 101,4/bbl, up 67% year-on-year. The average price of Brent during Q2 kept rising and was 10% above Q1 levels. The main incentives for a rise in crude oil prices are the continuation of the Russian-Ukrainian war and the consequential decisions arising from this conflict - EU sanctions on Russian crude oil imports, as well as speculation about Russia's exclusion from OPEC+. The International Energy Agency (IEA) expects global demand to increase by just 1.8 mb/d (million barrels per day) to 99.4 mb/d this year due to expected slower economic growth than expected and inflated prices. If these forecasts come true, global demand for crude oil will not reach pre-pandemic levels in 2022 (99.8mb/d in 2019).



¤ **Outlook, valuation –** Unless some extreme business restrictions occur, the company should achieve its best financial results this year since just before the oil crisis erupted in 2014-2015. The crude oil price at that point was over USD 100/bbl, so the company used domestic crude oil to refine at the Rafinerija Pančevo much more. The stock is trading now at an expected PE ratio of 2.5x, the lowest valuation since the company went public at the end of August 2010. This valuation accounts for the current geopolitical risks that escalated with the war, even though they were present before, making it difficult for the company to trade at higher multiples. The importance of geopolitics in the company's market valuation has also brought to light a potential scenario that would suit minority shareholders - the possible resale of the company by the majority owner. Although the chances of such a move by Gazprom remain thin, this scenario is mentioned more frequently in the current year through media speculation and informal announcements by domestic state officials. A possible sale of the company would mean achieving a much higher market capitalization that would probably not be below the book value of EUR 2.3-2.4bn (about RSD 1,700 per share) at which investment multiples remain attractive (PE of 7.1x and EV/EBITDA of 4.9x). It is worth noting that the likelihood of such an outcome remains low, especially in conditions where the war in Ukraine is still active.

When we talk about the usual limitations in the valuation of the company, the lack of liquidity of the stock remained a huge obstacle to achieving its higher market value. The domestic pension funds have been the biggest stock buyers for many years, but they are facing regulatory restrictions on further purchases due to their large stakes. Therefore, it is no surprise average daily turnover of just RSD 2.3m this year, despite the relatively high volatility in trading due to the outbreak of war. This limiting factor is the main obstacle to the arrival of potentially large investors who could be interested in attractive valuations and a higher future dividend that could yield around 10% without any increase in the payout ratio. When it comes to the potential buyback plan, which is the common practice of global oil companies, this may be a surprising factor in "leveling out" its market value, regardless of the fact current stock price is lower than at the moment of privatization of the company. However, this move seems very unlikely considering the behavior of the current management.