Lukoil: A Pricing

A couple of weeks ago, I valued Lukoil using a DCF model and arrived at a value just above $42, a few dollars below the stock price of $47 at the time of the analysis. The drop in oil prices has ravaged not just Lukoil's numbers but has made dents in the pricing and profitability of all oil companies. To get a measure of whether Lukoil is under or over priced, relative to other oil companies, I took a look at the data.

Defining comparable firms

The first step in the pricing was making a judgment of who to compare Lukoil to, with choices ranging from the very narrow (just Russian energy companies) to very broad (all energy companies). Even if you narrow your search to just integrated oil companies, which is where Lukoil would be grouped, the choices yield very different sample sizes.

Finding a multiple

As with any standardized pricing measure, there are two broad choices to make.

1. The first is whether to focus on market capitalization (market value of equity) or on enterprise value. Given the large differences in debt ratios across the companies in the sample, the latter may be more meaningful than the former.
2. The second is what to scale the market value (of equity or the enterprise) to, with revenues, measures of earnings (EBIT, net income) and measures of accounting value (book value of equity, invested capital) all possible choices from the accounting statements. You could also scale the enterprise value to proven reserves or even barrels of production (annual).

The most simplistic pricing approach is to look at Lukoil, relative to the comparable companies, on each of these multiples (with median values for the emerging and global oil companies and the average values for the Russian companies)"

	Lukoil	*Russian Oil*	*Emerging Oil*	*Global Oil*
Sample Size		4	21	40
PE	7.89	5.30	11.09	15.75

Price to Book	0.46	0.47	1.23	1.23
EV to Sales	0.33	0.57	0.95	1.01
EV/EBITDA	2.71	2.53	4.56	4.89
EV/EBIT	5.44	3.88	9.21	9.46
EV/Invested Capital	0.52	0.47	1.15	1.19
EV/Barrel of Proven Reserves	3.53	5.20	16.77	25.09

Lukoil looks under valued on every multiple, relative to emerging market and global oil companies. Relative to the three other Russian companies, it looks expensive on a PE and EV/EBIT ratio basis, cheap as a multiple of proven reserves and similar on the other multiples.

Controlling for differences

When comparing multiples, you have to control for differences in profitability, growth and risk, and with oil companies, this comparison becomes tricky. I look at the accounting returns for companies (as a proxy for profitability) and debt ratios (as a measure of risk) and compare Lukoil to the comparable firms:

	Lukoil	*Russian Oil*	*Emerging Oil*	*Global Oil*
ROE	5.85%	9.14%	8.56%	6.75%
Pre-tax ROIC	9.59%	12.57%	11.35%	11.61%
Debt/Capital (Market)	26.55%	28.16%	28.13%	29.59%
Debt/EBITDA	0.26	0.57	0.85	0.86
Interest coverage ratio	13.76	26.40	6.83	10.11

This does muddy the waters a bit, since Lukoil is less profitable than any of the other groups, while also being less levered. Put differently, if the market is focused on profitability, at least as measured on accounting returns, Lukoil should trade at a discount but if it is concerned about financial leverage, it should trade at a premium. To examine how the market is pricing in profitability and leverage, we looked at the correlation of pricing multiples with profitability and leverage measures (throwing in a dummy variable for emerging market companies, just in case that is a significant risk). The correlation matrix is below (with EV/Invested capital used as the multiple):

	EV/Invested Capital	*Pre-tax ROIC*	*Debt/Capital (Market)*	*Interest coverage ratio*	*Emerging Dummy*
EV/Invested Capital	1.0000	0.0510	-0.3780	0.1260	0.0980
Pre-tax ROIC		1.0000	-0.2750	0.1260	0.1630

Debt/Capital (Market)			1.0000	-0.2160	0.0330
Interest coverage ratio				1.0000	-0.2060
Emerging Dummy					1.0000

Red: Significant at 1% level   Green: Significant at the 5% level

Only one of the correlations is significant and it is with a debt measure. At least for the moment, the market seems to be primarily concerned about financial leverage, rewarding companies with lower debt ratio with higher multiples of invested capital. Neither the profitability measures nor whether the company is incorporated in an emerging market seems to matter much at this stage.

To bring financial leverage into the assessment, I ran a regression of EV/Invested Capital against debt to capital ratios:

EV/Invested Capital = 1.833 – 2.092 (Debt/Capital) R^2 = 50.8%

(19.04)   (6.42)

Plugging in Lukoil's debt ratio of 26.55% into this regression, we get a predicted EV/Invested Capital of 1.2776.

Lukoil's predicted EV/Invested Capital = 1.833 – 2.092 (.2655) = 1.2776

At its actual EV/Invested Capital of 0.52, it looks like an incredible bargain.

Caveats

There are two concerns that I outlined in my intrinsic valuation, that continue into the pricing.

- Country risk: There is the overlay of Russian country risk to contend with. As we can see, all four Russian oil companies are trading at huge discounts on global oil companies.
- Corporate governance risk: With Russian companies, there is a significant concern about corporate governance and what exactly a share in a company entitles you to.

I will not dismiss either concern, but I would argue that off all of the Russian companies, Lukoil is most insulated from country risk because the government's role is limited (relative to Gazprom and Rosneft) and its corporate governance, while leaving much to be desired, is golden by Russian standards.