

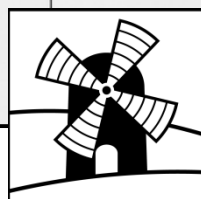
Naftna Industrija Srbije AD

BELEX:NIIS

Novi Sad, Serbia

Common Shares

RSD



**East Mill
Capital**

This report outlines the opinions of analysts covering the security listed above. A security snapshot is provided in the executive summary with an appropriate consensus rating.

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Executive Summary

Naftna Industrija Srbije AD (NIS) is one of the largest vertically integrated energy companies in Southeast Europe. Its principal activities are exploration, production and refining, sales and distribution of a broad range of petroleum products, as well as the implementation of energy projects. The head office of the Group is in Novi Sad, and its main production capacities are located all over the Republic of Serbia, which is, owing to its geographical position, the centre of trade and investments in the Balkans. Russian company Gazprom Neft owns 56.15 % of the share capital of NIS, while 29.87% of NIS shares are held by the Republic of Serbia. The remaining outstanding shares are attributed to citizens, employees, former employees and other minor shareholders. NIS shares are listed on the Belgrade Stock Exchange (BELEX).

The main activities of our company are exploration, production and refining, sales and distribution of a broad range of petroleum products, as well as the implementation of energy projects. The sales structure consists of export and domestic wholesale deliveries of crude, gas and petroleum products, as well as retail sales of finished petroleum products, liquefied petroleum gas and a series of related products. NIS owns the largest retail network in Serbia which has been expanding across the region since 2012.

Consensus:

East Mill Capital conducted a thorough research of Naftna Industrija Srbije AD in order to determine the potential value of an investment in its publicly traded shares. Based on our research we cannot with confidence declare a Buy rating currently for this company, and will not be making an immediate position. While NIS boasts several attractive traits of an investable company, there remain reporting issues, and inconsistencies within the information found by our team. Additionally, it has come to our attention that although NIS holds the largest market capitalisation within the energy sector of the Republic of Serbia – other players within the South Eastern European remain better placed in the market with competitive advantages.

At this time East Mill Capital will explore alternative positions.

Market Capitalization

Naftna Industrija Srbije AD is a company with the largest market capitalization on the Belgrade Stock Exchange. NIS' share capital amounts to 81,530,200,000.00 dinars and it is divided into 163,060,400 shares with face value of 500.00 dinars.

According to Coface (Compagnie Française d'Assurance pour le Commerce Extérieur) and their CEE Top 500, NIS was placed as 80th, which is a big improve from 2016. Coface analysis show a strong CEE region in expansion, with a reduction in risk in 2018.

As the region continued to grow, companies supported the macroeconomic environment in 2017, with the average GDP growth rate rising to its highest level in the past eight years to 4.5%, after 3.1% in 2016 and 3.7% in 2015. Coface forecasts show that it will remain firm at 4.1% in 2018.

According to the company, although social risk has risen in the last decade, the CEE region is far less risky than other emerging markets. The data indicates that political issues have not yet adversely affected CEE economies and companies. The inflow of foreign investments is still positive, and several large investments are already being realized in the region.

Profitability

Naftna Industrija Srbija A.D Income Statement	Six month period ended 30 June 2018	
	RSD 000's	USD 000's
Sales of petroleum products, oil and gas	104,167,164	1,014,924
Other revenues	6,564,204	63,957
Total Revenue from Sales	<u>110,731,368</u>	<u>1,078,881</u>
Purchase of oil, gas, and petroleum products	(62,013,711)	(604,214)
Production and manufacturing expenses	(12,721,200)	(123,946)
SGA	(10,305,449)	(100,408)
Transportation expenses	(563,342)	(5,489)
Depreciation, depletion, and amortization	(8,273,005)	(80,606)
Taxes & other income tax	(2,166,899)	(21,113)
Exploration expenses	(15,771)	(154)
Total Operating Expenses	<u>(96,059,377)</u>	<u>(935,928)</u>
Other income/(loss)	32,679	318
Gross Income	<u>14,704,670</u>	<u>143,271</u>
Net foreign exchange profit/(loss)	2,539	25
Finance income	819,884	7,988
Finance expenses	(1,120,506)	(10,917)
Total other income/(expense)	(298,083)	(2,904)
Pre-Tax Income	<u>14,406,587</u>	<u>140,367</u>
Current income tax expense	(1,066,672)	(10,393)
Deferred tax expense	(343,513)	(3,347)
Total Income Tax Expense	(1,410,185)	(13,740)
Net income per period	<u>12,996,402</u>	<u>126,627</u>

Assessing the company's income statement lends us insight into its profitability, which is at 12%. The highest expenses effecting the company's profitability remains the purchase of oil, gas, and petroleum products – which is subject to great volatility as the price of energy commodities has varied greatly during Q2 amidst oil market uncertainties.

Competitors

NIS, as it is, is already one of the biggest companies in Serbia, where they don't have big competition. Given that the NIS's mother company is Gazprom, we can reflect on their biggest competitors.

Gazprom has three biggest competitors (in order of disruption):

- BP plc (formerly The British Petroleum Company plc and BP Amoco plc)
- ConocoPhillips Company
- Valero Energy Corp.
- PJSC Lukoil Oil Company

BP is perceived as one of Gazprom's biggest rivals. BP was founded in 1908, and is headquartered in London, England. BP competes in the oil and gas exploration, and production sectors. BP has 393,400 fewer employees than Gazprom. ConocoPhillips. ConocoPhillips, an additional rival, that was founded in 1875 in Houston, Texas. ConocoPhillips operates in the Oil & Gas Exploration & Production industry. Due to the scale of operations needed to sustain competitiveness there is no threat of new entrants to the market.

NIS also competes on the domestic market with other petroleum product providers.

Croatian energy company INA d.d., Hungary's MOL Group, Austria's OMV, and Romanian OMV Petrom S.A are all major competitors within the domestic wholesale and retail markets. NIS still saw a 2% increase in domestic retail sales (consumer-automotive petroleum products) over competitors, and a 6% increase in wholesale sales.

NIS operates a total of 298 petrol stations across the region.¹ While the true number of petrol stations currently active in Serbia has not been determined by the government, which faces inefficiencies in estimating activities and distribution, a 2014 study conducted by the National Oil Committee and Organization of Serbian Oil Companies reports a total of 1186 full service gas stations. News agency "Blic" estimates that this number has grown rapidly to close to 2000.² In 2014, NIS held the dominant market share of 28% of gas stations (333 total in 2014).³

Regardless, of the validity of statistics published by all parties, the forward assumption remains that NIS continues to hold the largest market capitalization of full-service consumer gas stations in Serbia.

¹ <https://www.nispetrol.rs/sr-lat/kartica/nis-petrol-mapa-benzinskih-stanica>

² <https://www.blic.rs/vesti/u-srbiji-okolo-2000-pumpi/02yvwwh>

³ Nacionalni naftni komitet Srbije-WPC, Analiza tržišta derivate nafte Republike Srbije (2014)
<http://www.wpcserbia.rs/wp-content/uploads/studije/Studija.pdf>

Research Note: While it has been estimated by most media outlets and reporters that the number of full-service gas stations has increased over the past four years rapidly, totalling 2000. Major oil producers have failed to publish to public domain their total number of consumer facilities. NIS has been the only company to publish a comprehensive map of all stations amounting to 298. The assumption of rapid growth of consumer-service is not supported by evidence from NIS and the National Oil Committee study of 2014. It is important to outline that these discrepancies further contribute to the growing issues of availability of energy sector information in Serbia.

Valuation Multiples

NIS reported earnings per share of 165 RSD for 2017. However, given the latest financial report issued by NIS on June 30th, 2018 earnings per share were 79.70 RSD, with a trailing price to earnings ratio of 8.59.

Balance Sheet

NIS Naftna Industrija Srbije AD

Balance Sheet

June 30, 2018

RSD Million's

000s USD

Assets

Current Assets

Cash and Cash Equivalents	138,032.49	134,488.19
Short-term financial assets	123,343.71	120,176.58
Trade and other receivables	296,062.72	288,460.63
Inventories	322,059.92	313,790.29
Other Current Assets	55,475.64	54,051.18
Non-current assets held for sale	1.63	1.59
Total Current Assets	<u>934,976.11</u>	<u>910,968.45</u>

Non-Current Assets

PPE	2,474,379.78	2,410,844.39
Investment Property	15,605.72	15,205.01
Intangible Assets	26,823.27	26,134.52
Investments in Joint Ventures	10,388.00	10,121.26
Investment in Subsidiaries	134,255.86	130,808.53
Trade and other non-current receivables	28.34	27.61
Long-term financial assets	284,275.03	276,975.61
Deferred tax assets	18,576.10	18,099.12
Other non-current assets	28,799.61	28,060.11
Total Non-Current Assets	<u>2,993,131.71</u>	<u>2,916,276.17</u>
Total Assets	<u>3,928,107.82</u>	<u>3,827,244.62</u>

Liabilities

Current Liabilities

Short-term debt and current portion of long-term debt	82,875.74	80,747.71
Trade and other payables	285,847.42	278,507.63
Other current liabilities	48,060.82	46,826.75
Current income tax payable	2,777.17	2,705.86
Other taxes payable	104,096.64	101,423.72
Provisions	19,575.07	19,072.44
Total Current Liabilities	<u>543,232.86</u>	<u>529,284.11</u>

Non-Current Liabilities

Long Term Debt	845,674.46	823,959.82
Long Term Trade and other Payables	89.73	87.43

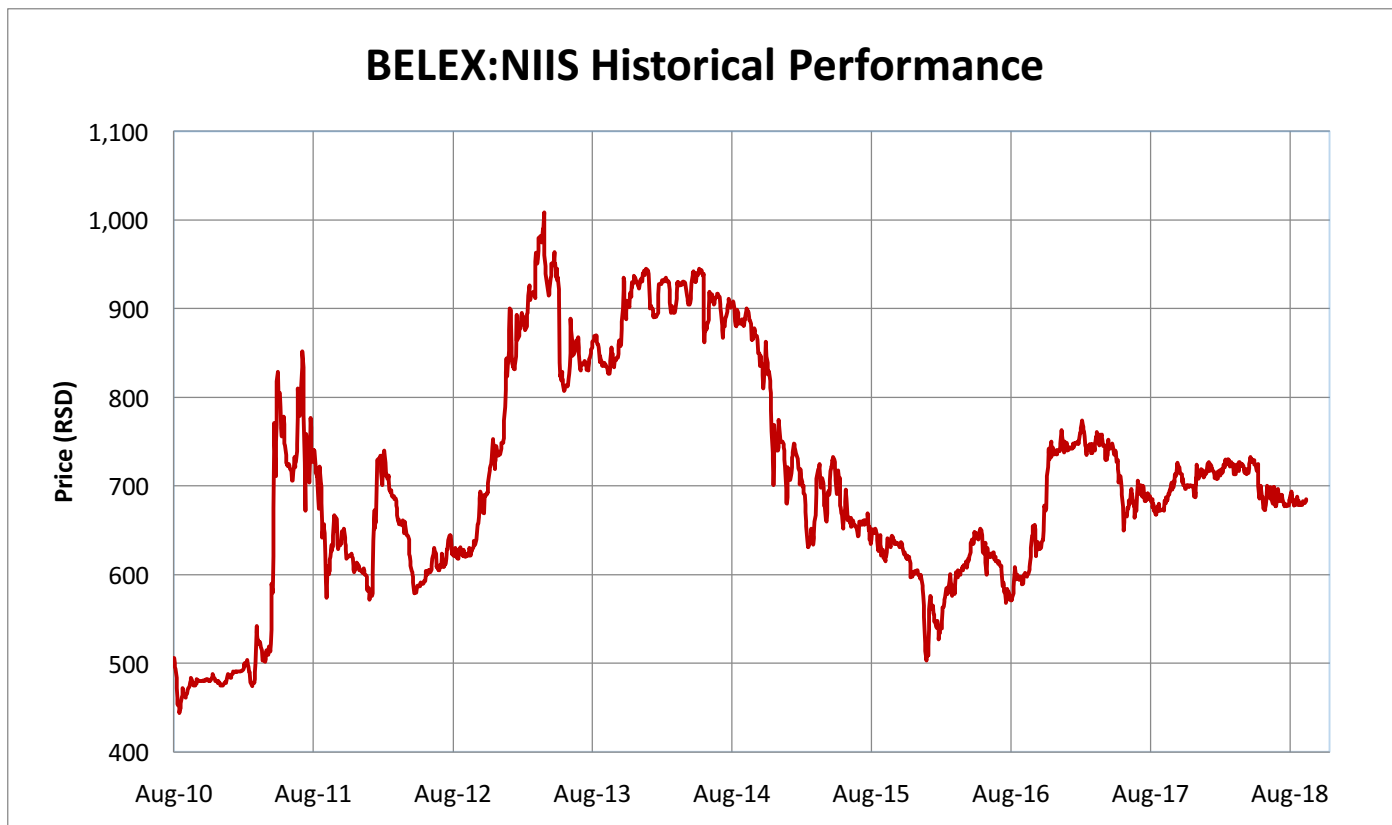
Provisions	97,565.76	95,060.53
Total Non-Current Liabilities	<u>943,329.95</u>	<u>919,107.78</u>
Total Liabilities	<u>1,486,562.81</u>	<u>1,448,391.89</u>
<u>Equity</u>		
Share Capital	815,302.00	794,367.25
Reserves	206.51	201.21
Retained Earnings	1,626,036.50	1,584,284.27
Total Equity	<u>2,441,545.01</u>	<u>2,378,852.73</u>
Total Liabilities and Equity	<u>3,928,107.82</u>	<u>3,827,244.62</u>

Examining the company's balance sheet shows a solid short-term business outlook, as the company is well placed to meet any of its short-term obligations. Additionally, the long-term outlook is stable, with a high proprietary ratio and low debt to equity ratio – suggesting that the company relies mostly on shareholder capital, rather than leveraging their operations through loans.

Current Ratio	1.72
Debt to Equity Ratio	0.61
Proprietary Ratio	0.62
Asset to Debt Ratio	2.64

Overall, NIS is good financial standing with no issues of immediate concern.

Historical Performance



NIIS shares have been trending between a 733 RSD YTD high in March, and 633 RSD YTD low in June.

The price action of the stock reflects investor uncertainty fading after the failure of the international joint venture lead by the Russian government and Gazprom to supply the European Union with natural resources, South Stream. The price continued to tumble during escalation of conflicts between Russia and Ukraine, the annexation of Crimea, and ultimately sanctions that put a complete halt on the project. The project has since been replaced by the TurkStream, which has no impact on Serbia aside from a secondary proposal, Tesla Pipeline, which has seen no progress. Currently the price action reflects only increasing sentiment for future company developments in refinery and additional processing plant construction scheduled to open in 2019.

The Company also increased their dividends in 2018 with the gross dividend per share currently marked at 42.61 RSD, yielding 6.2%.

General director of NIS, Kiril Tjurdenov, issued the following statement regarding performance: *"One of the basic goals of the Strategy of Development of NIS until 2025 is the creation of new values for the shareholders, our employees, and the community in which we do business. Positive financial results in 2017 enabled us to pay a significantly higher amount to the shareholders on behalf of the dividend than a year before. This year, we are focused on the development of strategic projects of NIS forming the basis of the future development and providing profitability in order to remain a safe source of income for our shareholders even in the challenging times".*⁴

⁴ <https://www.nis.eu/en/presscenter/nis-makes-dividend-payments-to-its-shareholders-totaling-nearly-7-billion-dinars>

Risks

Political Riskⁱ

The Republic of Serbia is still largely considered by many a post-war, post-communist country. It is important to note that although Serbia's economic outlook remains positive there remain risks associated with political authorities, corruption, and geopolitical issues. Serbia's status as a candidate to join the European Union remains debatable as tensions with neighbouring nations remain. The diplomatic status of Kosovo, and the relationship with the Russian Federation may also create market risk across the nation affecting the effective pricing of Serbian securities.

Equity Exchange Efficiency and Liquidity Risk

NIIS shares trade openly as a prime listing asset on the Belgrade Stock Exchange (BELEX). Emerging markets stock exchanges are often known for having problems in order execution and liquidity, with BELEX not exempt from these claims. The largest risk of this stock exchange is its underdeveloped liquidity and volume issues. Large positions are able to move the market price of the asset very easily, pushing the spread to larger differences than other markets. As a result, entrance into a position is expected to be filled at a higher price, and position exit may be difficult due to limited buying power of other market markers. Additionally, it is important to outline that due to volume and liquidity issues there is limited action within the price discovery process. Certain company development may not necessarily reflect immediately within the market price, making long-term asset-driven plays difficult for the market to effectively price-in. This often leaves securities largely mispriced, relatively undervalued, presenting investors with what traditionally are deemed good relative arbitrage opportunities. However, investors must be aware of the risk and opportunity cost associated with waiting for the market to price-in their discoveries.

Foreign Exchange Risk

Gazprom OAO engages in significant risk management and trading operations in order to combat the negative effects of the Russian Ruble volatility on NIS's resource importing operations. Shareholders of NIS must account for currency risk of the Serbian Dinar (RSD). Additionally, investors should note that the Serbian Dinar has showed signs of increased strength, higher money supply, and increased FDI in the region have pushed the currency to its pre-2015 levels. The USDRSD rate currently stands 101.51, with a strong low at ~94 earlier this year in March. The currency outlook of for RSD appears stable, with little cause for concern warranted by the Ruble.

Disclaimer:

East Mill Capital is an academic endeavour serving as a demonstrative tool in confirming the assumptions of the investment thesis.

Investment Thesis:

Select investments in public emerging markets equity and debt securities are able to yield outsized, risk-adjusted returns that outperform traditional western benchmarks.

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