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HEARD ON THE STREET

Gazprom Outlook Remains Bright Despite Politics

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MOSCOW -- Tarred as a tool in the Kremlin's drive for international influence, OAO Gazprom has politicians in Europe and the U.S. seeing red. But for many foreign investors, the Russian natural-gas giant brings to mind an altogether different color: green.

Gazprom stock is up about 70% this year after the Kremlin in January lifted restrictions that had prevented many foreigners from buying the 49% of the company that isn't government-owned. Gazprom's market value has overtaken **Royal Dutch Shell** PLC and **BP** PLC and, at $289 billion, is second only to **Exxon Mobil** Corp.'s among international energy companies. (It is the third-largest company in the world, behind Exxon and **General Electric** Co.)


Vladimir Putin

Money has poured in despite Gazprom's increasingly rough behavior with some of its biggest customers.

In January, the company cut off shipments to Ukraine in a price dispute, briefly reducing exports to Europe, where governments began to question Gazprom's reliability as a supplier for the first time in more than 30 years. In recent weeks, Gazprom officials, backed by Russian President Vladimir Putin, have publicly threatened to push into Asia, complaining that Europe, which gets a quarter of its gas from Russia, is trying to block Gazprom's efforts to expand.

The tough talk isn't scaring investors. Even after the surge so far this year, many are betting that things are just getting going.

"I think we're about to begin a new ride," says **Peter Halloran**, who runs **Pharos Financial Group**, a Moscow fund manager that is a big Gazprom holder. "Over the next year or two, 50% upside isn't unreasonable just based on fundamentals alone."

Gazprom bulls say it will take several more months before the company is found in more global stock portfolios. Gazprom's shares trade in Russia, as well as over the counter (not listed on any exchange) in the U.S. in the form of American depositary receipts, and in Europe. The ADR programs are still being expanded to make it easier for big institutions to hold the stock.

Rising Giant

The top four global oil companies by market value:

	2004 RESERVES billions of barrels of oil equivalent	2005 REVENUE in billions	NET INCOME in billions	MARKET CAP in billions
Exxon Mobil (U.S.)	60	$370.1	$36.1	$386.59
Gazprom (Russia)	117	45.9 (Est.)	17.8 (Est.)	289.96
BP (U.K.)	48	255.2	22.6	272.68
Royal Dutch Shell (U.K./Netherlands)	41	306.7	25.3	234.41

Sources: PFC Energy; Dow Jones Indexes; the companies

In trading Thursday in Moscow, Gazprom's shares, traded in dollars, rallied to $12.20, up 3%, ahead of the stock's increased weighting in Morgan Stanley Capital International's emerging-markets index.

Mr. Halloran and other Gazprom bulls insist that all the negative press over the past few months masks the company's true appeal: It has more gas in the ground than anyone else, just when the world is turning increasingly to the clean-burning fuel. Unlike other international majors, which are scrambling around the world to find new reserves to replace the oil and gas they pump every year, Gazprom has enough gas in the ground to last for decades. It also has a portfolio of big new projects to bring more of that fuel to market, say backers.

With Gazprom, "you have this growth story you cannot support in Exxon and BP," says Sergei Glaser, director of Vostok Nafta, a Stockholm-based investment group with about 90% of its $4 billion in assets in Gazprom.

The government influence on the company -- Mr. Putin is regularly involved in major decisions and the board is packed with government officials -- is a positive, fans say, since maximizing the share price seems to be a Kremlin priority.

When Gazprom last week overtook BP for the No. 2 slot among international energy companies, Mr. Putin himself touted the news to a visiting delegation of German officials. Gazprom's deputy chief executive, meanwhile, said the company's market value could hit $300 billion soon and predicted $1 trillion "wouldn't be unimaginable."

Critics of the stock say that kind of gigantism is typical of a company that started out as the Soviet Ministry of Gas and has struggled since to adapt to the ways of the market. They say the market discounts Gazprom's vast reserves because two-thirds of its production is sold on the domestic market and to other former Soviet countries at prices that barely cover Gazprom's bloated production costs. Combined with rising needs for capital spending to make up for falling output at aging fields and its huge pipeline network, that depresses profits.

Valued on an earnings basis, Gazprom is actually trading at a premium to majors like Exxon. Gazprom trades at about 14 times expected 2006 per-share earnings, slightly richer than the 11 times for Exxon.

"If you're a fundamentalist, then it's screamingly expensive against all global peers," says Martin Taylor, a fund manager at Thames River in London who says he's "neutral" on the stock. "Gazprom isn't being run for shareholders; it's being run for the government."

Even Gazprom advocates admit that restructuring at the company -- which saw the management team Mr. Putin installed in 2001 repair major holes in the company's balance sheet and cost performance -- could slow now.

"The major difference now is that the stock is pricing in some good news for the first time in its history, and the management will have to deliver," says William Browder, president of Hermitage Capital Management, which has assets of about $4 billion, with Gazprom its largest holding.

Some analysts question how committed the Kremlin is to further corporate improvement. Mr. Browder, who became one of Russia's best-known foreign investors by crusading against mismanagement and waste at companies including Gazprom, had his visa revoked in November and hasn't been able to get into Russia since, despite intervention by Western and Russian officials. Critics also worry that this year's rally could mean that the Russian stock market is ripe for a pullback.

Gazprom also has little incentive to radically cut costs as long as domestic prices are regulated far below world-market levels, since that would undermine its efforts to lobby for higher rates, analysts say.

But bulls on the stock note that the conflict with Ukraine, while it generated criticism for Gazprom, could actually help its financial performance since it was part of a broader drive by the company, backed by the Kremlin, to end the practice of selling gas at a discount to Russia's former Soviet neighbors. Mr. Browder calculates that bringing those prices to world levels could add nearly $6 billion a year to Gazprom's net income.

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