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JKX Oil & Gas Plc

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Refocusing on fundamentals

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Shares are down... but the story remains the same

The largest independent foreign producer of oil & gas within Ukraine, JKX is also the only foreign owned company to hold a 100% stake in its key producing asset. However, after rising and then falling sharply in recent months on sparse newsflow, we consider the stock to offer a clear value opportunity.

Opportunity to get an update on Ukraine's gas market evolution

JKX report H1-06 earnings on Tuesday 26th September and we expect the figures to highlight the continuing momentum of Ukraine's rapidly evolving gas price environment, and provide an opportunity for management to update the market on gas prices post Turkmenistan's recent price increase to Russia.

Share price down... but environment improved!

JKX's shares began 2006 at 248p, but after rising to 435p they fell to a 255p low in mid-September. Detailed analysis suggests that rather than weakening, gas price momentum has continued – realizations rising 38% across H1. Further upside should come as Ukraine moves into the winter and recent Turkmen gas price increases begin to bite. In the face of higher energy costs, Ukraine's government has proposed corporate tax cuts in an effort to maintain economic growth.

Valuation and Risk

JKX is valued using NAV analysis, underlain by DB's price deck, a standard 10% discount rate and a detailed review of portfolio technical risk. Total NAV equals 380p/share, a 34% premium to the current share price. We would expect the momentum-led E&P sector to trade at a premium to total NAV, and reflecting the leverage derived from exploration, our 385p/share target price is derived using total NAV adding 7.5% of the company's de-risked value. Risks include slowing of Ukrainian gas price increases and continued declines in group reserve life.

Recommendation

We consider JKX to offer a clear value opportunity; we rate the shares **Buy**.

Forecasts and ratios					
Year End Dec 31	2004A	2005A	2006E	2007E	2008E
DB PBT (USDm)	23	51	110	138	145
DB Net income (USDm)	19	37	76	103	109
DB EPS (USD)	0.1	0.2	0.5	0.7	0.7
DB EPS growth (%)	–	86.7	104.5	36.1	5.4
P/E (x)	14.1	13.0	11.3	8.3	7.9
DPS (USD)	0.01	0.02	0.02	0.02	0.02
Dividend Yield (%)	0.6	0.7	0.4	0.4	0.4
Oil & Gas Prod. (kboe/d)	8.0	9.4	11.1	13.0	14.5

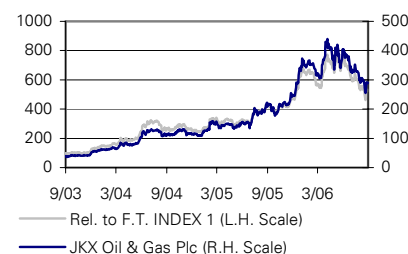
Source: Deutsche Bank estimates, company data

Company Review

Buy

Price at 20 Sep 2006 (GBP)	289.00
Price Target (GBP)	385.00
52-week range (GBP)	440.00 - 177.50

Price/price relative



Performance (%)	1m	3m	12m
Absolute	-8.3	-28.5	30.8
F.T. INDEX 100	-0.6	3.7	8.3

Stock data

Market cap (GBP)(m)	428.7
Shares outstanding (m)	157
Free float (%)	100
F.T. INDEX 100	5,866.2

Deutsche Bank AG/London

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DISCLOSURES AND ANALYST CERTIFICATIONS ARE LOCATED IN APPENDIX 1

Refocusing on fundamentals

JKC announce H1-06 results on 26th September at 7.00am. We expect the group to report clean net income of USD29m, underlain by an operating profit of USD40m.

Operational issues to watch for

- Relative to H2-05, volumes are expected to be slightly down, falling from 11.1kboe/d to 10.5kboe/d, reflecting a forecast decline in crude within the group's production mix.
- Offsetting this is a continued rise in Ukrainian gas prices which we forecast to have risen from USD1.75/mcf to USD2.69/mcf, realized prices currently resting at USD2.98/mcf.
- Since June, JKC has signed a gas sales contract with Shell and issued a number of drilling updates.

Current significant newsflow

- In Ukraine, debate is currently focused on Turkmenistan's recent 54% upward revision of its gas prices to Russia and the expected knock on impact to Ukraine, and the slower than normal seasonal build of gas storage.
- Recent elections have brought a renewed political stability to Ukraine, which should speed decision making and could re-open debate surrounding upstream privatizations.
- Ukraine's finance minister has outlined plans to reduce the country's corporate tax rate from 25% to 20%. The most likely enactment date would be during 2008.

Valuation, risk and recommendation

We value JKC using NAV analysis, underlain by DB's price deck, a standard 10% discount rate and a detailed review of portfolio technical risk. Total NAV equals 380p/share, but the shares currently trade closer to our core NAV of 294p/share. Risks include slowing of Ukrainian gas price increases and continued declines in the group's reserve life.

After rising dramatically following Russia's forced renegotiation of delivered gas prices to Ukraine, JKC's shares lost all the ground gained. In the last week, the stock has rebounded, and currently trades around the group's core NAV. At these price levels the shares look inexpensive and we reiterate our **Buy** recommendation.

We continue to recommend Buy, with a target price of 385p/share. Figure 1: JKC H1-06 summary P&L (USDm)

	H1-06e	H1-05	% chg	H2-05	%chg	FY-06	FY-05	% chg
Brent Oil Price (USD/bbl)	66.2	50.1	32%	59.4	11%	66.5	54.8	21%
Ukrainian gas price (USD/mcf)	2.7	1.8	54%	1.89	42%	3.1	1.9	68%
Production(kboe/d)	10.5	7.5	40%	11.1	-5%	11.1	9.3	20%
Turnover	60.5	23.8	155%	59.1	2%	146.1	82.9	76%
Production Cost & Taxes	-8.1	-4.8	68%	-11.4	-29%	-16.9	-16.3	4%
DD&A	-6.7	-2.7	151%	-7.0	-4%	-13.4	-9.7	39%
G&A Expenses	-6.0	-2.4	148%	-4.8	25%	-9.7	-7.2	35%
Operating Profit	39.8	14.1	182%	35.9	11%	106.1	50.0	112%
Net Interest	1.4	0.4	245%	0.9	61%	3.5	1.3	175%
PBT (Clean)	41.2	14.5	184%	36.8	12%	109.5	51.3	114%
Exceptionals	0.0	0.2	-100%	0.0		0.0	0.2	-100%
PBT (Reported)	41.2	14.7	180%	36.8	12%	109.5	51.5	113%
Taxation	-12.7	-3.7	243%	-10.4	22%	-33.7	-14.1	140%
Clean net income	28.5	10.9	162%	26.4	8%	75.8	37.3	103%
EPS - Clean fully diluted (p/share)	10.1	3.6	179%	9.5	6%	26.1	13.0	101%
DPS (p/share)	0.6	0.5	20%	0.6	0%	1.2	1.1	5%
Average No. of Share- Fully Diluted (m)	157.1	157.1	0%	157.1	0%	157.1	157.1	0%

Source: Deutsche Bank

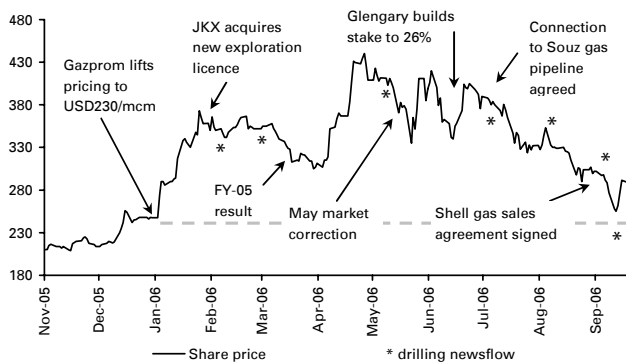
What other than the share price has changed?

After starting 2006 at 248p, JKC's shares raced ahead on news of Gazprom's forced renegotiation of delivered gas prices to Ukraine – Gazprom setting a price level of USD230/mcm, 250% above the 2005 average realised price.

However, after peaking on 24th March at 435p, the group's shares fell to a low of 255p on 12th September. Since then JKC has rallied, the stock currently trading around 2% below our 294p/share core NAV.

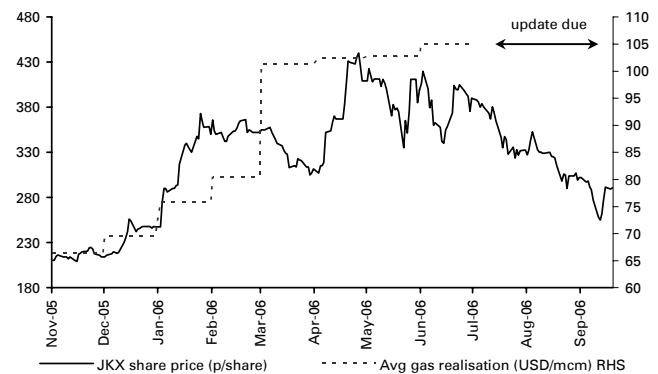
Between January and June, Ukrainian gas prices rose 38%, as domestic gas demand continued to grow and foreign suppliers lifted the delivered price of their gas.

Figure 2: JKC newsflow since Nov-05



Source: Deutsche Bank, Datastream

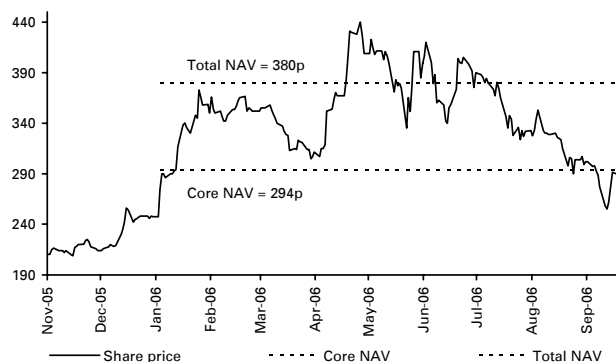
Figure 3: Ukrainian gas price evolution (USD/mcm)



Source: Deutsche Bank, Datastream, Naftogaz, Company data

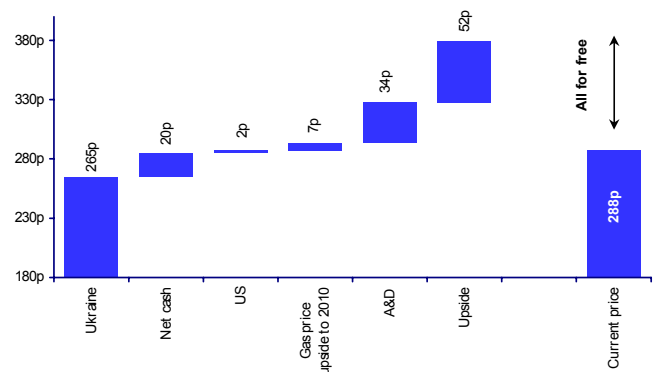
At current levels, under a conservative assumption that Ukraine's gas prices converge on Gazprom's USD230/mcm level by 2012, the group's shares discount the NPV of JKC's main producing asset (Poltava Petroleum Company) and the cash on the group's balance sheet – effectively offering a free option on any fiscal, operational or gas price upside.

Figure 4: Share price performance and NAV



Source: Deutsche Bank, Datastream

Figure 5: The value opportunity offered by JKC



Source: Deutsche Bank

On this basis, we believe that JKC offers a value opportunity, and in following pages we list a number of key factors which give us confidence in this assertion.

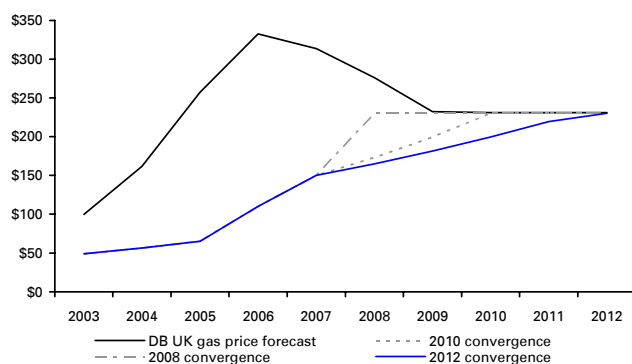
Gas price... 'Ukraine is ready to accept USD135/mcf in 2007'

Ukraine's domestic gas price averaged USD65/mcm during 2005, prices having risen at a CAGR of 16% between 2000 and 2005. Looking forward our forecast rises to average USD110/mcm across 2006.

Ukraine's Minister of Finance has indicated that the government is ready to accept a gas price of USD135/mcm (at the Ukrainian boarder) in 2007. He also indicated that the government had worked into its 2007 budget a USD600m cushion (USD10.5/mcm) in case gas prices turn out to be higher.

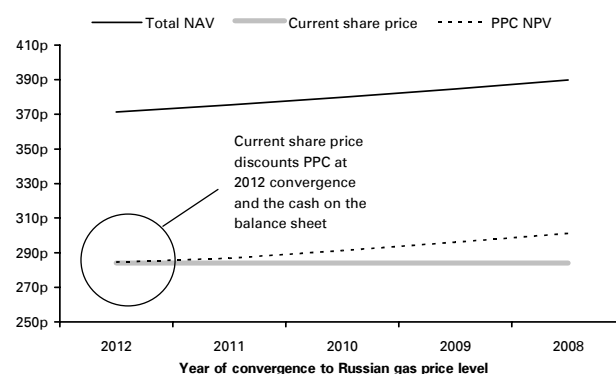
Our forecasts assume an '07 average level of USD150/mcm, before growth slows to a more conservative 10% per year, converging to USD230/mcm in 2012 - the slowing growth profile post 2007 reflects a belief that Ukraine's economy cannot endure such rapid rises in energy costs without a negative economic response.

Figure 6: Convergence between DB gas price and JKC realization assumptions (USD/mcm)



Source: Deutsche Bank, Naftogaz, Company data

Figure 7: Impact of pricing scenarios on JKC NAV



Source: Deutsche Bank

Across H1-06 Ukrainian gas prices averaged cUSD95/mcm, reaching USD105/mcm by the start of June. At this level, although prices have risen dramatically, they remain 54% below the levels set by Gazprom, and this has been achieved by substituting considerable volumes of Russian gas for cheaper Turkmen volumes.

However, the week before last, Turkmenistan lifted its gas price from USD65/mcm to USD100/mcm, and the impact of this move is yet to feed through into Ukraine's domestic prices.

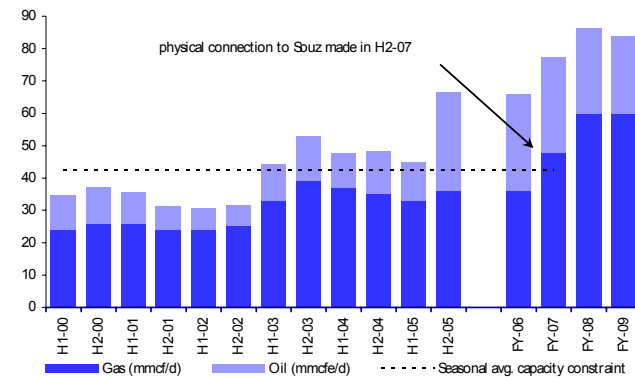
Our base gas price progression forms the lowermost line in the spread of pricing scenarios displayed in the figure above left. Under this scenario, JKC's current share price discounts the NPV of the group's main producing asset (Poltava Petroleum Company) and the cash on the group's balance sheet.

This means that those purchasing the group's shares today effectively get for free any fiscal, operational or gas price upside.

Production... rising to 60mmcf/d only when Soyuz is connected

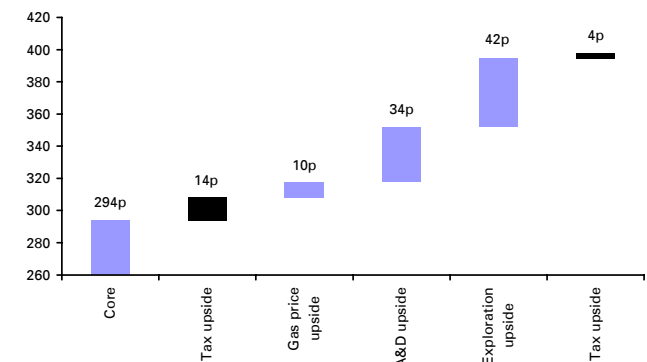
We forecast that JKY's FY-06 gas production will be flat on H2-05, oil dipping slightly, before ramping up across 2007/2008, peaking at c14,400boe/d – composed of c4,400bbl/d oil and c60mmcf/d of gas. To achieve this profile JKY must access new pipeline capacity and then deliver production increases from the Rudenkovskoye field in particular.

Figure 8: Ukrainian production assumptions and capacity constraint (mmcf/d)



Source: Deutsche Bank estimates

Figure 9: Potential impact of tax revisions to NAV



Source: Deutsche Bank estimates

The group received approval to connect to the Soyuz pipeline in late June this year, but our forecasts assume that a physical connection will not be made until H2-07. At this point we move production to 60mmcf/d.

Although once connected to Soyuz, JKY plans to lift peak processing capacity to 70mmcf/d, beyond 2007 we have prudently kept average production at a plateau of 60mmcf/d.

Longer term fiscal changes... tax cuts ahead?

As Ukraine effectively becomes a gas price taker, the government is clearly focused on the impact which higher energy costs could have on the country's economic growth.

In response to this, Ukraine's finance minister has outlined plans to reduce the country's corporate tax rate from 25% to 20% in 2008. If implemented, this will be the second such cut in the last five years.

This tax revision is not yet factored into our forecasts, we prefer to wait to see how the political discussions surrounding the proposal evolve. However, if it were, our 294p/share core NAV would rise to 308p, with our total NAV rising from 380p/share to 398p/share—ceteris paribus.

We suspect this is not yet factored into market expectations.

Other upside for free...

Having outlined our base pricing, volume and fiscal assumptions, the table below gives a detailed breakdown of our 380p/share total NAV.

The table below summarises our NAV calculation for JKC. Figure 10: Detailed NAV breakdown

	oil (mmbbl)	gas (bcf)	Total (mmboe)	NPV 10 (USDm)	NPV 10 (£m)	NPV (p/share)
Ukraine – PPC	16	244	57	770	416	265p
US	0	3	0	7	4	2p
Gas value upside - convergence in 2010				11	6	7p
	16	246	57	788	426	274p
Net cash				57	31	20p
				57	31	20p
Core NAV	16	246	57	845	457	294p
Appraisal & Development						
Re-booking upside	0	698	116	99	53	34p
Ukraine - Molchanovskoye oil upside	12	0	12	123	66	42p
	12	698	128	222	119	76p
Pricing upside						
Gas price upside - 2008 convergence				16	8	10p
				16	8	10p
Upside NAV	12	698	129	237	128	86p
Total NAV	28	944	186	1082	585	380p

Source: Deutsche Bank estimates

Over and above our 294p/share core NAV, we include three elements of upside:

- A 10p upside to reflect the impact of a faster pricing convergence to Russia's USD230/mcm level - equalization occurring in 2008.
- A 34p upside relating to the potential re-booking of a portion of the 116mmboe of un-risked 2P reserves which the group de-booked in 1999 following a technical/pricing review – our value risked with a 25% probability of success.
- A 42p upside relating to the potential discovery of oil-prone prospects similar to the M151/M152 discoveries which JKC made last year. We factor in c12mmbbl of reserves risked with a 50% probability of success – the higher NPV reflecting the disproportionate impact which oil reserves have of cash flow versus gas discoveries.

Finally, in August, Ukraine formed a new government under a union between President Viktor Yushchenko and prime minister Viktor Yanukovich. This government has introduced a considerably greater level of stability to Ukraine's politics relative to the country's recent turbulent past.

Although JKC's ongoing operations have largely been unaffected by this turbulence, licencing opportunities have slowed to a dribble, and we now hope that looking forward this stability could accelerate a process of privatisation of the state's oil & gas interests – a process which we believe JKC is well positioned to benefit from.

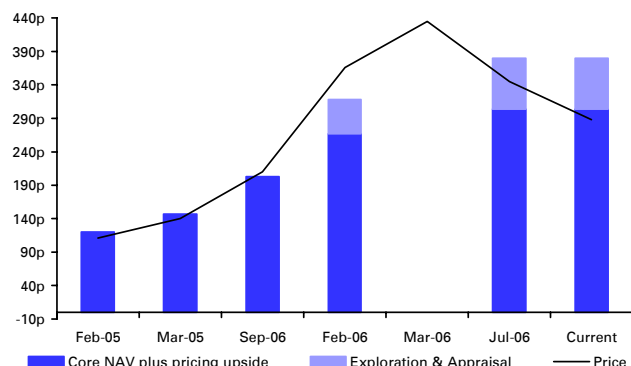
Our NAV includes no value for potentially significant upside within Georgia and Bulgaria where the group plans to drill wells in 2007/2008.

Conclusions and recommendation

After racing ahead on the back of Russia's imposed gas price rises at the start of the year, and then post May buoyed by Glengary's stake building, JKC's shares have been volatile both in terms of price and the volume of shares traded.

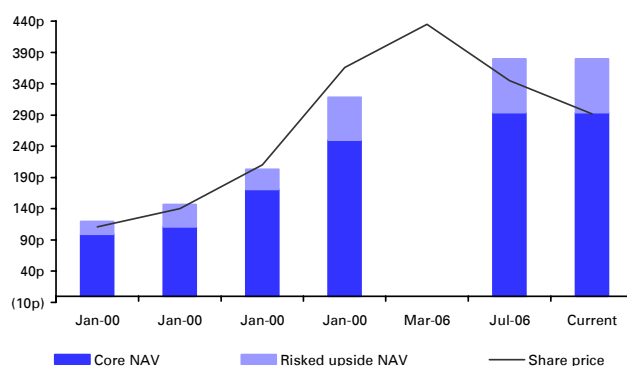
At current levels, the group's shares trade at a level which discounts only JKC's current production profile and balance sheet - a situation not seen since September 2005.

Figure 11: Evolution of JKC share price and NAV



Source: Deutsche Bank

Figure 12: Growth of exploration & appraisal in NAV



Source: Deutsche Bank

Weighing against the stock is the fact that JKC is unusual in that its drilling lends itself less to discreet newsflow events – the materiality of the production/reserves information emerging through cumulative drilling and testing activity.

However, JKC provides a unique opportunity to play Ukraine's rapidly evolving gas markets and at current levels investors buying the shares effectively receive a free option on any fiscal, operational or gas price upside which may emerge.

With this backdrop we believe JKC to offer a clear value opportunity and we recommend the shares with a **Buy** rating.

Figure 13: JKC summary P&L (USDm)

Year End: 31 December	2004	2005	2006e	2007e	2008e
Brent oil price (USD/bbl)	25.12	54.80	66.50	61.00	54.00
Ukrainian gas price (USD/mcf)	1.59	1.85	3.12	4.25	4.68
Production(kboe/d)	8.0	9.3	11.1	13.0	14.5
Ukraine	43.8	88.1	144.0	172.6	180.5
USA	0.0	0.1	2.0	2.4	1.8
Other	2.8	(5.3)	-	-	-
Turnover	46.6	82.9	146.1	175.0	182.4
Production Cost & Taxes	(13.7)	(16.3)	(16.9)	(18.7)	(19.0)
DD&A	(5.1)	(9.7)	(13.4)	(14.5)	(17.5)
G&A Expenses	(4.7)	(7.2)	(9.7)	(9.9)	(10.1)
Exploration Expenses	-	-	-	-	-
Other	0.3	0.2	-	-	-
Operating Profit	23.4	50.0	106.1	131.8	135.8
Other Income JV's & Associates					
Net Interest	0.0	1.3	3.5	5.9	8.9
PBT (Clean)	23.4	51.3	109.5	137.7	144.7
Exceptionals	0.3	0.2	-	-	-
PBT (Reported)	23.7	51.5	109.5	137.7	144.7
Taxation	(4.1)	(14.1)	(33.7)	(34.5)	(35.9)
Minorities & Preference Dividend	(0.1)	0.1	-	-	-
Clean net income	19.2	37.3	75.8	103.2	108.8
EPS – Reported fully diluted (p/share)	7.0	13.1	26.1	35.5	37.4
EPS -Clean fully diluted (p/share)	6.9	13.0	26.1	35.5	37.4
Cash EPS - fully diluted (p/share)	9.4	19.9	33.3	40.6	41.4
DPS (p/share)	0.6	1.1	1.2	1.2	1.3
Average No. of Share- Fully Diluted (m)	149.8	157.1	157.1	157.1	157.1

Source: Deutsche Bank estimates

Figure 14: JKC summary cash flow (USDm)

	2004	2005	2006e	2007e	2008e
Operating cash flow	28.7	69.3	117.1	146.1	146.5
Interest	0.1	0.7	3.5	5.9	8.9
Dividends from Associates & JV's					
Tax	(3.0)	(13.2)	(23.9)	(34.1)	(35.2)
Net Capex	(24.8)	(32.8)	(40.0)	(45.5)	(26.5)
Free Cash Flow	1.0	24.0	56.7	72.4	93.7
Dividends Paid	(1.3)	(2.2)	(3.3)	(3.4)	(3.6)
Cash Impact of Exceptionals					
Acquisitions & Disposals	-	-	-	-	-
Share Issues	25.7	(2.7)	-	-	-
Other Financial	(16.6)	16.3	-	-	-
Change in net debt	8.8	35.5	53.4	69.0	90.1

Source: Deutsche Bank estimates

Figure 15: JKC summary balance sheet (USDm)

	2004	2005	2006e	2007e	2008e
Intangible Fixed Assets	14.9	19.9	19.9	19.9	19.9
Tangible Fixed Assets	65.4	81.5	91.1	86.6	79.1
Net Working Capital	(0.8)	(6.8)	(4.4)	(4.2)	2.5
Assets Employed	79.5	94.6	106.5	102.2	101.5
Investments/Other Assets	3.1	1.6	1.6	1.6	1.6
Net Cash/(Debt)	21.5	56.9	110.3	179.3	269.4
Provisions & Other Liabilities (inc.	(3.7)	(4.8)	(3.4)	(3.4)	(3.4)
Net assets	100.3	148.3	215.0	279.7	369.0
Minority Interests	(0.1)	-	-	-	-

Source: Deutsche Bank estimates

Appendix 1

Important Disclosures

Additional information available upon request

Disclosure checklist

Company	Ticker	Recent price*	Disclosure
JKX Oil & Gas Plc	JKX.L	288.65 (GBp) 20 Sep 06	6

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Historical recommendations and target price: JKC Oil & Gas Plc (JKX.L)

(as of 20/09/2006)

Previous Recommendations

Strong Buy
Buy
Market Perform
Underperform
Not Rated
Suspended Rating

Current Recommendations

Buy
Hold
Sell
Not Rated
Suspended Rating

*New Recommendation Structure
as of September 9, 2002

1. 24/7/2006: Buy, Target Price Change GBP385.00

Equity rating key**Equity rating dispersion and banking relationships**

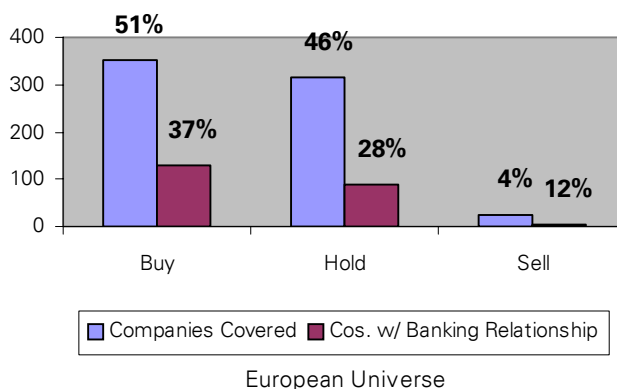
Buy: Expected total return (including dividends) of 10% or more over a 12-month period.

Hold: Expected total return (including dividends) between -10% and 10% over a 12-month period.

Sell: Expected total return (including dividends) of -10% or worse over a 12-month period.

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