Company Analysis
Naftna Industrija Srbije (NIIS)

Golden age for oil refiners

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Executive summary

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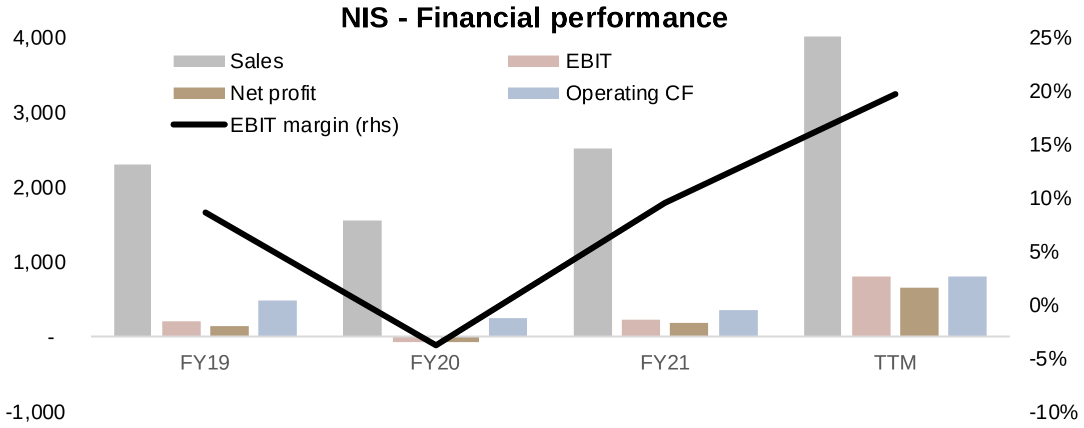

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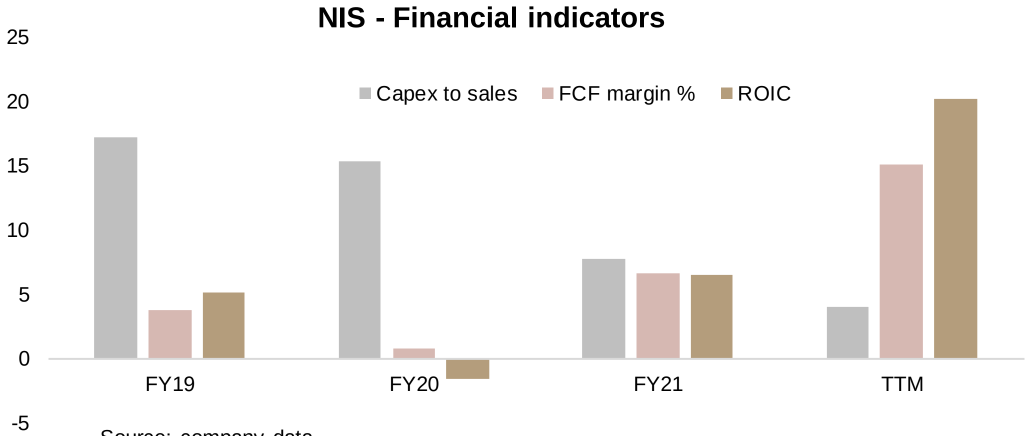

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NIS performance in the recent period was highlighted by stronger sales and profitability figures on the back of higher global oil prices. We see the latter somewhat lower on average for 2023, suggesting a drop in NIS' top and bottom line, however these key P&L elements will still remain strong. In terms of M&A activity, there is a potential for buyouts of smaller market participants in the retail segment, perhaps also in the neighbouring countries.

We are examining NIS as one of the key players in the energy sector in SEE. Similarly as with other refineries, the company's P&L is strongly correlated with crude oil prices. With the latter spiking, NIS' sales went up by 61% in 2021 and rose further in 2022. Aside from higher oil prices, increase of top line came on the back of strengthening of market position and increase in sold volumes. Aside from growing volumes and selling prices, NIS benefited from processing of cheaper crude oil inventories procured at lower oil prices, resulting in margin increases over the recent two years. Defying the negative effects of retail price caps and bans on import of Russian crude oil in late 2022, we nevertheless expect the **FY2022 to display record high financial results**.

In years until 2022, Upstream segment had a major share in profitability even with smaller portion in total revenues, The story was quite different in 2022, with **Downstream segment** becoming the **key contributor to the overall profitability** thanks to increase of sales prices, processing of cheaper stocks from previous period, more favourable procurement conditions (i.e. Russian oil) and better sales mix.

Looking for the stability of profitability in the upcoming years, we see a high dependence on growth of own resource base, which is confirmed by high capex invested in this segment – on average around 60% of total investments in period 2019-2021. **Average Capex to sales ratio of 13.4%** for the period of 2019-2021 is above values of regional peers. **For 2023, we expect continuance of strong investment activity, in both, Upstream and Downstream segment**, in line with the NIS' announcement of 100% higher capex in 2023 vs. 2022.

We believe that due to **significant improvement in operating cash flow in 2022,** NIS will be in a position to finance investments without raising debt. The planned level of capex is on the level recorded in 2018 and 2019, while profitability is much stronger. Despite expected **stronger appetite for distribution of dividends** (25% of net profit was regular practice in last 5 years except in 2020), which could be at the expense of the cash intended for capital expenditures, we still estimate low need for increase of debt in this respect. Apart from the acquisition of HIP Petrohemija which we see as a natural step to defend profitability, we believe that the energy segment with newly activated plant TE-TO could be the only segment with potential of sales growth.

Our mid-term outlook assumes a gradual reduction of crude oil prices and thus we see EBITDA margins falling ahead. Successful implementation of the named investments will act a major role in safekeeping EBITDA margins going forward.

Improving financials

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in 000 EUR	FY19	FY20	FY21	Δ (%)	9m21	9m22	Δ (%)
Sales	2,207,188	1,454,230	2,359,707	*62%*	1,593,964	3,093,261	*94%*
Other revenues	106,428	108,890	150,177	*38%*	108,539	144,812	*33%*
Total revenues	**2,313,617**	**1,563,120**	**2,509,884**	***61%***	**1,702,503**	**3,238,073**	***90%***
Cost of material and goods sold	-1,468,423	-975,528	-1,522,853	*56%*	-1,009,243	-1,867,708	*85%*
Production and manufacturing expenses	-199,545	-202,433	-239,119	*18%*	-169,294	-232,598	*37%*
SG&A expenses	-222,300	-207,557	-232,264	*12%*	-160,903	-175,499	*9%*
Depreciation and amortisation	-178,370	-193,928	-212,233	*9%*	-159,462	-163,630	*3%*
Taxes other than income tax	-44,283	-45,863	-56,356	*23%*	-38,608	-51,748	*34%*
Other expense/income - net	-6,873	2,287	-9,022	*-294%*	-346	-20,057	*5696%*
Operating income (EBIT)	**193,822**	**-59,901**	**238,037**	***297%***	**164,647**	**726,833**	***341%***
Finance cost - net	-14,154	-17,738	-23,747	*34%*	-19,508	-20,854	*7%*
Profit before tax	**179,668**	**-77,639**	**214,291**	***176%***	**145,139**	**705,979**	***386%***
Income tax	-38,543	13,303	-36,085	*-171%*	-31,879	-115,438	*262%*
Net income	**141,126**	**-64,337**	**178,206**	***177%***	**113,260**	**590,541**	***421%***
EBIT margin	*8.4%*	*-3.8%*	***9.5%***	*+13 pp*	*9.7%*	***22.4%***	*+12 pp*
EBITDA margin	*16.1%*	*8.6%*	***17.9%***	*+9 pp*	*19.0%*	***27.5%***	*+8 pp*
Net profit margin	*6.1%*	*-4.1%*	***7.1%***	*+11 pp*	*6.7%*	***18.2%***	*+11 pp*

Source: company data

After a drop in 2020 caused by decrease of fuel prices and lower consumption as a response of the market on Covid pandemic, lockdown measures and slowing of economic activity**, in 2021 revenues rebounded, with the top line pushing to record highs in 2022.** The major driver for increase of revenues was a combination of higher fuel prices and increase in sold quantities. Total petroleum products sales volume rose by 14% in 2021 and by 11% yoy in 9M2022, providing further strengthening of market position. Observing 9M of 2022, we see hefty sales revenues growth (up by 90% yoy!) and lower increase of costs of raw materials and goods sold, leading to 8pp rise in the EBITDA margin to 28% (vs. 19% in 9M2021).

Cap on retail prices did create some negative effects on profitability, however this was offset by higher sold quantities. The rational is that **NIS provided a stable supply in the downstream segment** in circumstances of cap on retail prices (contrary to some other retail market players), less retail petrol purchases abroad and demand being further pushed towards NIS by lower prices guaranteed to agricultural producers.

Increasing D&A expenses are connected to finalization and activation of Bottom of the Barrel project in 2020. The past period highlighted large investments into modernization of production capacities, now providing production of higher quantities of high-value added products with additional positive impact on profitability. This effect is not easy to quantify due to prevailing positive effect of increase of oil prices, however it is evident that the increase in EBIT is primarily driven by the top-line and higher D&A costs are relatively non-negligible in this respect.

In the current commodity pricing scenario - we expect Brent prices at the lower level than in 2022 (80-90 USD/bbl) – both the top and bottom line are likely to be under pressure in 2023. Another element is that **purchases of crude oil at least in the near term will be done at less favourable terms**, with the ban to ¸buy cheaper oil from Russia. Come what may, we do not expect significant drop in margins and generation of losses since the projected Brent price is still by 40-50% higher than average price in past 6-7 years. The company does not disclose its break-even points, however observing the historical outcomes we estimate that NIS is surely operating with profits at crude oil prices at above 40 USD/bbl. Base effects are also important to bear in mind – when oil prices are going down, the current stocks were likely purchased at higher prices, hence also affecting future profitability. With our view that the average prices will be lower in 2023 than in 2022, we see this as adding to the overall trend of lower profitability.

Liquidity management

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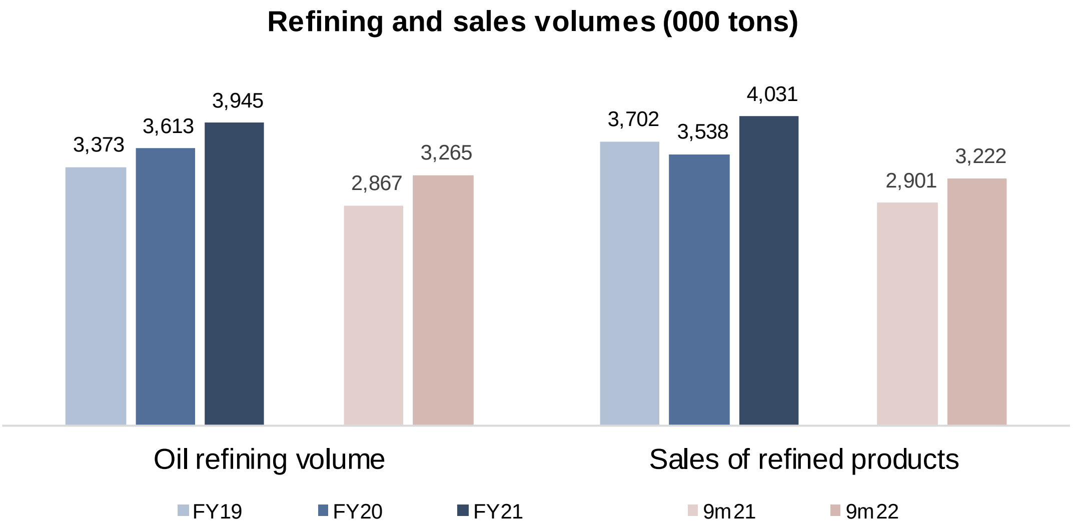


Source: company data

Market contributions still highlight **concentration onto domestic market**, with sales share from B&H at 10% and mid single digit contributions from Romania and Bulgaria. On one hand, this means that NIS profitability potential is dominantly driven by the domestic market, however we also see this as an indication that NIS could look into potential buyouts of smaller retailers in the already present markets in order to reap the benefits of its integrated processes onto profitability.

As for capacity utilization, NIS marked a **record high refinery capacity utilization of 82%** in 2021, coming in the very average of integrated oil and gas peers from the region. The only peer carrying higher capacity utilization was OMV with 88%, MOL was at level with NIS, while INA displayed the lowest utilization rate of 72%. We see upside potential to the capacity utilization in the integration of petrochemical business as indicated by regional peers with such business model, providing also better profitability profile.

NIS	2019	2020	2021	TTM
Days of receivables outstanding	36	48	31	27
Days of inventory on hand	94	97	55	62
Days of payables outstanding	65	82	37	38
Cash Conversion Cycle	66	63	49	51

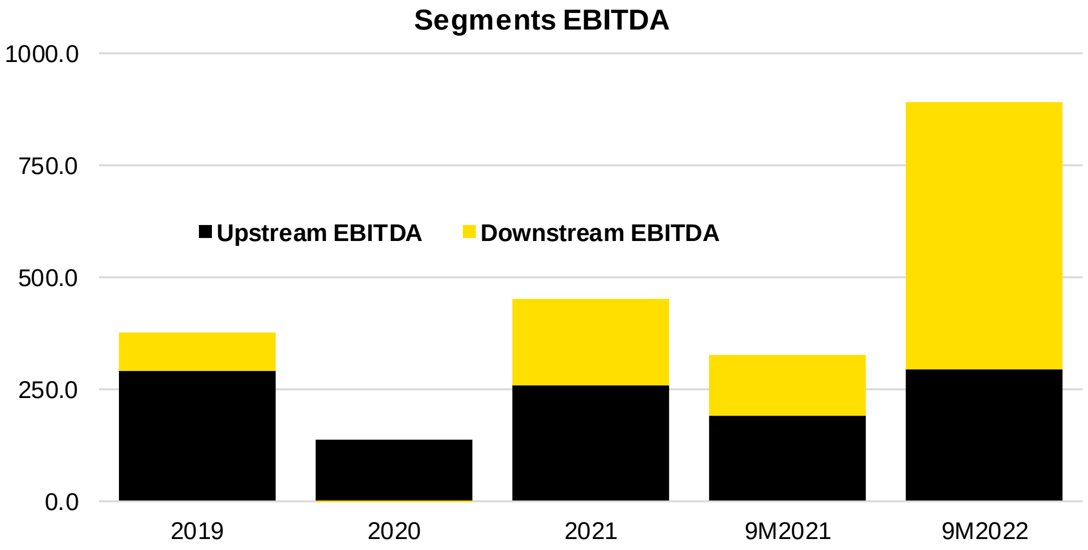
INA	2019	2020	2021	TTM
Days of receivables outstanding	31	40	26	30
Days of inventory on hand	51	64	40	46
Days of payables outstanding	34	51	37	28
Cash Conversion Cycle	48	53	29	48

OMV	2019	2020	2021	TTM
Days of receivables outstanding	24	38	30	27
Days of inventory on hand	39	67	42	37
Days of payables outstanding	97	129	68	41
Cash Conversion Cycle	-34	-24	4	23

Source: company data

Cash conversion cycle figures suggest **weaker management of working capital** against integrated oil and gas peers in the region. The key reason is in longer turnover of inventories, with NIS turning over its inventories during two months (still better than three months as seen in 2019-2020) while peers manage it even up to one month. Within the region, we see OMV managing its liquidity in the most efficient way, with low/negative CCC thanks to shorter inventory turnover and prolonged payables outstanding days. On the other side, NIS handles DPO in much shorter run, which can be explained by higher participation of own sources/,equity in financing of assets (EQR at 64%). A fact that should not be ignored is that OMV is using factoring to pay suppliers in shorter terms. In case that factoring is not used, payment periods would be probably shorter, which would extend the CCC. For NIS, we see the average day of receivables outstanding as the strongest element, being concentrated around 30 days in last two years.

Downstream EBITDA spikes



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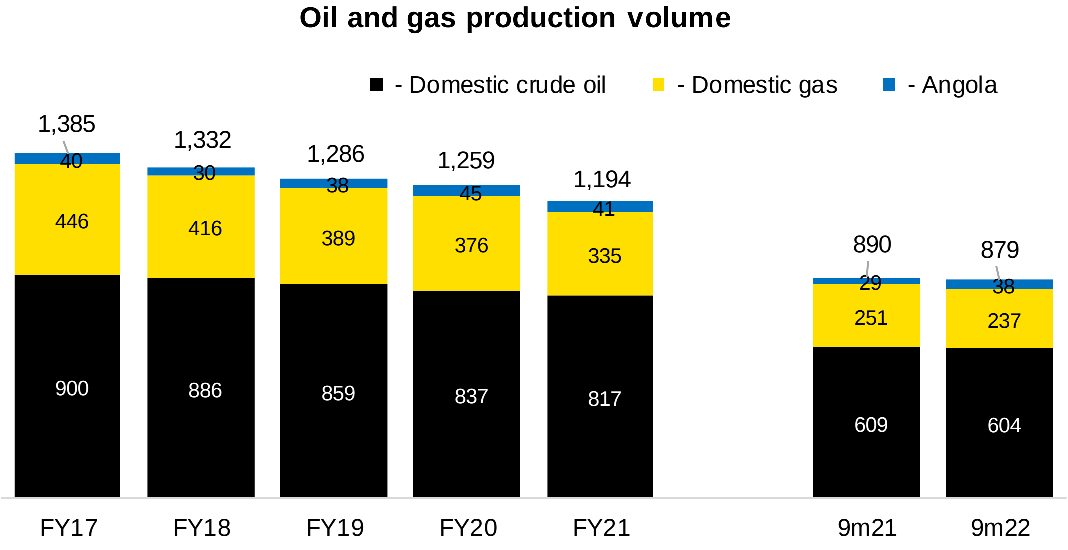

Source: company data

In the past seven years up to 2022, profitability was largely generated by Upstream segment, however in a declining trend. Hence, preserving the contribution of Upstream into overall profitability will require growth of own resource base. Share of own production in total refining volume was around 22% in 2021. Unlike many global oil companies, NIS is not allowed to disclose the amount of hydrocarbon reserves due to the state strategical view. So, despite the fact that each year around 50-60% of total capex is invested in E&P segment, efficiency of investments can not be precisely evaluated. Over 9M 2022, almost EUR 300m of EBITDA was generated by Exploration and Production, rising by 56% yoy.

For 9M 2022, total EBITDA rose to record highs, being up by 2.7x vs. the same period in the last year. Contrary to previous years, the biggest contribution came from Downstream segment thanks to combination of cheaper oil in processing and sales – the latter supported both in value and volume. Ahead of sanctions and limitations related to imports of Russian oil, NIS increased stocks of crude oil purchased at more favourable price levels. Downstream EBITDA with EUR 595m accounted for 70% total reported of EBITDA (EUR 890m) over 9M 2022.

In the light of geopolitical challenges and changing energy flows in Europe, we are taking a special look at the supply side risks. Refinery in Pancevo is set up for processing of different types of heavy oil and is not dependant on Russian oil. Iraqi oil dominantly participates in total supplies since 2014. Last year, around half of total procurements referred to Iraqi oil, 16% to Russian oil, 13% to Kazakh and 3% to Norwegian oil. Heavy oil is generally cheaper as it requires more complex refining process, however it also provides higher profitability and stability in the long run. Absence of Russian oil in refining processes will reduce overall profits, but certainly not to the extent of generating losses. We believe that alternative to Russian oil is already in place, so supply disruptions are not expected. By the end of December 2022 NIS signed a 2-year contract with JANAF securing transportation of crude oil from sea port in Croatia to refinery in Pancevo. JANAF pipeline was the main transportation channel so far as well.

Cost ratios outperform for now

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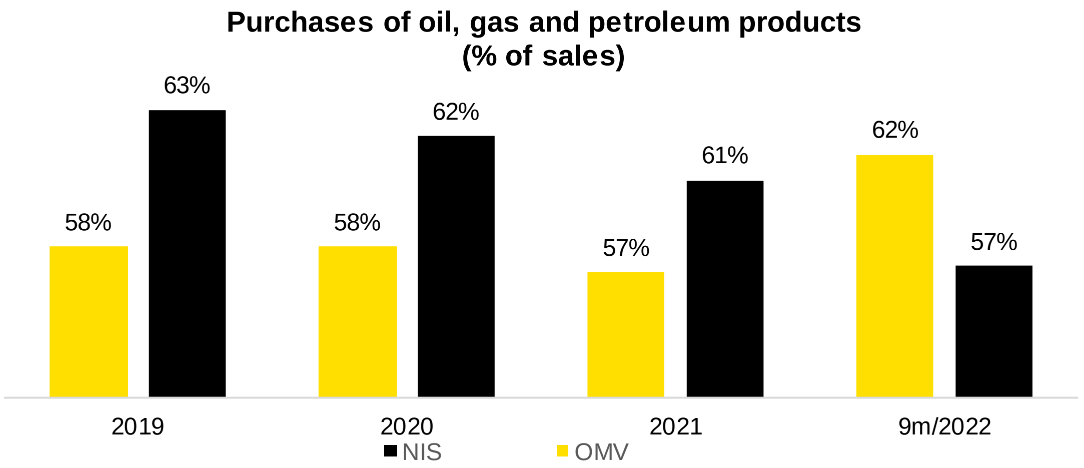

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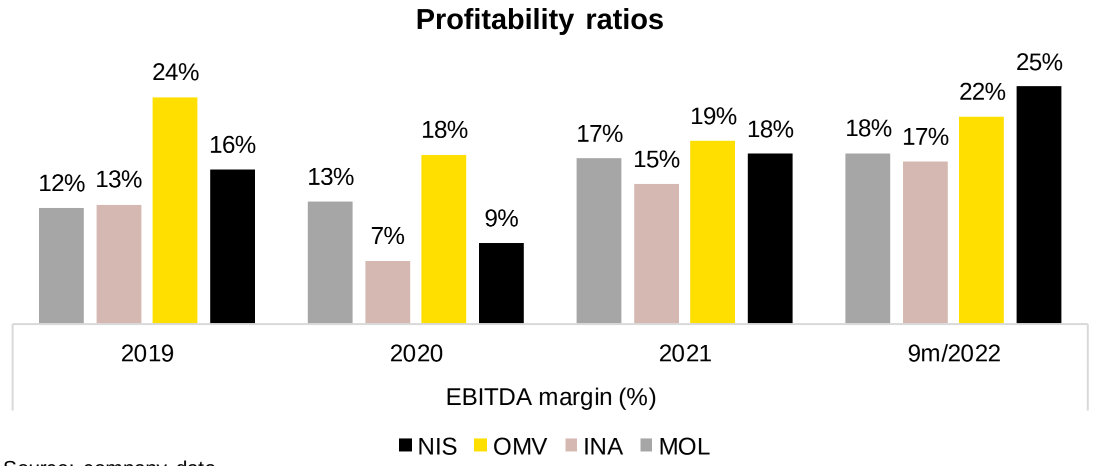

Source: company data

On **cost effectiveness**, over a multiyear period until 2022, **NIS displayed weaker cost management compared to OMV** (single company reporting cost under the same methodology) with higher cost to sales ratios (per cost segments). The weakest point was a high level of purchases of oil, gas and petroleum products as a share of total sales, with big regional peers such as OMV faring better on the back of broader geographical presence especially at markets with higher incomes, wider product mix (e.g. petrochemicals lifting sales) and economy of scale. As also displayed with other metrices, the 2022 was an outlier, having been marked by a few successful strategical decisions, notably purchases of cheaper Russian oil, which pulled the ratio of purchases of oil, gas and petroleum products against sales a way below peer levels. However, with import bans for Russian oil, **in 2023 we expect the purchases cost ratio back at levels above those at regional peers**, **signalling reduction in EBITDA margin** as well.

On **productivity**, **NIS is marking the lowest sales per employee figures against integrated oil and gas peers** in the region, with EUR 217tsd sales per employee for FY2021 being much below that of INA's EUR 308tsd and notably below that of OMV (EUR 1.6m per employee) and MOL (EUR 684tsd per employee). While we expect that the FY 2022 figures will display much stronger sales numbers and NIS' sales per employee will increase accordingly, we also do not see a major change in the named indicator relations against regional peers i.e. NIS to remain on the weaker end of productivity peer comparison. The named sales per employee must also be seen against the fact that NIS and INA do not generate material sales figures from gas and chemicals, while those two streamlines are sizeable at both OMV and MOL, hence explaining much higher sales per employee therein. The fact that NIS is increasing focus on petrochemicals we see as a positive factor for profitability going forward, however regardless of that a much more material improvement in sales per employee indicator would still require wider changes in core business lines.

On **financial cost effectiveness**, NIS is running relatively low interest expense burden, with interest costs accounting for only 1% of total sales, hence not significantly influencing bottom line. We estimate the average interest rate of 2% for NIS' liabilities being close that of INA (2.5%), and lower than OMV's 2.7% average interest rate. MOL is running the lowest interest rate of 1.5%. There are at least two reasons for the mentioned interest rate differences: i) both NIS and INA fund themselves at shorter maturities with 98% debt maturing within 5Y bucket compared to 75% in 5Y bucket for OMV i.e. 25% of OMV debt matures beyond 5Y; ii) OMV is funding itself at a share of 40% via financial markets by issuing bonds, which normally carry higher interest rates than bank loans, which on the other hand are the main source of funding for NIS and INA. We still see MOL as the top performer herein with the lowest interest rate even with 38% share of >5Y debt. Come what may, we see higher interest burden for NIS going forward due to general increase of cost of money courtesy of monetary policy tightening, and ESG rules demotivating lending towards industries with negative environmental influences.

CAPEX above average

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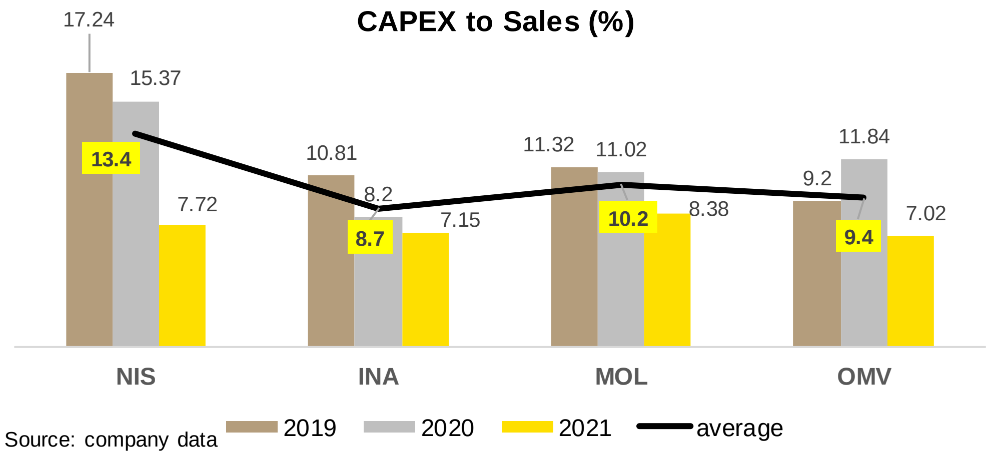

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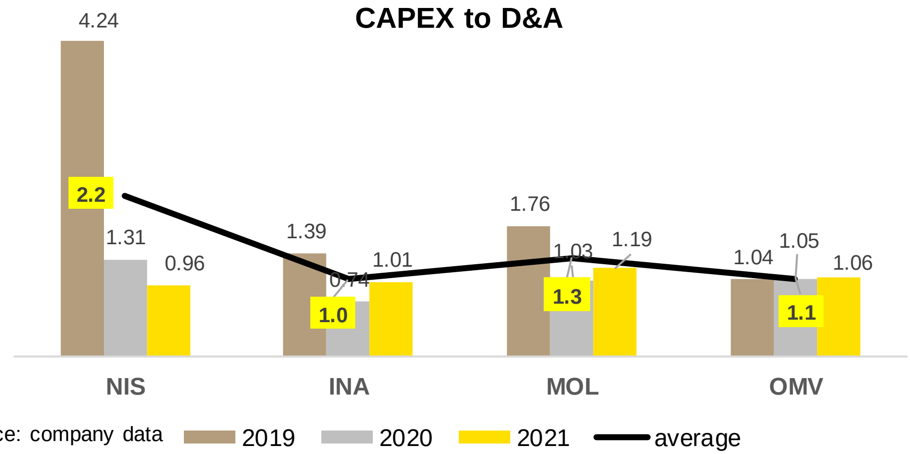


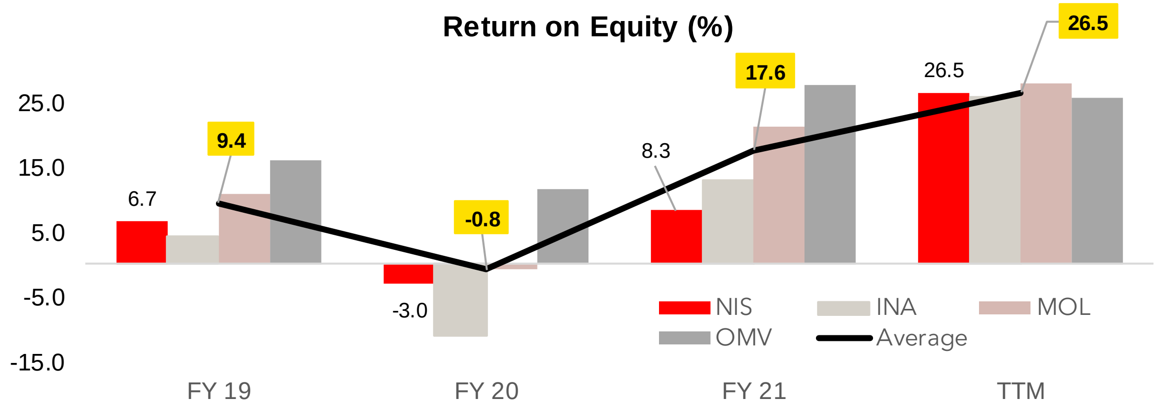
Source: company data

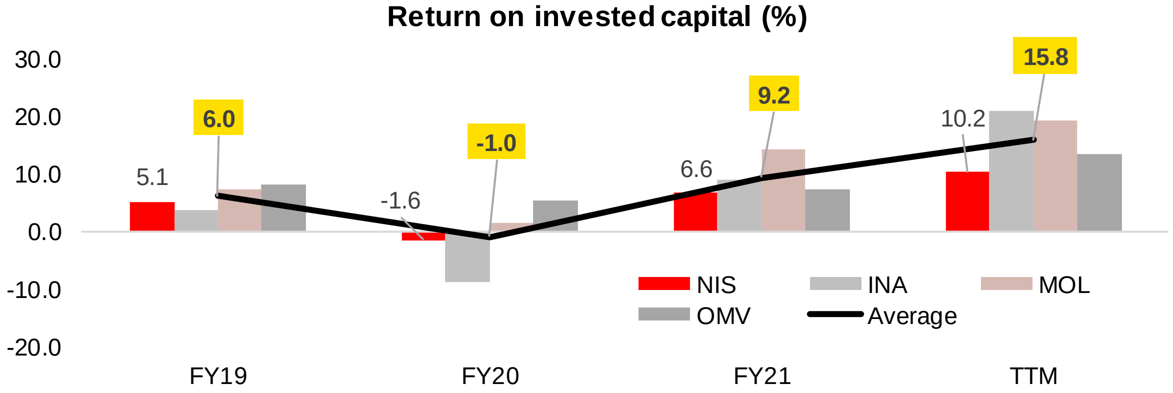
NIS was quite active with investments in the recent years, with the **capex to sales ratio at 13.4% on average during 2019-2021 being at least 3 percentage points above the integrated oil and gas peers** in the broader region. A smaller part of investments was streamlined into Downstream, however we praise the effects from investments into refinery modernization onto the company's competitiveness and earnings. Investments were somewhat reduced in the last two years, but the overall trend still shaped an average capex to depreciation & amortization ratio at 2.2x for 2019-2021. In the second phase of refinery modernization „Bottom of the Barel" project, it was invested more than EUR 300m, dominantly from own sources. Its worth mentioning that the new plant, provides deep refining with 99.2% efficiency, meaning that from the same raw material base the plant can be produce higher quantities of high-value added products (more precisely, by 38.2% higher EU-categorized diesel output). Having in mind competitive market environment (Hungary, Bulgaria, Romania, Croatia all have refineries), a new investment cycle announced for 2023 is rather considered as must.

For 2023, NIS announced CAPEX of EUR 416m CAPEX (vs. EUR 212mln for 2022), mainly in E&P segment and preparation works for third phase on the refinery modernization. The plan is to construct a new ETBE plant for high-octane component gasoline and reconstruction of catalytic cracking plant (FCC), having a high importance for the connection with HIP Petrohemija. This investment will enable production of the propylene, semi-product used by HIP Petrohemija. The new business direction towards petrochemical industry is a step into broadening the product mix with stronger vertical integration - NIS is a key supplier of HIP Petrohemija so effects from acquisition can be seen in short period through improved profitability.

Good indebtedness metrics with **Net Debt/EBITDA ratio below 2x** in past 5 years (with exception of Y2020 amounted 4.92x due to significant drop in earnings), **Net Debt/Equity ratio below 32%** and **Interest Coverage ratio above 15x** in past 5 years (with exception of Y2020 due to negative operating profit) leave sufficient room for additional financing if necessary. In the recent years, debt was falling and investments were covered by own funds. Due to extraordinary strengthening of operating cash flow in 2022, we think that the planned investments will be financed from own sources as well. We did not see the same practice by other integrated oil and gas peers, with OMV and INA seeing changing levels of debt during the same period. Still Net Debt/EBITA and Net Debt/Equity ratio of INA and OVM are also within the favourable value, in the similar range as that of NIS.

Returns underperform peers





Financial leverage ratio	FY 17	FY 18	FY 19	FY 20	FY 21	TTM
NIS	1.8	1.7	1.6	1.6	1.6	1.5
INA	1.8	1.7	1.8	2.0	2.0	2.1
MOL	2.6	2.4	2.4	2.4	2.4	2.4
OMV	3.6	3.6	3.7	4.2	4.4	3.7
Average	2.4	2.3	2.4	2.5	2.6	2.4

Source: company data

Oil refining industry does not generate materially high returns on capital in global terms, with profitability highly volatile amid global commodity price. This is especially visible with energy companies running high capital levels, while those who manage to effectively utilize borrowing, ideally at low borrowing costs from the previous years, typically display comparatively higher returns. For NIS, **TTM ROE** (for period ending 30/09/2022) **went up significantly** compared to previous years on the back of strong profits driven by hefty price tailwinds. The same move was displayed by other integrated oil and gas companies in the broader region. Structurally, NIS displayed a sub-average ROE before 2022 due to lower profits and continuous deleveraging. Furthermore, **NIS is displaying sub-average ROIC** even with material improvement of profits in 2022, with the regional peers running ROIC at levels between 13-21% on TTM basis (for period ending 30/09/2022), while NIS shaped a multi-year high of only 10%.

The key explanation behind such movements stands in **NIS' relatively higher share of capital in overall financial management of company** i.e. equity being comparatively higher than with other integrated oil and gas peers in the region as NIS was paying out less dividends and opted for de-leveraging - **capex funding from own sources** rather than taking loans. This is further corroborated by the financial leverage ratios, which for NIS stand at 1.5x under the TTM (for period ending 30/09/2022), while regional peers run leverage ratios on average around 2.5x and within distribution of 2-3.7x. On a positive note, higher own sources share in financing (EQR at 64% vs. 40-48% by peers) provides stronger financial stability which is especially important now due to growing inflation.

Glossary

Term	Definition	Formula
ROE	Return on Equity	Net income/average total shareholder's equity
ROA	Return on Assets	Net income/average total assets
ROIC	Return on Invested Capital	(EBIT - income tax)/ average invested capital
INVESTED CAPITAL	Invested Capital	Short-term debt + long-term debt + provisions + long-term payables + deffered tax liabilities
AR DAYS	Accounts receivables days	Average accounts receivables/Sales revenues*365
AP DAYS	Accounts payables days	Average accounts payables/(cost of materials + cost of services)*365
INVENTORY DAYS	Inventory days	Average inventory/cost of materials*365
CCC	Cash Conversion Cycle	AR days + Inventory days - AP days
INTEREST COVERAGE RATIO	Interest coverage ratio	EBIT/interest paid
CURRENT RATIO	Current ratio	Current assets/current liabilities
NET DEBT/EBITDA	Net debt/EBITDA	(Long-term debt + short-term debt - cash)/EBITDA
NET DEBT/EBIT	Net debt/EBIT	(Long-term debt + short-term debt - cash)/EBIT

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