GULF KEYSTONE: RIPE FOR A TAKEOVER?

Introduction

With a market capitalisation of less than £1.5bn, Gulf Keystone Petroleum is not the largest player in the oil and gas exploration and production sector. However, the company which focuses its drilling projects in Kurdistan is one of the most popular stocks followed by the private client investor community. According to IG Index, Gulf Keystone Petroleum is in the top five companies most traded by its clients. The reason is that for several months there has been on-going bid speculation that has surrounded the story.

The rollercoaster ride in the shares over the past 9 months will have left speculative investors either happy with handsome profits, or tearing their hair out as they sit on sizeable losses. As the shares have now retraced much of the bid premium, does this suggest that the takeover story is now a busted flush? Or has the decline in the shares been enough to renew potential appetite for Gulf Keystone Petroleum (GKP) as a bid target?

History of the bid speculation

GKP has a sizeable presence in Kurdistan. The politics are extremely complicated in the region which covers parts of northern Iraq, Syria, Turkey and Iran. This means that there are complex issues surrounding who owns the rights to the oil reserves. GKP runs four highly prized blocks, Shaikan, Akri-Bijeel, Ber Bahr and Sheikh Adi. On its own latest estimates, GKP has a share of gross mean oil-in-place reserves of at least 16 billion barrels of oil. However, it is believed that the enormous extent of the reserves is far too big for GKP to handle on its own. The assets require a significant investment to commercialize. This has led to speculation that an oil major would swoop in and make a bid for the company.

On 18th October 2011, US oil giant ExxonMobil signed a deal with Kurdistan which made it the first major international oil company to sign a contract in the autonomous region. The deal was confirmed on 11th November 2011 and meant that ExxonMobil had agreements to explore for oil in six blocks in Iraqi Kurdistan. The shares of GKP first reacted to the news on 11th November 2011 having previously closed at 142p. Over the next three months, the shares embarked upon a stellar move, which eventually saw the price peak at 465p on 20th February.

Positive sentiment in GKP began to seep away from the shares in late February after Genel Energy announced that it would not be pursuing any potential bids for fellow Kurdistan-focused oil explorers such as Gulf Keystone. The potential suitor noted that following the entry of ExxonMobil into the region the shares price of GKP had become too expensive.

The sell-off in the shares really began in earnest on the announcement on 6th March that ExxonMobil needed more time to decide whether to cancel its contract with Kurdistan owing to legal conflicts with the Iraqi government. After an initial spike lower (and subsequent bounce), the shares began a steady decline which continues to date. From the high at 465p in February, the shares have now lost over 60% in value.

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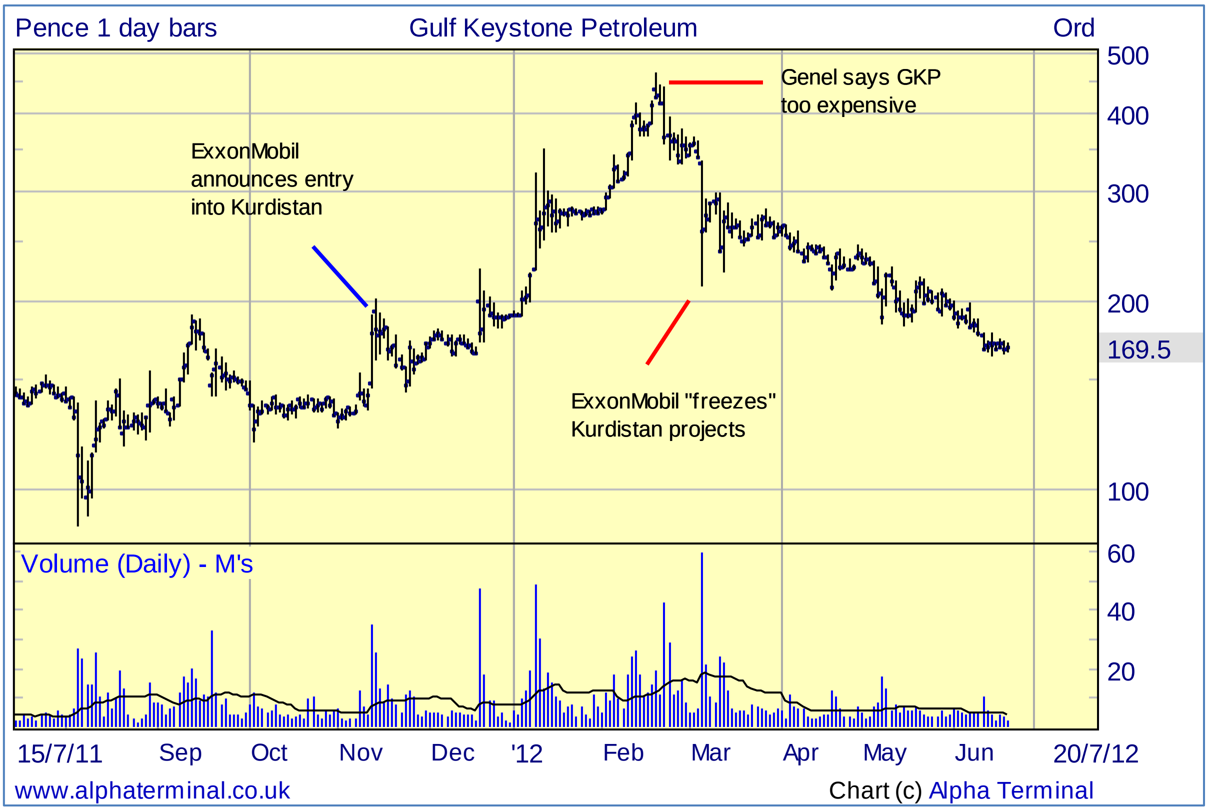

ExxonMobil, Iraq and Kurdistan

As already stated, on 18th October 2011, ExxonMobil signed a deal with Kurdistan. The deal, confirmed on 11th November 2011, meant that the company had agreements to explore for oil in six blocks in Iraqi Kurdistan. This was what shareholders of GKP had been hoping for. With the potential reserves GKP was sitting on and the large investment needed to capitalize on them, entry by ExxonMobil was seen as a first step towards a bid. Even the board of GKP have acknowledged this.

However, this is a complicated part of the world. Iraq considers agreements such as the one between ExxonMobil and the Kurds as illegal, with Iraq's claim on reserves in the region disputed since the US invasion in 2003. With Iraq threatening to block them from future contracts, ExxonMobil froze the deal with Kurdistan. However, despite letters to the Government claiming it had stopped work in the region, this appears not to have been the case. According to Reuters, this month, Ali al-Moussawi, media adviser to the Iraqi Prime Minister, said that Baghdad "still receives information that suspicious work is going on relating to their exploration activities".

Reuters also stated that the Kurdistan natural resources minister, Ashti Hawrami told an energy conference in London on 19th June that he expected further oil majors to follow Exxon into the region. He said, "The market is very buoyant in Kurdistan. We have a lot of majors circling around looking at new PSCs (production sharing contracts) and certainly mergers and acquisitions." He continued, "In the next few months we expect to see another two or three major companies coming and working in Kurdistan."

Is GKP still a bid story?

The shares are currently not far from the level just prior to the ExxonMobil entry into Kurdistan which kicked off the speculation. This suggests that the original bid premium has been all but removed from the shares. The board of GKP continues to look for a buyer to offload its 20% stake in the Akri Bijeel block in order to raise funds and rationalise the portfolio. The Hungarian partner, MOL Nyrt, which holds 80% of the Akri Bijeel assets estimates the block holds around 2.4 billion barrels. Broker Seymour Piece has previously valued the asset at around £120m (although this was in May when the oil price was over $110). GKP has been searching for a buyer since Q4 last year and remains a feature of its outlook statement.

In December GKP was forced to deny the rumour of a 800p bid from ExxonMobil, which was around five times the share price, which was around 165p. At the time, Reuters noted that a source close to GKP said that such a takeover would rarely go for more than a 50% premium. This suggests that a takeover price of around 250p would have been more realistic.

Genel Energy, which is in partnership with GKP in the Ber Bahr block, backed away from a possible bid in February. At the time, the group reportedly had around $1.9bn (c. £1.2bn) in cash to fund an acquisition. However, it had ruled out a bid due to the excessive price with GKP at the time having a market capitalisation of around £3.6bn. Genel had instead decided to look beyond northern Iraq, towards the Middle East and North Africa, with Libya and Egypt of particular interest. This would presumably rule out Genel from the list of potential suitors for a pure cash bid. Even at today's reduced price of 170p, with an arbitrary 50% bid premium, GKP would be worth £2.2bn (c. 255p) under potential offer

In April, Investec Securities updated its Net Present Value based target price on GKP following the successful well test results on Shaikan 4. The price target was increased from 191p to 232p. This suggests that with the improvement in potential yield from the group's major asset, the valuation under a potential takeover scenario would be even greater.

Current group prospects

Recent well updates (for Sheikh Adi and Ber Bahr blocks) in addition to the major independently audited upgrades of the gross oil-in-place volumes for Shaikan, suggest good progress underneath the ground is being made. Furthermore, plans are underway for a 122km pipeline to connect the Shaikan Field with the existing Kirkuk-Ceyhan export pipeline to the world markets, which could be capable of transporting at least 440,000 barrels of oil per day (bopd). Kurdistan is hoping to export crude oil via the pipeline to the Turkish border by August 2013.

Pre-tax losses may have widened in FY2012, however oil production is beginning to ramp up. From just over 30k barrels of oil produced in 2010, production increased to a net entitlement of 166k barrels in 2011. Production since November has been encouraging, increasing the stabilised output of an average of 2,520 bopd achieved from Shaikan 1 and 3, increasing to over 5,000 bopd by the end of Q1. Even if this remains constant throughout 2012 then, on a quick and dirty calculation, this suggests production could be over 1.8m barrels for the Full Year. With the commercial viability of Shaikan already demonstrated and the other blocks progressing well, the potential increase in production is significant.

How to play GKP in the current financial markets

The share price decline over the past few months has not been indicative of a company that the market believes to still be a bid target. Certainly if investors were holding CFDs in GKP, hoping for the bid rumours to resurface, they would have had their fingers seriously burnt. Playing potential bid targets using CFDs is an incredibly high risk strategy. While there is the potential for huge upside, the downside risk of the bid never materialising is equally significant.

Smaller oil exploration companies often need to raise cash to ramp up operations, meaning there is the added risk of additional share placings. With GKP, for example, following the announcement of a £200m share placing the shares gapped lower by 10% at the open on 20th September 2011. With the reduced risk of not trading on margin, playing the bid story using physical shares would be the safer and more prudent strategy.

However, for those with a higher appetite for risk that want to trade the CFDs, the positives surrounding the story remain. The decline in the shares is to a certain extent understandable, considering the risk averse trading environment that has prevailed in recent months. The smaller E&P companies such as GKP are certainly towards the riskier end of the spectrum. However, if the volatility in the equity markets can stabilize and risk appetite can begin to improve again then the shares could begin to find support once again.

Talk of a potential takeover of GKP will linger in the background. ExxonMobil's continuing presence in the region is supportive, while other players such as US giant Chevron and Chinese company Sinopec are also possible suitors. While the shares continue to trend lower, the risk of owning Gulf Keystone Petroleum is high, especially as a leveraged investment through CFDs or spread betting. However, for some investors the possibility that the company will be taken over will continue to be a key factor in choosing to own the stock.

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