

## Company Flash

# Pearl Oriental Oil Limited

0632 HK

## Earning accretive oilfield acquisition

- ❑ Pearl Oriental Oil announced early in July that it has signed a contract for the acquisition of 63.05% equity interest in an oilfield project in Russia.
- ❑ The project consists of 2 onshore oilfields and 2 offshore exploration blocks. The oilfields are estimated to have 3P reserve of 609m barrels and 3C contingent resources of 157m barrels.
- ❑ We estimated the NPV of the NGPT Oilfield to be US\$1,137m and diluted NPV per share to be HK\$0.8.

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**Stock Data (0632 HK)**

Rating	Not Rated
Price (HK\$)	0.435
Target Price (HK\$)	n.a.
12m Price Range (HK\$)	0.355-0.82
Market cap. (US\$m)	181.8
3M average Daily t/o (HK\$)	1,753,484.9
Free float (%)	46.2

Source: Bloomberg

**Financial Summary**

Year to Dec	10A	11A	12A
Turnover (HK\$ m)	558.494	510.931	453.52
Gross profit (HK\$ m)	15.112	30.093	24.235
Net profit (HK\$)	423.195	-59.204	-303.321
EPS (HK cents)	22.77	-1.96	-8.9
DPS (HK cents)	0	0	0
P/E (x)	1.8	n.a	n.a
P/B (x)	0.9	1.0	0.6

Source: Bloomberg

Pearl Oriental Oil Limited is principally engaged in recycling plastic materials and oil and natural gas exploration and production in Utah, United States. The company was previously known as Pearl Innovation Limited before Nov 2011.

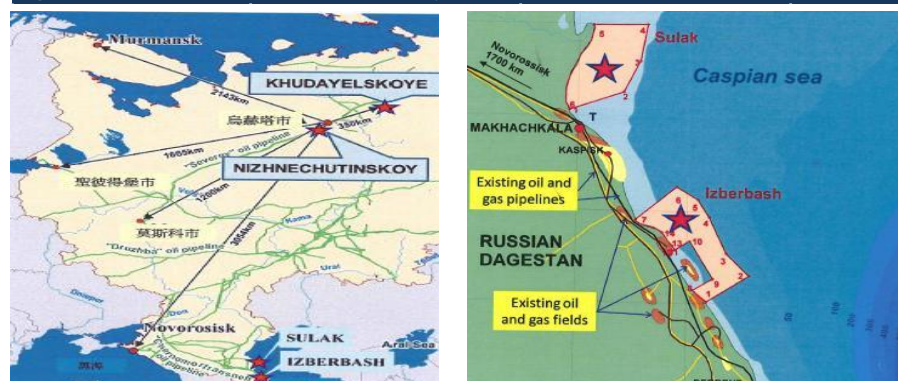
**What's New.** Pearl Oriental Oil Limited announced on 1 July 2013 that it has signed a Sales & Purchase Agreement (the S&P Agreement) on Jun 2013 for the acquisition of 63.05% equity interest in Timan Oil & Gas plc (“Russian Oilfield Project”), at a consideration of US\$406.6m. The acquisition will be completed in three phases as described in Table 1.

**Table 1: The three phases of acquisition**

	Phase I	Phase II & 3	Total
Consideration (US\$ m)	105.6	301.0	406.6
Ownership of the Russian Oilfield Project	23.79%	39.26%	63.05%
Method of payment	20% by cash; 40% by the issue of new shares; 40% by cash or CB with conversion price of HK\$0.55 per share	50% by cash; 50% by CB with conversion price of HK\$0.55 per share	-

Source: Company Data

The Russian Oilfield Project consists of 4 oilfield and exploration blocks in Russia including 2 onshore oilfield (with 100% ownership by Timan), namely Nizhnechutinskoy Oilfield (“NGPT Oilfield”) and Khudayelskoye Oilfield (“KNG Oilfield”), and 2 offshore exploration blocks (with 80% ownership by Timan) on Caspian Sea (See Fig 1).

**Figure 1: Locations of the Oilfields and Exploration Blocks of Timan**


Source: Company Data

According to the Competent Person's Report (CPR) conducted by Oilfield Production Consultant (OPC), NGPT Oilfield has the 3P oil reserve of 609m barrels, and another oilfield, KNG Oilfield has the 3C contingent resources of 157m barrels. Compared with the Utah Gas and Oil field, which was acquired by the company in 2011 and had net probable and possible reserves of 1.9m barrels of oil and 80m Barrel of Equivalent (Boe) of natural gas, the Russian Oilfield Project is a significant step up in terms of the amount of resources.

**NPV of NGPT Oilfield is estimated to be US\$1,137m.** While the NGPT oilfield's volumes have been allocated to Reserves, the KNG oilfield has been allocated to Contingent Resources (not yet commercial) due to technical and financial uncertainties. The two offshore exploration blocks are still under exploration, which means there is a high level of uncertainty with regard to their future oil production. In view of this, we mainly focus on the value of the NGPT oilfield, to be conservative.

Based on the cash consideration of the transaction, which is US\$214m in total, and our assumptions regarding oil production, number of wells, capex, etc (See Table 3), we estimated that the net present value (NPV) of the NGPT oilfield is US\$1,137m. As Pearl Oriental Oil purchased 63.05% of the asset, the NPV of the NGPT oilfield that purchased by the company is US\$717m, implying the NPV per share of this oilfield will be HK\$1.5 and diluted NPV per share will be HK\$0.8. It is worth to note that this number only represents the NPV for the NGPT oilfield. If we take into account the other assets that owned by the company, such as Utah oilfield, KNG oilfield and the two offshore exploration blocks, the NPV would definitely be higher.

		2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023 ...	2043
Cash consideration	US\$ m	-214	0	0	0	0	0	0	0	0	0	0	0
Revenue	US\$ m	0	244	497	760	1,034	1,318	1,614	1,920	2,098	2,283	2,473	433
Capex	US\$ m	0	-147	-138	-134	-136	-140	-133	-116	-49	-50	-51	0
Opex	US\$ m	0	-38	-77	-115	-154	-192	-230	-269	-288	-307	-326	-38
Tax	US\$ m	0	-168	-341	-518	-701	-888	-1,080	-1,278	-1,388	-1,502	-1,618	-284
FCF	US\$ m	-214	-110	-58	-8	43	99	170	257	373	423	478	110
Discount rate		14%											
NPV	US\$ m	1,137											
63.05% of the NPV	US\$ m	717											
NPV per share (basic)	HK\$	1.5											
NPV per share (diluted)	HK\$	0.8											

Source: SBI E2-Capital

		2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023 ...	2043
Number of wells		0	616	1,231	1,847	2,463	3,078	3,694	4,310	4,546	4,782	5,019	6,436
New wells		0	616	616	616	616	616	616	616	236	236	236	0
Daily production	bbls	0	11,688	29,517	46,723	63,169	78,009	91,003	102,514	111,856	114,750	106,016	13,071
Oil price	US\$/bbl	80	82	84	86	88	91	93	95	97	100	102	168

Source: SBI E2-Capital

Discount rate	rate of increase in oil price	0%	1%	2%	3%	4%
	10%	660	1,346	2,131	3,033	4,071
12%	439	960	1,553	2,230	3,003	
14%	278	681	1,137	1,653	2,240	
16%	159	476	832	1,233	1,685	
18%	72	324	606	922	805	

Source: SBI E2-Capital

**KNG Oilfield stands a good chance of successful exploitation.** As for the KNG Oilfield, as mentioned previously, it has been allocated to Contingent Resources as they are yet to be commercial. Nevertheless, one has to note that not far away from the KNG Oilfield is the Yarega oilfield, which is a heavy oil field owned by LukOil, the 2<sup>nd</sup> largest Russian petroleum company. The Yarega oilfield, after many years of development and production, has currently a daily oil production of 15,600 barrels in 2012. According to the CPR, KNG Oilfield has very similar reservoirs with Yarega oilfield in terms of porosity and thickness. It is therefore believed that the KNG stands a high chance of successful exploitation in the future.

Apart from that, the KNG Oilfield, being a heavy oilfield, has been granted by the Russian tax authority full exemption of mineral extraction tax and a preferential tax term to pay only 10% of the normal export duty, which is US\$313.9 per tonne. The reduction in tax expenses would therefore hugely enhance the future profitability of the project.

**The two exploration blocks have high potential to discover large oil and gas field.** The two exploration blocks, namely Izberbash Exploration Block & Sulak Exploration Block, are currently in the stage of exploration. Yet, as shown in Figure 1 on page 2, they are located in the near shore water area of continental shelf of Caspian Sea, whose oil reserve accounts for around 17% of total oil reserve of the world. There are actually many onshore and offshore oilfields with completed infrastructure facilities for oil and gas. For instance, the Kashagan offshore oilfield, the largest oilfield of Kazakhstan, is in the area north to Sulak Exploration Block, and a group of oil and gas fields of Azerbaijan is in the south of Izberbash Exploration Block. We therefore believe the both Izberbash Exploration Block & Sulak Exploration Block have high exploration potentials to discover large oil and gas field as well.

Table 5: Peers Comparison Table

Company	Ticker	3M avg turnover (HK\$ m)	Mkt Cap (HK\$ m)	2012E P/E (x)	2013E P/E (x)	Total 1P reserve (m Boe)	market cap/Boe (HK\$/Boe)	P/B (x)	ROIC (%)	ROE (%)	ROA (%)	Dvd Yield (%)	Net Debt/Total Equity
Peral Oriental Oil	0632 HK	1.7	1,361.4	n.a	n.a	118.0	11.5	0.64	n.a	-12.7	-10.0	0.0	-9.3
United Energy	0467 HK	1.9	14,477.8	13.16	11.10	60.3	240.1	2.00	n.a	12.7	5.6	0.0	59.1
MIE Holdings	1555 HK	8.4	4,661.1	6.79	5.74	62.7	74.3	1.06	11.4	16.9	6.7	3.1	84.3
Sunshine Oil	2012 HK	7.4	4,989.6	n.a	n.a	80.0	62.4	0.76	n.a	-12.1	-8.5	0.0	-32.4
CITIC Resources	1205 HK	5.5	8,970.1	n.a	8.5	157.2	57.1	0.67	n.a	-9.2	-4.0	0.0	18.6
Kunlun Energy	0135 HK	238.4	95,298.6	14.11	12.88	119.4	798.1	2.14	9.7	17.4	6.8	1.9	19.4
SINOPEC	0386 HK	613.2	649,815.8	7.82	6.89	3,964.0	163.9	0.98	9.2	13.0	5.3	5.0	49.9
CNOOC	0883 HK	737.3	619,706.7	7.70	7.98	3,490.0	177.6	1.58	17.2	22.2	15.2	3.3	-24.5
PETROCHINA	0857 HK	821.0	1,821,543.1	11.11	9.82	12,663.0	143.8	1.15	8.1	10.5	5.2	n.a	33.8
<b>Average</b>		<b>270.5</b>	<b>357,869.4</b>	<b>10.1</b>	<b>9.0</b>	<b>2301.6</b>	<b>192.1</b>	<b>1.2</b>	<b>11.1</b>	<b>6.5</b>	<b>2.5</b>	<b>1.7</b>	<b>22.1</b>

Source: Bloomberg, SBI E2-Capital

**Valuation.** As Pearl Oriental Oil has incurred loss in FY12/12A, P/E comparison is not feasible between the company and its peers. We therefore deploy another method to look at the valuation of the company. As shown in Table 5, the total proven reserve (1P) of the company is 118m barrels of equivalent (Boe), which is actually large compared to other small-to-mid players such as **United Energy (0467 HK, HK\$1.11)** and **MIE Holdings (1555 HK, HK\$1.76)**. However, when it comes to market cap per Boe, the company is the lowest among its peers. We believe the market is discounting the counter by considering whether the company can successfully close the transaction, as there are still some uncertainties regarding the approval from Russian government for Phase II and Phase III of the acquisition. We believe, however, it stands a good chance for the company to get the approval given Russian government has been encouraging to foreign investment. We think the company will deserve a higher valuation once the cloud is clear in the future.

**Risks.** Investing in Pearl Oriental Oil is not without risks. Major investment risks include 1) disapproval of acquisition by the Russian government, 2) lower-than-expected oil reserve on oilfield, 3) slower-than-expected rate of exploration and exploitation, 4) lower-than-expected crude oil price, 5) cancellation of favourable tax policies by Russian government and 6) failure to extend the oil production licence.

Table 6: Profit and loss items

HK\$'000	FY12/10	FY12/11	FY12/12
<b>Revenue</b>	<b>558,494</b>	<b>510,931</b>	<b>453,520</b>
Cost of production	543,382	480,838	429,285
Gross profit	15,112	30,093	24,235
Operating expenses	133,419	72,774	60,136
<b>Profit from operation</b>	<b>-118,307</b>	<b>-42,681</b>	<b>-35,901</b>
Finance cost	-53	-27	0
Other gain/loss	505,131	-48,564	-365,546
Income tax credit	4,703	25,109	97,576
<b>Profit/loss for the year from continued operation</b>	<b>391,474</b>	<b>-66,163</b>	<b>-303,871</b>
Profit for the year from discontinued operation	36	0	0
<b>Profit/loss for the year</b>	<b>391,510</b>	<b>-66,163</b>	<b>-303,871</b>
Profit/loss attributable to Shareholders	423,195	-59,204	-303,321
Minority interest	-31,685	-6,959	-550
Basic EPS (HK cents)	23	-2	-9
Diluted EPS (HK cents)	22	-2	-9

Source: Company Data

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