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SPECIAL REPORT

Gulf Keystone Petroleum (GKP)

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Speculative Buy

TARGET PRICE 145p

Gulf Keystone Petroleum is one of the hottest stocks in the UK market. After striking it big in Northern Iraq, the company is potentially sitting on several billion barrels of oil. The problem is the oil is deep underground and Gulf Keystone doesn't have the money to get it to the surface. What does the future hold for this highly popular stock?

An overnight success

Gulf Keystone listed on AIM in September 2004. The shares spent the first couple of years drifting sideways. Exploration in Algeria had showed promise but no significant progress was made. The shares got pummeled in the market sell-off of 2007/09 and hit lows of 4.5p in March of this year. A month later drilling began at Shaikan in the Kurdish region of northern Iraq.

The shares recovered to 20p in May before gradually drifting back down to 12p in early August. On 6th August, Gulf Keystone hit the jackpot. A significant oil discovery was found around a mile underground.

The latest estimates are that Gulf Keystone could be sitting on 2 billion to 4 billion barrels of oil. The company is continuing to drill towards a final depth of just over two miles and there's every chance of further discovery.

Iraq is the key to Keystone

Iraq has long had vast oil and gas potential and has the world's second largest proven reserves. It is no wonder the country has been in the political spotlight for many decades. The US and UK governments in particular have been preoccupied with Iraq. Both countries also happened to be the home of some of the world's largest oil companies (join the dots).

Now Saddam Hussein's regime has been toppled the land grab is on. Iraq still has plenty of problems and is considered one of the worlds' three most dangerous countries, however the northern region of Kurdistan compares well to the rest to the country. It has the lowest poverty rates and highest standard of living in Iraq. It is also the most stable and secure region where not a single coalition soldier or foreigner has been killed, wounded or kidnapped since the 2003 invasion of Iraq.

The problem in Kurdistan is not security but a lack of definitive legal guidelines for foreign investment.

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Iraq has yet to agree on a national oil policy. Oil companies typically pay a royalty (percentage of revenues) to the government. The local and central government then decide how they split the pot. This has yet to be agreed in Iraq. Kurdistan is estimated to have around 45 billion barrels of oil reserves so the stakes could not be higher.

Kurdistan is effectively being governed independently from the central government in Bagdad and has agreed dozens of deals with international oil companies during the past few years.

The central government considers these contracts illegal. Oil extracted in Kurdistan can only be exported through Iraqi government pipelines running to Turkey. Baghdad has refused to pay the companies for the oil exported from Kurdistan.

The local government has now halted all oil exports from Kurdistan unless Baghdad pays for it. The Bagdad government may be happy to allow Kurdistan to govern its people but it wants to share in the spoils from its natural resources.

Gulf Keystone will probably not be in a position to start production for years, so we would expect a resolution to the dispute well before then. The dispute does however lower the value of Gulf Keystone's reserves due to the increased country risk. This will impact Gulf Keystone's ability to negotiate with institutional investors, development partners or banks.

The discovery at Shaikan in Kurdistan should not have come as a complete surprise as there are already two large producing fields nearby, Taq Taq and Tawke, owned by other operators.

Gulf Keystone owns a 75% stake in the Shaikan block. A Hungarian oil and gas company, MOL, owns 20% and Texas Keystone owns the other 5%. MOL is actually one of Central Europe's 10 largest companies with a market value of around £6 billion. While MOL has exploration interests, it owns a mix of upstream and downstream assets including three large refineries, an extensive pipelines system and even 1,000 petrol stations. In other words, they're not a bad partner to have.

Gulf Keystone's hopes don't rest entirely with Shaikan. Drilling at a second well in Akri-Bijeel, Kurdistan, is due to start before the year-end and is expected to take around four to five months. News is not expected before February 2010. Akri-Bijeel is 80% owned by MOL and Gulf Keystone owns the other 20%.

Gulf Keystone also owns an 80% interest in Sheik Adi block and a 40% interest in the Ber Bahr block. These stakes were only announced in July, so we are not expecting any news from these for some time.

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The next Cairn Energy?

Comparisons between Gulf Keystone and Cairn Energy are inevitable. Just to recap, Cairn Energy hit the big time five years ago when it discovered several billion barrels in Rajasthan, India's remote desert state. That discovery eventually propelled Cairn into the FTSE 100. Finding the oil was the easy bit. Cairn has spent the last five years building the infrastructure needed to bring the stuff to the surface. Production only just started a few months ago with Cairn and its partners having invested about $2 billion developing the fields.

Getting such a big project off the ground needs the support of major players. The Indian government owns a 30% stake in the Rajasthan fields and global oil giant Petronas also has around a 15% stake in Cairn India. Standard Chartered Bank and the World Bank have also lent hundreds of millions of dollars to Cairn India. In other words, you need big money from big players to turn the dream into a reality.

Unlike Cairn, Gulf Keystone is in a delicate financial situation. It has struck a deal with US investors allowing the company to draw up to £30m in exchange for shares. So far about £7 million has been drawn down but based on the current rate of cash burn, the remaining money won't even last a year.

In order to preserve cash, the company decided in July that it is going to exit its Algerian operations and focus on Kurdistan. That's a good decision in our view.

Gulf Keystone simply can't afford to keep operating in both countries. As Gulf Keystone had agreed to fund its share of development in Algeria, pulling out has proved tricky. The company is now in legal dispute with its Algerian partner BG Group. A lot of the cash on its balance sheet is ring fenced for the Algerian development, so it can't touch this cash at the moment. Even if it could, it's still not going to last very long.

It's clear that Gulf Keystone needs a more substantial and secure source of funding. The good news is that large discoveries of oil are increasingly rare. The peak year for global oil discovery was 1962. Since then, the global discovery rate has dropped off sharply.

Many of the multinational oil companies are struggling to maintain their reserves each year – meaning their production is greater than their new discoveries. Surely several billion potential barrels in an untapped region will appeal to someone?

MOL is an obvious development partner as the Hungarians already own 20% of Shaikan. Having a more meaningful stake in the block should appeal to them.

So far MOL have been playing it cool compared to Gulf Keystone. Gulf Keystone was obviously over the moon when the drilling results come through. MOL was far less enthused saying it was too early to say whether the oil was suitable for sale and an

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independent audit would be necessary to evaluate the results. MOL conceded that preliminary test results seem significant but results of long-term tests won't be available until the end of 2010. They declined to give their own estimates of the size of the field.

It's a strange reaction by MOL. It feels like they're keeping a poker face. Either way, a funding deal with MOL is a real possibility. Of course the easiest solution to a lack of money would be an outright takeover.

Takeover talk

Back in August the shares jumped 70% in one day on false bid rumours. Talk was that Gulf Keystone had received a joint $2.3 billion bid from Indian Oil Corporation and Oil India. As the rumours were both very specific and widely reported in the press, the shares rocketed up.

Interestingly MOL and ONGC (India's biggest oil company) have an agreement to share exploration and production projects in India and elsewhere. Perhaps that would have been an even better rumour given the link back to Gulf Keystone.

Despite the potential of the Shaikan discovery, an outright bid for Gulf Keystone would be a brave call. Testing is still at early stage and the range of oil in-place for the Shaikan structure is estimated to be between 1 and 5.3 billion barrels of oil. The size of the range is huge and demonstrates how vague the guesswork is at this stage.

What are the shares worth?

The company as it stands today is loss making and its rate of cash burn is cause for concern. Based on past performance it offers little value. Valuing a company like Gulf Keystone requires making broad assumptions as its value lies in its potential. Its main asset is the 80% stake in the Shaikan block.

Oil discovered as deep down as a mile cannot be fully recovered. At the depths of the Shaikan discovery, the industry rule of thumb is that around 25% of the oil is recoverable. Based on the mean estimate, this would imply 700 million barrels recovered. Obviously, the drilling programme is still ongoing. Should more oil be found nearer two miles underground, then the recovery rate falls to around 10%.

Another key consideration is what these buried barrels of oil are worth? The oil price is trading near $80 a barrel but that is for the finished article delivered to your door.

Valuing in-ground reserves is a complex task. There are a lot of factors to consider such as the quality of the oil, the cost of producing it, the transportation costs, the country risk and the royalty paid to the government.

There is not a huge amount of commercial data on Iraqi reserves. Most multinational oil companies are currently being paid for their services in Iraq, rather than owning rights to the oil itself. The current going rate for oil majors is only $2 a barrel after development costs, but this is just a service fee.

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Based on the global proven reserves of Royal Dutch Shell, an undeveloped barrel is worth over $5 a barrel, but this is an average across a global portfolio and Royal Dutch Shell has the engineering and financial capability to bring the stuff to the surface. For Gulf Keystone some analysts have used a yardstick price of around $2-3 a barrel, but this is highly subjective.

Kurdistan offers a mix of opportunity and risk. There is clearly a lot potential value in the rest of Gulf Keystone's Kurdistan portfolio given the region is believed to have enormous untapped reserves. Having said that, there's no denying that the newly liberated Iraq remains politically unstable. The current dispute between the local Kurdistan and central Iraqi government over oil exports is a perfect example of the risks facing foreign oil companies.

Perhaps the biggest problem for Gulf Keystone is its delicate funding position. Investors need to have more than one year of financial visibility. One option would be to sign a long-term development partner in exchange for a greatly reduced stake in Shaikan or alternatively just hand over the asset to an oil major in exchange for a licencing / royalty business model (as is often used in the technology and pharmaceutical sectors).

Dilution for existing shareholders is inevitable, but as the saying goes "it's better to have a small share of something than a big share of nothing."

There is no doubt that the shares already have plenty of good news in the price. The current valuation implies the recoverable barrels will be at the upper end of the estimated range or that further upgrades or additional discoveries will be made. This is not an unreasonable assumption given the recent developments.

Our view is that Gulf Keystone is a highly speculative share but there is enough drilling potential and near term catalysts to warrant further share price appreciation. We have set a 12 month price target of 145p.