



October 24, 2012

Rating: RESTRICTED

Issued 17/08/12

Equity Report: Merger/acquisition

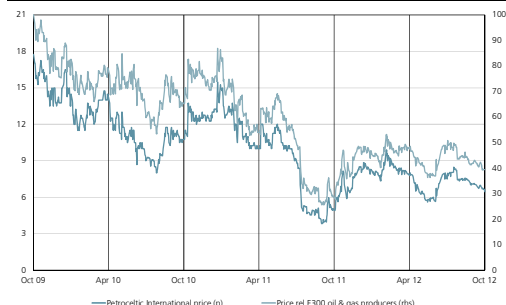
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## Petroceltic

### Share Price Performance

Price: 7p



## Strength in unity: Petroceltic and Melrose combination provides solid template to continue to develop a MENA-focussed E&P company

### Company data

Reuters/Bloomberg/Xetra	PCI.L/PCI LNEG5
Sector	Resource
Shares (m)	4388.1
Daily No. Shares Traded (m)	12.148
Free Float (%)	99.3
52 Week High/Low	9.9/4.91

### Capital Structure

Mkt. Cap (£m)	293
Net Debt/(Cash) (£m)	131
Deferred consideration/debt-related	N/A
Pref Shares/Non Eq Min	N/A
Minority interests	N/A
E.V. (£m)	424

### Recent research and research resources

Recent research and financial data on [Petroceltic](#)

Sector research and data on [Resource](#)

### Merger has benefits for both sets of shareholders

- Following sanction by both sets of shareholders, Petroceltic and Melrose Resources have merged and now trade as the combined entity. We view the deal as positive for both sides.
- Petroceltic shareholders now have the stability of a production stream, additional financial flexibility and increased newsflow.
- For their part, former Melrose shareholders are now involved with a more exploration-focussed group, a longer-term production project to complement existing production and a management team that intends to pursue a growth agenda.

### Growth vectors/catalysts

- By year-end, the sanction of the Algerian gas development plan will convert contingent resources to reserves. Assuming current market values, post-conversion, the group will be trading at an EV/bl of just US\$1.80.
- The group will continue to focus on the Middle East and North Africa (MENA) region. This is an area where oil and gas remain core to national development and consequently deal flow is established and frequent.
- Up to nine wells are scheduled in the enlarged group, including a maiden well on the Kurdistan acreage.

### Still plenty of upside post deal

- For Petroceltic shareholders, the deal is marginally dilutive on our calculated pre-deal NPV per share valuation.
- We estimate that the combined entity is now worth 21.4p per share (versus 25p prior to the deal). However, de-risked assets – either producing or scheduled to be brought on production – account for 17p of this.
- Our view that there is considerable upside in the stock is unchanged. It is arguable too that the upside is a more realisable target due to the added strength the merger brings. We think the stock will perform well in the coming months.

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## Combined company

We think the combined Petroceltic/Melrose entity is a stronger unit than the sum of its parts. Arguably, each company brings something to the enlarged group that either improves an aspect of the operation or provides cover in other areas that were less than optimal. This is illustrated in the table below.

**Table 1: How the merger works**

<i>Petroceltic challenges</i>	<i>Melrose strengths</i>	<i>Combined entity</i>
Focus on one large asset at start of development cycle	Wide spread base of assets	More diversified full cycle asset company
Short on newsflow	Long on newsflow	Greater levels of activity to maintain market interest
No production at present	Current production	Production capability now available throughout group
No cash flow	Large EBITDA/cash flow	Self-funding capability
Resources status only at present	Reserves status now	Improved status on hydrocarbon inventory
<i>Petroceltic strengths</i>	<i>Melrose challenges</i>	<i>Combined entity</i>
Growth potential through exploration	Limited exploration scale and potential	Material exploration focus
Market known management	Poorly known management	Access to market assured
No debt on balance sheet	Very heavily leveraged	In enlarged group the debt profile provides development optionality for Algerian development
Strong profile of mainstream investors	Shortage of mainstream investors	Opportunity to grow profile of enlarged group
Big future production profile	Declining future production profile	No decline in production profile

Source: Davy

- Following the merger the debt facility in place with Melrose was terminated and a new \$300m line of credit was created

## Funding flexibility

There is one main reason why the merger works: the combined entity provides additional flexibility to maximise the value of the 52% stake currently held in the giant Ain Tsila gas field in Southern Algeria. This is because the Egyptian and Bulgarian fields provide a reserve base lending option that was not previously available to Petroceltic shareholders.

As the Egyptian and Bulgarian fields will have paid down the current \$300m facility by 2015, the production tail associated with these facilities can be used to put in place a new line of reserve based lending. The timing is exactly in line with the estimated requirement for the Ain Tsila project development.

Based on published data, our estimates of Melrose's post 2015 cash flows discounted at 10% per annum amount to over \$300m. Depending on the cover ratio assumed and the years used in the production profile, a debt capacity of between \$150m and \$200m should be possible.

### Ain Tsila capital requirement

The full cycle life of field capital investment programme at Ain Tsila is estimated to be \$2.5bn. Of this, some \$1.4/1.5bn is required to first gas in 2017. Petroceltic has always guided that it would finance this on the basis of the proceeds of a farm-down from its present position and debt.

On the basis that Petroceltic cannot reduce its interest in the field below 37.5%, as this would imply a change of control that is not possible under the PSC before first gas, the theoretical capital commitment is \$0.55bn.

- The Competent Person's Report (CPR) related to the merger reports that the Ain Tsila field will involve a plateau rate of 335m cubic feet of gas per day for a period of 14 years (median case). A breakdown of the costs assumes a spend of \$1.39m on facilities and hook up (a number that includes a 20% contingency). Other costs around this number amount to c.\$100m.

- Petroceltic has a 20% stake in the Shakrok and Dinarta licences in the Arabian foreland Basin of Kurdistan. The licences are operated by Hess. This drilling programme offers material upside. An independent CPR indicated 'net' aggregate prospective resources of 140m barrels across the Kurdistan licence to Petroceltic. Moreover, this was after a 25% chance of success had been taken into account.

Post-merger, Petroceltic has more options to finance this commitment. We assume that the group will initially utilise the proceeds of a second farm-down – estimated to be up to \$200m – with the balance being a combination of the Melrose reserve base lending (say \$200m) and a debt instrument based on the Ain Tsila field itself. The latter will be possible as Ain Tsila will have reserve status gas at that stage (post declaration of commerciality as well as post substantial field development drilling).

We also think that, given the clear line of sight to financing now possible because of the merger, Petroceltic will be in a stronger negotiating position with respect to bringing in a second farm-in partner.

## Additional newsflow

The merger also means there will be much more newsflow in the short term. This is shown in the activity table below which includes the additional wells in Egypt, Romania and Bulgaria expected as a result of the Melrose merger.

**Table 2: Drilling activity list (all wells) over next 18 months**

<i>Well</i>	<i>Start</i>	<i>Location</i>	<i>Interest</i>	<i>Target size P50 (gross)</i>	<i>Risked (pence)</i>	<i>Unrisked (pence)</i>
Mesaha	Q4 2012	Egypt	40%	NA	NA	NA
Mustafa	Q4 2012	Egypt	100%	4.6 BCF	NM	0.1
Kamchia	Q1 2013	Bulgaria	100%	27 BCF	0.2	0.5
Carpignano Sesia	Q1 2013	Italy onshore	48%	162 mmbbls	1.1	6.6
Sinbelaywan	Q2 2013	Egypt	100%	10.2 BCF	NM	0.5
Muridava	Q2 2013	Romania	40%	100	0.3	3.4
Est Cobalcesu	Q3 2013	Romania	70%	200	0.5	6
Shakrok	Q3 2013	Kurdistan	20%	650 mmbbls	0.8	tbc
To be selected	Q4 2013	Italy offshore			NA	NA

Source: Davy; company reports

## Significant wells

- **Mesaha:** The first well will be targeted at one of the few undrilled basins onshore Africa. Petroceltic has a 40% interest in the well which is scheduled to start in December and is likely to take some six to eight weeks to drill. No guidance has been provided on scale as it is a wildcat well in the purest sense of the word.
- **Kamchia:** The next well will be on the Kamchia target in the Bulgarian sector of the Black Sea. This is a 27 BCF target with a guided 40% chance of success (0.2p per share risked, 0.5p unrisked in our group valuation).
- **Romanian wells:** The same rig will be used to drill two wells in the Romanian offshore later in the year (combined 0.8p risked, 9.4p unrisked).
- **Italy onshore:** A well is also scheduled to be drilled in the Po Valley onshore Italy (1.1p risked, 6.6p unrisked). This has the potential to be a hugely significant well, but timing remains subject to obtaining appropriate permission, a process that is underway but not finalised.

**Table 3: Break-out of post-merger asset valuation (p)/share**

	Pence/share (post-merger)	Section totals
<b>Producing &amp; commercial</b>		
Egypt & Bulgaria	8.5	
		8.5
<b>Undeveloped/ contingent</b>		
Egypt & Bulgaria	0.3	
Algeria	8.4	
		8.7
<b>Prospective</b>		
Egypt & Bulgaria	0.6	
Romania	0.8	
Italy	3.4	
Kurdistan	0.8	
		5.6
Balance sheet	(1.4)	
		(1.4)
<b>Group</b>		<b>21.4</b>

Source: Davy; company reports

- **Kurdistan:** Further down the track in Q3, a first well is scheduled to commence on the Shakrok target in Kurdistan. We carry this asset at cost of entry for now (\$53m) but will refine further as we approach the drill date.
- **Italy offshore:** An Italian offshore well is slated for the fourth quarter of the year.

## Post-merger metrics

Post-merger, the former Petroceltic shareholders will have a 54% stake in the combined group. Melrose shareholders will have a 46% interest.

### Post deal valuation per share

Based on discounted cash flow analysis for both companies, our post-merger NAV per share looks as follows (our valuation of Petroceltic's assets is unchanged post-merger).

**Table 4: Pre- and post-merger valuation per share**

	Pre-deal NAV/share (p)	With Melrose debt now NAV/share (p)	With Melrose YE 2012 f'cast debt NAV/share (p)
Petroceltic	25		
Melrose NAV (Davy estimate)	302		
<b>Combined NAV/share</b>		<b>21.4</b>	<b>21.8</b>

Source: Davy

Within the overall group valuation above, we value the current 2P producing and undeveloped reserves at 8.7p per share. Algeria, which does not yet fit into this category but is essentially de-risked, is valued at a further 8.4p per share. This means that over 17p per share out of the 21.4p per share (80% of the value) is essentially de-risked.

### Debt and enterprise per barrel valuation

Assuming a year-end net debt gearing ratio of 60%, the combined enterprise value will be just over \$673m (based on current market prices). The resulting post deal per barrel metrics are shown in the following table. In the combined case, assuming conversion of Petroceltic's resources to reserves clearly makes for a much more attractive valuation per barrel. This process is well in train and is expected by year-end – full conversion of the Algerian contingent resource would lead to a 2P reserve of 384mmboe at year-end.

**Table 5: Pre- and post-merger and debt enterprise value metrics**

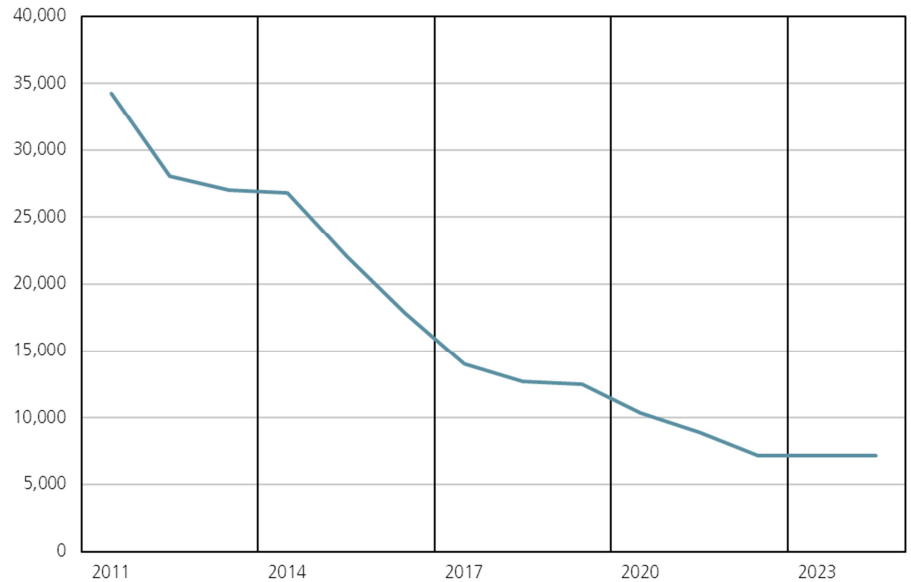
	Mkt cap £m	Net debt \$m	EV \$m	Net debt F1 YE \$m	EV F1 YE \$m	2P reserves Mmbls	2P reserves & resources Mmbls	EV/1b reserves	EV/1b Y/E reserves & resources	EV/1b F1 Y/E reserves	EV/1b F1 Y/E reserves & resources
Petroceltic @17/08/2012	190	-55	249	-30	273		356		0.7		0.8
Melrose @17/12/2012	156	263	513	235	485	79	79	6.5	6.5	6.5	6.1
<b>Combined (now)</b>	<b>293</b>	<b>209</b>	<b>678</b>	<b>205</b>	<b>673</b>	<b>79</b>	<b>435</b>	<b>8.6</b>	<b>1.6</b>	<b>8.6</b>	<b>1.6</b>

Source: Davy; company reports

## Production and balance sheet

Post-merger, Petroceltic will have a production profile generating revenue and cash flow.

**Figure 1: Production profile (boe/d) from Melrose assets**



Source: Davy; company reports

- Post-merger, we estimate that the combined debt is in the region of \$220m

At mid-year the production profile was 28,600 boepd, with the majority from the Egyptian assets and the balance from Bulgaria. This is scheduled to decline as the fields mature. The profile, as modelled by Synergy – independent consultants commissioned at the time of the merger – is based on existing fields and planned developments. It does not take into account possible gas reserves and prospective resources – which would include the targets being drilled in the Bulgarian and Romanian offshore next year.

Based on the above production schedule and current pricing, it is possible to identify net cash flow of up to \$330m (pre-tax) from these fields after 2015.

At mid-year the net debt in Melrose was \$263m with Petroceltic reporting cash of \$54m. In the first six months, Melrose reported a net cash inflow of \$93m before capital expenditures of \$25m. The balance was applied to debt reduction.

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			Count	Percent
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