

Mediterranean Oil & Gas

Buy

Italian Oil and Gas - and Maltese Giants?

07 March 2006

AIM Code

MOG

Target Price

220p

Share Price

146p

Issued Capital (Fully diluted):

33.3m (48.4m)

Mkt. Capitalisation

£48.6m (£70.7m)

Key Shareholders (fully diluted)

Stark Intl. 25%

Transcontinental* 24%

* Associated with A Trevisan, Exec. Dir.

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Mediterranean Oil & Gas is an established Italian gas explorer and producer. Management is well qualified with plenty of relevant experience. Production is modest but cashflow from operations is growing and covers overheads and the bulk of the expected onshore work programme.

The company intends to become a medium sized oil producer through the appraisal and development of its 100% owned Ombrina Mare oilfield, due to come onstream in 2008. The field has two satellite structures to explore and also gas potential.

MOG has a significant position in some prospective offshore exploration blocks south of Malta. These have been only lightly explored to date but may lie on trend with some large Libyan oil fields. Drilling will be expensive but the company has just opened a data room for companies interested in farming in.

MOG also has 20% in the exciting Monte Grosso prospect (Serra San Bernardo permit), which lies near Europe's biggest onshore oilfields. Work is in progress to finalise a drilling location.

The company is the operator and owns 20% of a significant gas development project, the Guendalina field. It is also planning to expand and develop its other Italian onshore gas assets.

A recent deal has given the company 11% of the undeveloped heavy oilfield of Grenade in Southern France. Appraisal work is planned for this year.

Recommendation / Comment

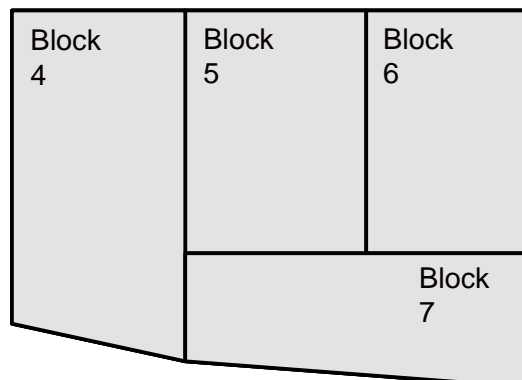
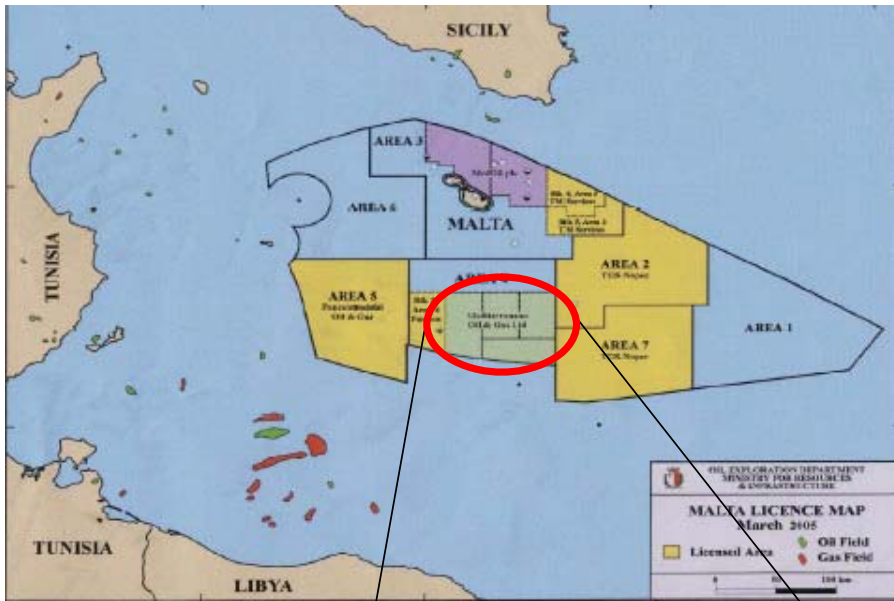
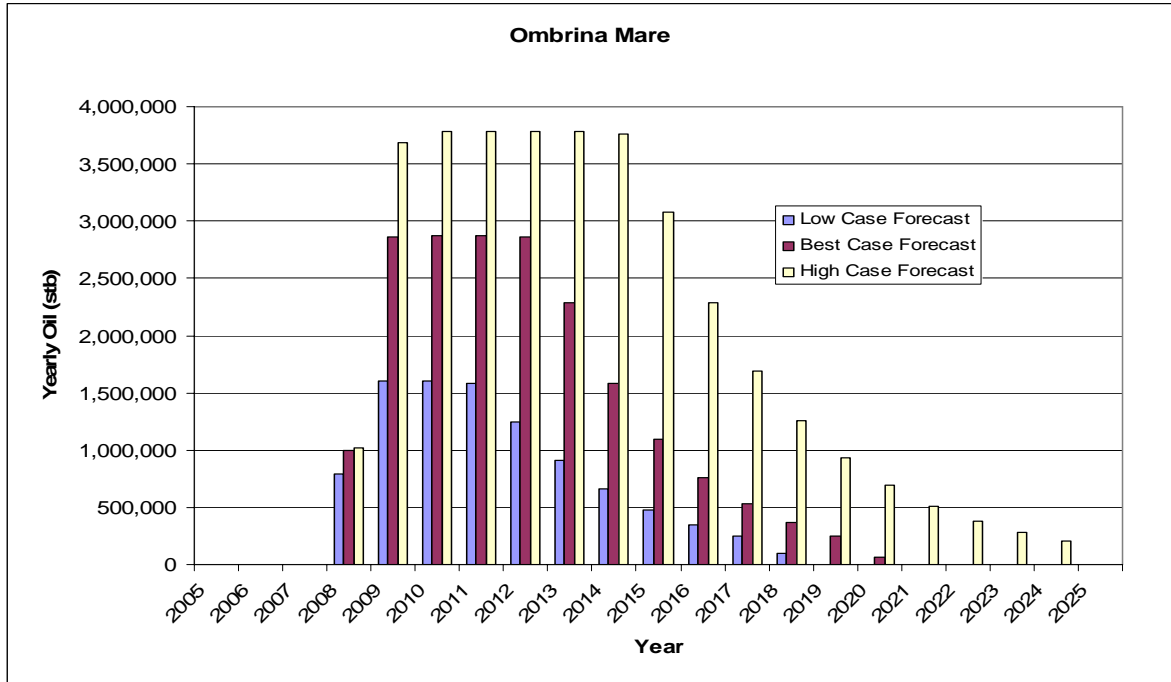
Mediterranean Oil & Gas came to AIM in November at 100p. The share price has been firm since then, and as the company will become better known, the downside risk of investing now seems modest. MOG is unusual because it already has established production and cashflow as well as a spread of development projects and exploration, some of it with very high potential. This provides an element of solidity not found in purer exploration plays. We expect interest to grow as drilling on Ombrina Mare nears and ahead of a farm-out deal on Malta. We also like the Mediterranean focus, centring on Italy. After years of dominance by ENI, the Italian market has opened up and just a few companies have taken advantage so far – MOG is one. Our valuation model comes up with a conservative fair value (risked) for the company of more than double the current price.

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Overview

Mediterranean Oil and Gas PLC (referred to as MOG or the company) is an UK registered incorporated early in 2005 to become the holding company for an oil and gas business in Italy and Malta. Its strategy was to acquire and develop oil and gas assets in the Mediterranean region. MOG's wholly owned subsidiary, Australian registered Malta Oil Ltd, applied for and was awarded exploration interests in prospective acreage offshore Malta. In May 2005, MOG acquired 100% of Intergas Piu S.r.l. (IGP), which operates the Italian oil and gas concessions. The company was listed on the AIM market on 16th November 2005 following the raising of 11.7m shares at £1 each through an institutional placing.

The company has some significant exploration and development projects which are likely to move it up the league tables in the next few years. The most important at present is the 100% owned Ombrina Mare oil and gas field. The recent Competent Person's Report (the CPR, produced by RPS Troy Ikoda) gave a best estimate of around 20mb of recoverable proven and probable oil reserves in this field. Ombrina Mare is likely to commence production in 2008 and should reach a plateau production rate approaching 8,000b/d the following year. The field has several satellite structures, including probable gas zones, and has significant upside potential from further appraisal of the field.

The real blue sky exploration holding is the 100% interest in four blocks south of Malta. These are adjacent to Libyan waters and have barely been explored. On one block, three large structures have been identified by 3D seismic. The company is currently seeking farm-in partners to bear the cost of drilling wells. The oil in place potential of these structures is several hundreds of millions of barrels.

Another key exploration asset is MOG's 20% of the intriguing Monte Grosso oil prospect. This is very close to Europe's biggest oilfields and oil majors are snapping up adjacent acreage.

Mediterranean Oil and Gas (MOG) has built up an impressive array of 18 onshore and offshore gas production concessions in Italy, along with 8 exploration permits. The production at present is modest at around 2.8mcf/d but rising gas prices means that cashflow is set to double this year. It already covers the company's overheads and the bulk of the Company's onshore exploration.

Other development projects include the Guendalina gasfield (20% interest) and the Grenade heavy oilfield in France (11.1%). There are a further four gasfields with significant reserves in the Northern Adriatic which are awaiting development. However these are currently 'frozen' due to Government legislation and there is no clear timetable for development to begin.

Finances are in good shape. The company placed 11.7 million shares at 100p prior to its AIM listing and the cash from that placing, net of listing costs, remains intact. The current work programme is fully funded.

Part of the company's strategy is to examine potential acquisitions with a view to increasing the portfolio of assets in the Mediterranean region. Clearly, extra funding is liable to be required if such deals are large.

The Italian Gas Market

Gas prices in Italy are high at around \$8/mcf. Domestic production has fallen in recent years while demand has been strong. Over 80% of the country's gas is imported, mainly from Russia and through the Transmediterranean pipelines from North Africa. The import routes are close to capacity, leading to supply problems at peak times. Italy has a significant pipeline network, which means that new fields can easily be linked to the market.

Mediterranean's Italian Gas Portfolio

The company has interests in 18 production concessions covering 1707 sq. km. and 8 exploration permits totalling 1963 sq. km.. Two other applications are pending. Most of these interests are onshore with a few in shallow water offshore. They are scattered throughout Italy. Proven and probable reserves total some 6bcf. The company also has interests in various gas treatment facilities.

The company's modest production is enough to make it the fourth largest producer in Italy. Furthermore, Italian gas prices are rising sharply due to supply/demand pressures so that cashflow in 2006 is likely to be around double the 2005 figure of some €500,000/month. This is partly because the Italian wholesale gas price is linked to oil prices but lagged by six months. However, spending on infrastructure this year is also expected to lead to a jump in gas production. The company plans to drill five new onshore wells and four workovers in the next 18 months.

On 6th February Mediterranean announced the grant of a new "highly regarded" exploration permit, Masseria Gaudella, which adjoins the company's Scanzano acreage in southern Italy.

Ombrina Mare (100% MOG)

MOG's primary focus at present is this potentially large crude oil field (at a heavyish API 18 deg), located in shallow water offshore Italy. The field was discovered in 1987 by Elf Aquitaine, when a successful drill stem test proved the existence of oil and gas horizons. The discovery well flowed 400b/d and 1.5mcf/d of gas from the top section. At the time oil prices were low and the field probably only marginally economic. Times have changed. Oil prices are now much higher while advances in technology allow for much more cost-effective development of the field. Ombrina Mare is 0.7 km offshore with water depth of a mere 20 metres. Subsequent seismic and interpretive work has suggested that the field may be the largest field in a cluster.

There are other comparable fields in the area. The Rospo Mare field, which has been in production for almost 20 years, lies nearby to the southeast while discoveries have also been made in blocks to the northwest. ENI have a large adjoining block to the north and are drilling for structures similar to Ombrina Mare. ENI also has oil production and an oil processing plant onshore north west of Ombrina Mare.

The Competent Person's Report (CPR) suggests a "best estimate" (which we interpret as more or less a probable figure) of 89.5mb of oil in place and 19.5mb of recoverable oil. This may well not prove to be the end of the story. The CPR puts a high figure for oil in place of 143mb but this is based on the discovery well, which did not drill very deep. MOG's presentation suggests that the lowest closing contour covers an area two and a half times as big as that appraised by the CPR. This may or may not contain oil-bearing strata but there seems to be a good case for drilling deeper to find out if there are further intervals.

The next step is an appraisal/development well – the pre-placing money was earmarked particularly for this. Current thinking suggests a horizontal well, which may be spudded by year end. If successful, this would put the reserves into the proven category. The company intends to fast track this development to allow pilot production in 2007 and full field development the following year. Horizontal drilling at heavy oil fields such as this gives sharply higher production rates than traditional vertical wells – sometimes 10-15 times as much.

Very close to the main field there are two satellite prospects (Ombrina South and Ombrina Southeast), which have significant oil potential, with oil in place estimates of 32mb and 68mb. If these structures are fields, they could be developed in conjunction with the main field. These structures need to be evaluated to determine an optimum development plan for the complex.

The discovery well found gas intervals above the oil. MOG believes that there could be two gasfields partially overlying the oilfield, with a "best estimate" total 11bcf of gas in place. If so, this could be developed

commercially with the oilfield and/or used to improve the flow and recoverability of the oil. There is a third gas lead around 12km away.

The production chart indicated on page 2 is taken from the recent CPR.

Malta (100% MOG)

MOG's Maltese acreage is an intriguing, high potential play. Through an Exploration Study Agreement granted in March 2005, the company has 100% interests in four blocks due south of Malta, with an area of over 5000 sq. km. They are blocks 4, 5, 6 and 7 of Offshore Malta Area 4 and are on the Mediterranean Pelagian Shelf. The prospective acreage south of Malta has hitherto been little explored because of an ongoing border dispute with Libya and Tunisia. However, the border on the edge of MOG's acreage (although not elsewhere) has been formally agreed and settled permanently

There are two analogous trends which may extend into MOG's Maltese acreage. These are the Tunisian Metlaoui fields and reefs extending from Libya's prolific Sirte Basin. The Libyan fields produce high quality crude oil and boast exceptionally high recovery rates of up to 80%. There is a great deal of industry interest in the Maltese blocks at present. There are not too many high potential, lightly explored areas in stable political areas. Malta is a member of the EU. What is more, the country's fiscal terms are favourable as the country presently imports all its energy and is keen to attract drilling.

Of the four blocks, Block 7 is the most advanced and three large structures have been identified from 3D seismic and matured to the point that a well is justified. According to the CPR, Tarxien is the largest with an unrisks "best estimate" of 124mb recoverable, from 322mb of oil in place. On the same basis, Hagar Qim could have 71mb recoverable from a 246mb deposit and Skorba could be 23mb from 81mb in place. These total 218mb from oil in place from 648mb. These numbers are significant. However, the high estimates are put at nearly double, with a potential 430mb from structures adding to 1178mb. The recovery factors here look conservative – if the structures turn out to be fields analogous to the Sirte Basin, we would expect recovery factors in excess of 50%.

It should be noted that wells in this area are high risk/high reward. We are assessing them in our model as 10% shots. It is believed that one well in the surrounding acreage was dry – probably not too relevant in the context of the size of these blocks - but the closest, Hana 1, 27 km to the south, had hydrocarbon shows. Understanding of the geology of the region has been improving with more seismic, especially 3D, having been shot and with data from earlier wells. MOG's acreage appears promising.

Blocks 4, 5 and 6 need further study and 2D and 3D seismic work in order to identify prospects. Ideally, they would then be packaged for a farm out deal. Only around 10% of the company's acreage has so far been given 3D seismic. A new seismic program is planned to start shortly, with the initial focus being on the Melita/Medina channel in which the 3 existing prospects have been identified.

Drilling offshore Malta will be expensive – possibly \$35m, which is too high for MOG alone. However, the company has said that it has recently opened a data room for other companies to decide whether they want to farm in to the acreage. The company expects a farm-out deal to result and we would also expect a deal to be possible. If the company wants to be carried in the wells, it may well have to sacrifice 50% or even a little more of its holding. In our model we have assumed that MOG retains 40%. Although the farm-out may be for Block 7, it may be structured to allow for an option on the other blocks as well. Such companies as Exxon, Woodside, CNPC, Sirte/Exxon and Petrobras are active in the region. Anadarko last year farmed into the acreage adjoining and immediately west of MOG's acreage.

Monte Grosso (20% MOG)

The Monte Grosso prospect lies in the Serra San Bernardo Permit. The company operates the permit. Its partners include ENI and Total, which illustrates both the company's credibility and the prospectivity of the license.

There have been a rash of commercial discoveries in the region with many of the majors involved. Total's Tempa Rossa field, one of Europe's largest onshore oilfields is close and there is a nearby Monte Alpi field, owned by ENI and Shell, which is producing 70,000b/d – and rising. Another adjoining discovery being developed in the area is Cerro Falcone. It is interesting that Shell has applied for substantial amounts of acreage nearby, including some bordering on Serra San Bernardo.

Formal approval to drill the prospect is expected by 2Q 2006 although drilling is unlikely before late 2007. One possibility is to re-enter an old well drilled by British Gas. This well encountered technical problems and wasn't completed. Nevertheless, part of the old well might be usable, which would cut costs and speed up the drilling process.

The prospect is large. The CPR puts forward a Best Estimate of 710m barrels of oil in place on an unrisks 100% basis. Recoverable reserves on this basis are put at 121mb. However, the CPR's high estimate for oil in place is 2.1bn barrels, nearly three times as high.

North Adriatic interests

The ENI-operated Guendalina gas discovery (MOG 20%) has recoverable reserves put at around 16bcf by the CPR. Development options are being considered.

The company has a 15% interest in several other concessions and gas discoveries in the region. These have been "frozen" for some years as the government has disallowed drilling in the area for a rather strange fear of subsidence if reserves were to be developed. We expect these assets to remain frozen for some time although MOG will join ENI and Edison in lobbying the government to release the area for development. If and when the acreage is released, the gas reserves net to the company would be substantial – the CPR placed a best estimate of 39bcf on the company's gas in place reserves – around 22bcf recoverable.

Grenade (11.15% MOG)

In January this year the company announced that it had agreed to acquire a stake in this known heavy oilfield in the Aquitaine Basin, in the south of France. Grenade was proved up in the 80's by Elf but the oil price collapse of 1986 killed the economics and the field was abandoned. The field has oil in place of somewhere between 68mb and 485mb, with a best estimate of 221mb. The oilfield is well-placed, close to markets, and the fiscal terms are good.

The main problems are to get commercial flow rates from the 10 deg API crude and to obtain a decent recovery factor. Techniques developed in recent years have made fields like Grenade attractive. It is useful that UK heavy oil specialist Nautical Petroleum has 22% and is likely to take over as development operator from Egdon Resources. 2D and 3D seismic has recently been shot and work is being carried out to identify a drilling location. A well is likely to be drilled in a matter of months. Horizontal drilling appears certain to be used.

Management

The full time CEO is Giovanni Catalano, who was appointed in June 2005. Mr. Catalano has more than 25 years of experience in the upstream oil and gas business, most recently spending 7 years at Woodside (latterly Business Development Manager – Far East). He is a former director of Woodside Energy UK and Agip

Mauritania as well as having been Chairman of Woodside Energias in Spain. Mr. Catalano spent 9 years working with Agip (ENI) and before that was 11 years with LASMO. Mr. Catalano has a strong technical and commercial background and has wide experience of developing new exploration and development ventures.

The other Executive Director is Anthony Trevisan. Over 20 years, he has played major roles in a large number of corporate transactions involving financing, mergers and acquisitions and the restructuring of industrial, oil and mineral companies. He has participated in the start up of substantial operating businesses and been responsible for public offerings and the floating of companies. Mr Trevisan has held senior executive positions in listed public companies such as Arabex Petroleum (Rubiales oil discovery), Callina NL (workover project in the Russian Komi oilfield) and Trident Petroleum.

MOG's other directors, including the Chairman, David Lenigas, are all non-executive. They are of very high calibre and are a formidable resource. Mr Lenigas, presently CEO of Lonrho Africa, has been the MD and CEO of many resource companies in recent years. Salvatore Russo has held senior positions on the Boards of some of Italy's largest corporations and has been Chairman and CEO of Saipem, Snam and Snam Rete Gas. He is currently chairman and CEO of EnerTADHe has been a board member of Agip, EniChem and Italgas, amongst others.

Peter Clutterbuck has broad experience in global exploration, development and production. He began his career with BP and has managed independent oil companies for over 20 years. Patrick Collins worked for Morgan Stanley and Merrill Lynch, where he headed their European Distressed Debt trading team. Mr. Collins now runs the Global Special Situations Group at Mizuho International, a major shareholder of MOG.

The company has 20 full time employees and consultants at present, in its Head Office in Rome and its operational base at Foggia.

Financial Situation and Share Structure

Mediterranean Oil and Gas is well financed for its ongoing plans. The cashflow from the Italian gas production will not only cover overheads but will contribute towards the exploration and development projects. Coupled with the money from the placing prior to the IPO, an "aggressive" €16m work plan is fully funded. The initial phase of the expensive Maltese exploration program is likely to be paid for by the farm-in partner.

If the company makes any substantial acquisitions or if exploration and appraisal success leads to further oil or gasfield developments, extra finance will be required.

The only debt that MOG has is some convertible notes which expire in March 2008. These were issued to two investors, Mizuho and Stark Intl. They expire in 2008 and can be converted into shares at 50p – the notes carry an interest rate of 6% p.a..

The company has 33.3m shares in issue. There are likely to be 9.5m more as a result of the convertibles and a further 5.6m from options granted to the founding shareholders. These are exercisable at 106p on average. So the fully diluted number of shares in issue is 48.4m.

The early stage investors signed an orderly market agreement so that for 12 months from the IPO any sales would be managed through the company's broker, WH Ireland – Mizuho's holding was recently sold. Subscribers to the IPO placing with more than 3% of the company's shares (around 24% of the issued capital) were similarly constrained for six months. As a result of the orderly market agreement, the supply of stock to the market is limited and may remain so if the early shareholding institutions remain fully committed. However, while the agreement remains, there may be further opportunities for substantial investors to take a meaningful stake without moving the share price against themselves – if the broker can find a matching seller in the rather thin ranks of the locked-in investors.

Valuation and Appraisal

Our valuation model is based on risk discounting the company's assets rather than any discounted cash flow basis. This method was chosen because of the lack of precision possible in the development and exploration projects which comprise most of the company's value.

The model is simplistic and should not be regarded as an accurate guide to the company's worth. However, it does give an order of magnitude for the value of the assets. Very conservative assumptions have generally been used. For instance, we have assumed gas in the ground to be worth only €1.5 (\$1.80)/mcf with oil at €6 (\$7.2)/bbl, except that Grenade has been discounted as it is so heavy. We have given only a notional 10% chance of success to the frozen assets, even though they are discoveries. We assume that the company's cash is used in the current work programme and that the eventual convertible and option money is also absorbed. The model uses only a 40% share of Malta, with 60% notionally allocated to a farm-in partner.

	Potential Size (Recoverable)	% Owned	Rate €/mcf or €/bbl	Possible Value (€m)	Estimated Chance of Success	Risked Value (€m)	Risked Value (£m)
Ombrina Mare	20mb	100	6	120	80%	96	66
Ombrina Mare South	6mb	100	6	38	25%	10	7
Ombrina Mare Southeast	17mb	100	6	102	25%	26	17
Ombrina Mare gas leads	7bcf	100	1.5	11	20%	2	1
Ombrina Mare - gas lead	3bcf	100	1.5	5	15%	1	1
Guendalina	16bcf	20	1.5	5	95%	5	3
Monte Grosso	120mb	20	6	144	15%	22	15
Other gas fields (net)	6bcf	100	1.5	9	95%	9	6
Grenade	33mb	11.15	4.2	16	80%	12	8
Malta (3 prospects)	73mb	40	6	526	10%	53	36
Frozen assets	22bcf	100	6	133	10%	13	9

Total **€247m** **£169m**

Fully diluted per share 348p

It should be noted that this valuation gives no weight to many of the upside possibilities. For instance, the reserves, as used in the CPR best estimates, may well be rather conservative. The maximum cases are sometimes much higher but we have not allowed anything for this. We have also made the harsh assumption that Malta will produce no more drillable structures.

It can be seen that the main drivers of value at present are Ombrina Mare, the Maltese acreage and Serra San Bernardo. This year's work on Ombrina Mare is important for short term share price prospects.

Despite our deliberately pessimistic assumptions, our model suggests a fair value for the shares at present to be well over double the present price. As time passes and the work plan progresses, we believe that our valuation is more likely to rise than fall. In consequence, we believe that there is a solid base to the present share price and conclude that our rating should be a BUY with a medium term price upside of around 50%