

**Mediterranean Oil & Gas**

**Buy**

**Update - The Story Unfolds**

05 June 2006

**AIM Code**

MOG

**Target Price**

310p

**Share Price**

216p

**Issued Capital (Fully diluted):**

33.4m (44.1m)

**Mkt. Capitalisation**

£72.1 m (£95.0m)

**Key Shareholders (fully diluted)**

Stark Intl. 23%

Transcontinental\* 22%

\* Associated with A Trevisan, Exec. Dir.

**Analyst**

Philip Morgan 01227 264310

[philip.morgan@wh-ireland.co.uk](mailto:philip.morgan@wh-ireland.co.uk)

**Sales**

Philip Haydn-Slater 020 7220 1690

[phs@wh-ireland.co.uk](mailto:phs@wh-ireland.co.uk)

Raj Karia 020 7220 1693

[raj.karia@wh-ireland.co.uk](mailto:raj.karia@wh-ireland.co.uk)

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Mediterranean Oil & Gas is an established Italian gas explorer and producer. The company has Italian oil and gas development projects and exciting exploration prospects.

The company is likely 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 gas potential.

Since our note in March, MOG has entered a highly attractive block in Tunisia (25%). Several prospects have been identified and it is planned to drill the first one, Teboursouk, late this year.

Furthermore, the company has issued further results of seismic work off Malta. The potential, already large, now appears potentially world-class. We await news on a farm-out which should allow MOG to be carried through early drilling.

MOG 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 owns 20% of the significant Guendalina gas field. Now that approval of a neighbouring field has been officially approved, Guendalina has moved into the development phase. Most likely reserves have been increased by the operator by over 40% compared with MOG's AIM admission document. Also in Italy, four more exploration applications have been filed.

**Recommendation / Comment**

Although the share price started to move ahead sharply on the back of a flow of good news, as all the company's key projects advanced, the sharp sector setback nipped the revaluation of MOG in the bud. The consequence is that there is another chance to buy in at a reasonable price. The profile of the company has, in our view, changed significantly. Although the Italian gas production will continue to provide growing cashflow and the development projects will add significant output over the next few years, the major focus of potential now appears to be the exploration acreage. Malta in particular gives massive upside gearing potential. We would recommend continued purchases and would expect a significant and steady rerating ahead of the drilling which gets under way in earnest early next year.

**W H Ireland Limited, 11 St James's Square, Manchester M2 6WH. Telephone: (+44) 161 832 2174/6644**

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## Malta

We have been startled by the size of the structures being identified offshore Malta by MOG and its Competent Person. These are clearly world-class and it is unusual to find a small company with such a big stake in such enormous prospects. Clearly the company will farm down its 100% holding but it should retain a significant holding and the gearing to any exploration success is huge.

Our note of March used as a basis for valuation the prospective reserves for the 100% owned Malta Area 4 detailed in the Competent Person's Report (RPS Troy-Ikoda) in the November 2005 AIM Admission Document. In May, the company released updated resource estimates prepared by RPS.

Potential reserves had previously only been allowed for three structures identified on Block 7, all on the part of the block where 3D seismic had been shot. The company also has the rights to Blocks 4, 5 and 6. The most likely potential of the three structures previously identified (Tarxien, Skorba and Hagar Qim) has been trimmed from 648 million barrels of oil in place to 607 million barrels. However, high estimate of potential oil in place has been increased from 1177 million barrels to 1371 million barrels. Tarxien is possibly the most worked-up prospect and is liable to be the first structure to be drilled.

The good news is that RPS have identified a further six prospects, some of which are very large. The more significant lie outside the area where 3D seismic has been shot and will thus need further work to be firmed up. The largest new prospect, Luzzu, has been given a most likely potential of 2420 million barrels of oil in place. Although RPS assumes that only 25% of this would be recoverable, we would point out that most fields in the region have recoverability rates of over 40% and some are considerably higher. The high side number for Luzzu is a startling 6860 million barrels in place. This structure, ahead of any 3D seismic, is very high risk.

The remaining new prospects are so far unimaginatively called, A, B, C, D and E. The biggest of these is C, which has a most likely potential resource of 1630 million barrels. The five together with Luzzu total 5138 million barrels, with a high estimate (10% chance) set at over 13 billion barrels in place.

It may be thought that such prospects are just (rather wet) moose pasture, because all really highly prospective blocks are assumed to have been grabbed by the majors. However, this does not appear to be the case here. The acreage was clearly missed by the big boys. The company has announced that it commissioned an academic regional study by the University of Rome, the findings of which are supportive of the existence of a working hydrocarbon system in the area and are consistent with the RPS analysis. In other words, there are favourable conditions for hydrocarbon accumulation within the company's concession. When one considers that the acreage is on trend with either the Libyan Sirte Basin or the Tunisian Metlaoui fields, it is clear that this is a serious new exploration play and the risks, while still high, are coming down.

So MOG has a 100% interest in nine prospects given a 50% chance of prospective reserves totalling around 1.5 billion barrels. Even if each structure has only a 10% chance of finding oil and assuming the company farms its interest down to, say, 40%, a risk discounted number of barrels would come to maybe 60 million barrels net to the company. At a net value of maybe \$6 per barrel of undeveloped reserves in an area where there is little infrastructure, this suggests a risked value for the acreage at this point of nearly £200m compared with the company's market capitalisation of £75m. This seems anomalous – although it should be borne in mind that drilling in a new area is a binary bet. It is quite likely that there is nothing much there or there will be fields which will be worth a lot more than the risked valuation.

MOG opened a data room to a few selected companies early this year, giving the opportunity for them to preempt a wider audience, to whom invitations to view the data will go out shortly. The recent update from RPS and the academic study complete the data provision for the potential farm-in candidates. We expect to hear some news in the next few months about any farm-out deal.

### **The Medjerda Block - Tunisia (25%)**

MOG's first entry into Mediterranean Africa took place recently with the acquisition of 25% of a Tunisian permit. This is a large onshore Block (4956 sq km) and is in a relatively unexplored part of the country. A number of prospects and leads have been identified and a rig has been contracted for the first well (on Teboursouk), scheduled for late this year. Since 1995 there has been plenty of seismic and geological work carried out so the acreage has now been matured enough for drilling to be justified. There are several different geological domains on the block and an assortment of potential targets.

MOG acquired its stake from Carthago Oil, which retains a 10% interest, free carried by MOG through the first two wells. MOG's liabilities to carry Carthago are capped at \$1m. The operator is Range Petroleum, which has a 65% interest in the block.

Potential recoverable reserves on Teboursouk have been assessed at around 107 million barrels in two horizons, which is substantial. Risks are high as the area is only lightly explored but exploration costs are modest. Furthermore, any fields discovered would have low development and production costs due to the location – and the Bizerta refinery is close by, which will also vastly aid the economics. The block contract is a Production Sharing Contract and the fiscal terms are described as favourable.

### **Ombrina Mare (100% MOG)**

Ombrina Mare is MOG's primary development focus at present. The field, now estimated by RPS to hold some 20mb on a most likely basis) was discovered in 1987 by Elf and is located in shallow water offshore Italy. The discovery well flowed both 18 degree API crude oil and gas but the field was uneconomic at the time. MOG announced at the interims that a drilling location would be finalised shortly and we would anticipate that an appraisal/development well is likely early in 2007, although we await confirmation from the company.

If all goes well, production of around 10,000b/d starting in 2008 would catapult the company into the middle rank of producers. There are surrounding oil and structures which suggest that production could continue to climb for some years. Similar nearby fields (such as Rospo Mare) have been producing for many years while other analogous discoveries have been made in adjacent blocks.

### **Monte Grosso (MOG 20% and operator)**

Progress is being made on the Monte Grosso prospect, which lies in the Serra San Bernardo Permit. The company's partners include ENI and Total. The area is hot and large fields have been discovered nearby and on trend.

The interims suggested that a formal decision on a drilling program would be made shortly. The prospect is large (RPS estimated 710mb in place in the IPO document as their most likely case and three times in their high case) and exciting. It is very deep – the well is expected to reach 6500 metres and could take as long as a year to drill. It is expected that a first well will be spudded around the middle of next year.

### **Guendalina (MOG 20%)**

It was recently announced that the government ministry has approved the development plan for the Tea gas field. This approval covers the Guendalina field because Guendalina is going to be tied back into the Tea development as the most economic way of producing the field. This regulatory clearance means that the operator, ENI, can prepare final feasibility studies and budgets for the partners to approve.

ENI's latest development plan has raised the most likely estimate of gas reserves in Guendalina from 455 million cubic metres (160 bcf) to 653 Mcm (230bcf), an increase of 43%.

Production is due to start in 2009 but when full output is reached the following year ENI has indicated a likely output level which would double MOG's Italian gas production. This is in line with the CPR from the AIM listing.

### **Grenade (11.15% MOG)**

Progress has been made in evaluating this field and drilling plans are being prepared. Drilling of an appraisal/development well will probably take place early in 2007 as part of an early production scheme. Development will probably involve a vertical well deviated to become a horizontal one. This allows much higher flow rates of the heavy oil. One of the partners, Nautical Petroleum, is a heavy oil specialist and it is likely that their carbon dioxide technology will be used to optimise production, allowing the light fractions of the oil to be separated and sold.

### **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.. Seven other applications (840 sq. km.) 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.

Although production is modest, it is growing and the high profitability of gas in Italy means that the revenue generated covers overheads and the cost of onshore operations. Cashflow in 2006 is likely to be around double the 2005 figure of some €500,000/month. This is partly because of higher wholesale gas prices and partly because of a jump in production. Spending continues on the portfolio and recent successes suggest that further improvements are on the cards.

### **Shareholding Structure**

Following the sale by Mizuho mentioned in our original note, new institutional names have appeared on the share register. L-R Global has 13%, while Enso has picked up a 5% stake and Goldman Sachs 4%. It is clear that MOG is primarily an institutional stock. If and when private investors notice the company, we suspect a shortage of stock could lead to significant volatility in the share price, especially when the orderly market period expires in November.

### **Valuation and Appraisal**

Our previous note came up with a conservative valuation of MOG of 345p on a risk-discounted basis. Since that time, the size of the Maltese prospects has soared, from a most likely case of 648 million barrels potentially in place to nearly 6 billion barrels, with Luzzu in particular a possible giant field. However, these new structures are at an early stage and need 3D seismic to be proved up. They are high risk and will be high-cost too so it is difficult to put a value on them. The farm-out process will doubtless provide clues. Ahead of that, we are reluctant to assign specific values. The Tunisian acquisition appears shrewd and clearly adds value. The increase in Guendalina reserves has also added at least 10p per share to our asset assessment.

In view of the sensitivity of our model to Malta, we are unwilling to make a specific valuation for the company at present. However, the model does suggest comfortably over 400p as a fair value on even the most conservative scenarios we have been able to devise. MOG has become a very exciting exploration company.