23 May 2011

Seismic reflections

Commodity prices only a side issue

Oil and gas stocks have taken a beating on the back of recent falls in global oil prices. However, while both small and large caps are affected by oil price volatility, our analysis suggests endogenous factors have far more of an impact on juniors than their larger cousins. Investments in smaller E&P companies obviously carry significant risks; however, oil price exposure is probably not top of the list. And for this reason alone we suggest a balanced oils portfolio should always contain some smaller stocks.

Downward pressure from oil volatility

Commodity markets have experienced significant volatility of late, most notably with silver falling 30% and Brent crude falling by 12%. An end to QE2, China inflationary pressures and unwinding of supply premiums brought on from MENA unrest are all potential reasons for the oil price drop. When the oil price falls, equities are quick to follow. The FTSE 350 oil and gas index has fallen 6% to date since Brent's recent peak, while the AIM oil and gas index has fallen 10%.

But correlations not obvious

Tying oil and gas equities to crude prices is in no way obvious, especially when it comes to juniors. For example, over the last four to five years, while Brent has moved from a peak of $147/bbl down to $36/bbl, the FTSE350 oil and gas index including all London-listed majors and large independents has only moved from a high of 9,500 down to a little above 5,000. However, the AIM oil and gas index has moved from a high of 6,200 all the way down to only 1,500, ie it is far more volatile.

Juniors far less affected

So does this mean that juniors are more sensitive to oil price movement than their larger cousins? Regression analysis suggests they are similar. However we would hazard the AIM index volatility is driven far more by other factors. Prices slumped in 2008, for example, not because of lower oil-driven revenues, but because of lack of funding to drive drill programmes that are the lifeblood of juniors. Capital market liquidity figures far higher in the concerns for juniors than the simple oil price.

What we look for instead

At a more micro level, we focus on each junior's management teams, partners, strategy and track record for getting the job done. These are the drivers of investor confidence that good companies can convert exploration and development activity into material stock price gains. So, whereas the majors and larger independents are inherently exposed to oil price volatility, we believe the drivers for juniors lie elsewhere. And critically these are in areas far more within the control of each company, management team, and, ultimately, each and every investor.

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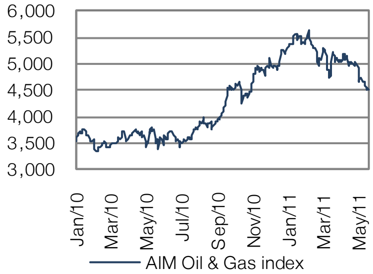

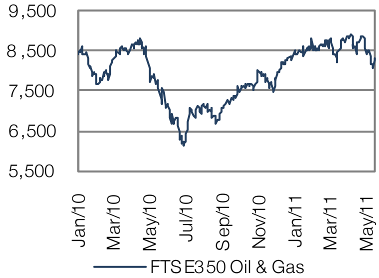

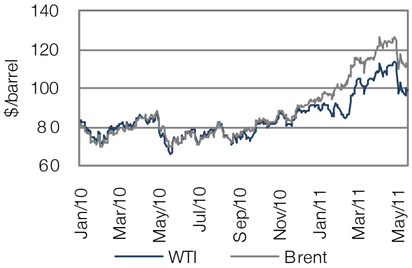

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		1 week			
No.	Best performers	% change	No.	Worst performers	% change
1	GLOBAL PETROLEUM	19.2%	1	ENCORE OIL	(21.8%)
2	TOWER RESOURCES	12.4%	2	PETRO MATAD	(16.0%)
3	LOCHARD ENERGY GROUP PLC	11.6%	3	SERICA ENERGY	(14.6%)
4	ANTRIM ENERGY INC	9.2%	4	MAX PETROLEUM	(12.3%)
5	AFREN PLC	6.9%	5	ITHACA ENERGY	(11.8%)

		1 month			
No.	Best performers	% change	No.	Worst performers	% change
1	GASOL PLC	34%	1	XCITE ENERGY	(48.5%)
2	FORTUNE OIL	14%	2	ENCORE OIL	(43.7%)
3	AMERISUR RESOURCES	10%	3	NIGHTHAWK ENERGY	(33.0%)
4	KEA PETROLEUM PLC	9%	4	PETRO MATAD	(27.8%)
5	GREAT EASTERN ENERGY CORP	9%	5	SERICA ENERGY	(26.1%)

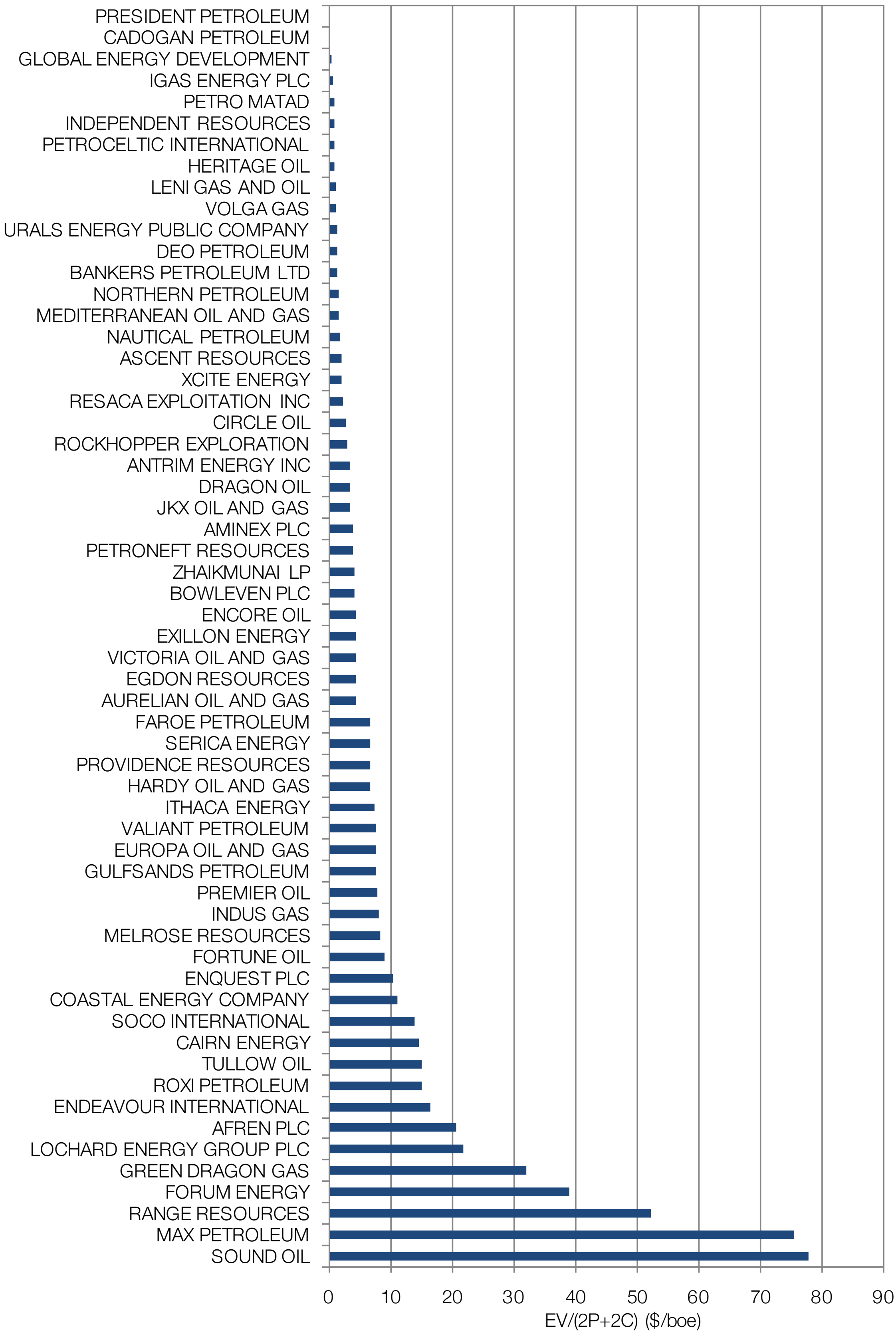
		3 months			
No.	Best performers	% change	No.	Worst performers	% change
1	SOUND OIL	67.0%	1	PRESIDENT PETROLEUM	(66.4%)
2	GASOL PLC	41.7%	2	DESIRE PETROLEUM	(63.4%)
3	VOLGA GAS	39.3%	3	XCITE ENERGY	(47.6%)
4	FORTUNE OIL	34.1%	4	EUROPA OIL AND GAS	(47.1%)
5	HARDY OIL AND GAS	29.6%	5	MEDITERRANEAN OIL AND GAS	(46.0%)

		6 months			
No.	Best performers	% change	No.	Worst performers	% change
1	SOUND OIL	168.8%	1	DESIRE PETROLEUM	(89.5%)
2	RANGE RESOURCES	164.0%	2	PRESIDENT PETROLEUM	(68.0%)
3	CADOGAN PETROLEUM	115.2%	3	NIGHTHAWK ENERGY	(52.2%)
4	FORTUNE OIL	97.6%	4	FALKLAND OIL AND GAS	(47.3%)
5	GLOBAL PETROLEUM	88.2%	5	ENCORE OIL	(41.0%)

		1 year			
No.	Best performers	% change	No.	Worst performers	% change
1	NAUTICAL PETROLEUM	577.7%	1	DESIRE PETROLEUM	(84.4%)
2	TOWER RESOURCES	371.2%	2	DEO PETROLEUM	(73.1%)
3	BPC LIMITED	364.3%	3	NIGHTHAWK ENERGY	(71.5%)
4	RANGE RESOURCES	354.6%	4	SERICA ENERGY	(70.8%)
5	ENCORE OIL	285.3%	5	MEDITERRANEAN OIL AND GAS	(69.0%)

Source: Bloomberg

EV/2P + 2C rankings



Source: Bloomberg, Company releases, Edison Investment Research

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