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Small oil firms off peak, but buyers still keen

Simon Webb and Barbara Lewis, Reuters

Investors are still hungry for a stake in small exploration firms that hunt out pockets of oil ignored by their bigger rivals, but a few high-profile failures and weaker markets have curbed enthusiasm for now.

Since the start of May, £2.6 billion have been wiped off the value of the 18 oil and gas firms in the top 100 companies on London's Alternative Investment Market (AIM), taking their combined worth to about £5.4 billion.

But many still see good buying opportunities and predict weaker oil prices could lead some investors to move from direct commodity exposure into equities that deliver dividends.

"We went through a period in which investors piled into anything to do with oil," said Richard Savage, head of energy research at asset managers Mirabaud Group.

"Some of the froth has come out of the market for pure exploration plays, but investors still have good appetite for explorers with a good story and good management."

A small company striking relatively small amounts of oil in mature producing regions, such as the North Sea, can provide investors with multiple returns, much larger than the potential earnings from dividends from holdings in oil majors.

Because they are narrowly-focused on getting oil out of the ground, small oil stocks have given more exposure to high oil prices than unwieldy majors, dogged by difficulties over replacing reserves and downstream operations.

"The big oil companies have a lot less gearing to the oil price (than smaller ones)," said David Dugdale of MFC Global Investment Management.

"BP, Shell, Total.... their earnings have not been revised to the upside, despite oil being well ahead of most people's estimates at the start of the year."

Oil prices hit a peak of $78.65 a barrel for Brent in August, but they have since fallen by around $15.

A weaker oil market and concerns future demand growth might be constrained by any economic slowdown have encouraged some investors to sell oil futures and invest in oil company equity.

"If you want to be long on oil in the medium to long term, I think you could favour trying to find shares of an oil company strongly correlated to the oil price," said Olivier Jakob of Petromatrix.

"You can still enjoy any pick up in price and you get the dividend." Next to investment in oil futures, buying into a small company can be the most direct approach.

"Very large firms seek to balance their portfolios in various ways: geographic location, sovereign risk, quality of reserves, timing of production," said energy consultant William Prast.

"On the other hand, small firms usually have one aim: they want to make as much money as possible as soon as possible. The location of the play is secondary, as is the sovereign risk."

But investors in smaller oil and gas firms whether listed or privately owned need to have a stomach for risk.

Among companies that have suffered the most this year is Hardman Resources, which has seen its value plunge by nearly 50 per cent since April in part due to disappointing news from its only producing asset, Mauritania's Chinguetti field.

Troubled oil explorer Regal Petroleum saw shares plunge last year after one of its most highly valued assets - a Greek oilfield - turned out to be a dry hole.

"What happened with Regal shocked a lot of people," an industry source in oil mergers and acquisitions said.

"It's a bit harder now for somebody to go to AIM for financing without a proven track record."

Among the latest success stories, Tullow Oil chief executive officer Aidan Heavey set up the firm with a bank loan of £500,000 in 1985. The company transformed its profile by buying some UK North Sea assets from BP in 2001 for £200 million and Energy Africa for $500 million in 2004.

The London and Dublin-listed company now has a market capitalisation of nearly €3.6 billion.

Falling oil prices, which cut the cost of buying producing assets with proven reserves, could spur mergers and acquisitions and further fuel share prices in some small producing companies.

"A number of factors are pointing towards more activity," a mergers and acquisitions specialist said. "If we lose another $5-$10 from the oil price, we could see a flurry of sales."

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