Global Resources Travel Diary: Teaching an old dog new tricks

Client note
March 2014

Key points

– Prudent application of proven technology (new tricks) across mature oil fields (the old dog) is typically amongst the most value accretive investments that can be made in the upstream energy industry. Identifying these opportunities for our clients is a core part of what we do;

– Bankers Petroleum is one such company which fits this mould. Following a promising meeting with the new CEO of Bankers in January of this year, we quickly arranged for a site visit to establish an independent assessment of the company’s key asset in Albania;

– The site visit indicates that Bankers meets all of our investment criteria and we subsequently established a position in the company.

Albania Opens Up

After World War II, Albania became a Communist state under the rule of Enver Hoxha. Whilst Hoxha’s early reforms showed promise the country became effectively closed both to foreigners seeking entry and locals looking to exit. This marked a prolonged period of economic degradation. The situation was only reversed upon the death of Hoxha, the timely downfall of communism in Eastern Europe at the end of the 1980s, and the collapse of the nation’s economy.1

The 1990s, saw Albania ‘open for business’ and contracts were quickly signed with Western oil companies to help rejuvenate its mature oil industry.

The Old Dog

At over 5 billion barrels (bnbbls) of Original Oil In Place (OOIP), Albania’s Patos Marinza [Figure 1] is the largest onshore (heavy) oil field in Europe. Discovered in 1928 and developed in stages through the 1930s, the field reached a plateau of circa 12,500 barrels of oil per day (bopd) in the early 1960s [Figure 2].

By 1995, less than 5% of the OOIP had been recovered at Patos Marinza: by modern standards the government recognised that substantial oil volumes remained untapped. A contract was duly signed with Anglo Albanian Petroleum (AAP) that year with the primary aim of increasing output from the field by utilising foreign capital to apply leading-edge technology. However, weak oil prices, punitive contract terms and limited technical success saw AAP relinquish the block in early 2004.

**Figure 2: Bankers delivers record production, 1928-2013**

Source: Bankers Petroleum Corporate presentation, Feb-14.
Note: chart shows Patos Marinza oil production under successive operators.

**New Tricks**

At 173bnbbls, Canada has the third largest oil reserves in the world with a large proportion exhibiting similar characteristics to that of Patos Marinza heavy oil. Moreover, around 80% of Canada’s reserves are recoverable using leading edge in-situ technology. In short, Canada’s oil engineers are amongst the best in the world at commercially exploiting heavy oil to the highest environmental and socially responsible standards.

Despite AAP exiting Albania, a select few Canadian engineers stayed behind believing that, with the prudent application of proven technology, substantial value could be unlocked from the Patos Marinza field. Canadian-listed Bankers Petroleum was subsequently formed. The team quickly renegotiated the terms covering the block and with the help of the Canadian engineers, a new license was signed in July 2004.

**So, how does Bankers’ investment case stand up against our investment process?**

**Investment framework**

Consistent with our long-held investment philosophy, we have several criteria that act as a framework (Figure 3) when allocating capital. This can broadly be grouped as follows:

**Quality**
- World-class assets => attractive risk-adjusted returns

**Mgmt**
- Experienced management with demonstrable track record

**ESG**
- Strong focus on Environmental, Social, Governance issues

**Debt**
- Strong balance sheet

**Growth**
- Real underlying earnings/cash flow growth

**Figure 3: FSI global resources investment framework**

Source: First State Investments.
Note: *This does not represent the full scope of our investment process.

Our detailed analysis is supplemented by regular interactions with board members, senior management, technical and operating personnel as well as industry experts. However, the litmus test for all of this work is visiting a company’s key assets to help identify key risks that cannot typically be captured by sitting at a desk poring over a set of annual accounts.

In the following sub-sections we highlight some examples of how we assess company’s against our investment criteria.

**Quality**

Although there are several parameters which provide an assessment of the overall quality of an asset, one way of benchmarking quality is to look at full-cycle returns. On our analysis (Figure 4), Patos Marinza offers amongst the best risk-adjusted returns globally with a breakeven oil price of USD55/bbl.

**Figure 4: Patos Marinza asset quality stands out**

Source: First State Investments.
Notes: *Breakeven Oil Px represents the oil price required to yield a Net Present Value of zero utilising a discount rate of 10%.

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AAP was a partnership between UK-listed Premier Oil; private German energy company Preussag Energie; the IFC – part of the World Bank; and Albania’s State oil company, Albpetrol.

**Management**

Management teams should be regularly benchmarked against the long-term targets they communicate to shareholders. Following a brief operational hiatus through late-2011 and into the first half of 2012, Bankers Petroleum has been on a consistent path of delivering against expectations.

Interestingly, part of the operational issues that the company suffered in 2011-12 were related to the poor performance of progressive cavity pumps (PCPs). Bankers technical team were able to demonstrate a substantive improvement in the PCPs [Figure 5] performance following an extensive research program^{4} conducted by Technical Director, Kris Gustafsson.

![Figure 5: PCP test facility – improving reliability](source: First State Investments)

**ESG**

The IFC^{5} and EBRD^{6} are directly (and indirectly) involved in the rejuvenation and remediation of the Patos Marinza oil field and as such demand a high standard of environmental, social and corporate governance.^{7}

One particular aspect of Bankers ESG responsibilities has been that of site remediation. Bankers took over control of the Patos Marinza field from the State oil company, Albpetrol, in July 2004. Sites previously administered by Albpetrol suffer from considerable surface contamination (pre-Bankers) and the company has made significant strides in remediating hundreds of well leases and safely removing ageing and dangerous equipment [Figure 6 and 7].

![Figure 6: Patos Marinza, October 2009](source: First State Investments)

**Figure 7: Patos Marinza, January 2014**

Source: First State Investments.

Notes: Looking northwards from the "Look-Out Point" at Patos Marinza showing the removal of legacy Albpetrol drilling derricks (oval outlines) and remediation of surface contamination (arrows).

**Debt**

Energy is a cyclical industry: commodity prices can be volatile and unpredictable. The most successful companies in the sector have sustained superior returns by managing a conservative balance sheet. To this end, Bankers has maintained a strong balance sheet in the last several years even through the global financial crisis of 2008-09. By living within projected cash flows we anticipate that the company will be able to maintain a strong balance sheet [Figure 8].

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^5 The International Finance Corporate (IFC), a member of the World Bank Group, is the largest global development institution focused exclusively on the private sector in developing countries. See: [http://www.ifc.org](http://www.ifc.org)

^6 The European Bank for Redevelopment and Construction (EBRD) invests primarily in private sector clients whose needs cannot be fully met by the market, the Bank promotes entrepreneurship and fosters transition towards open and democratic market economies. See: [http://www.ebrd.com](http://www.ebrd.com)

^7 Environmental & Social Review Summary (ESRS), Feb-2013

Figure 8: Gearing remains comfortable*

Source: Bloomberg for actual data. Forecast data from Macquarie Equity Research as at 20th Feb 2014.
Notes: *Gearing defined as Net Debt / Total Shareholders Equity. A gearing ratio of <=50% is only one metric that is considered when assessing balance sheet strength.

Growth

Given the scale of the Patos Marinza field and its 35-year life⁸, there is clearly scope for continued growth. Indeed, management has guided to headline production volume growth in the range of 10-15%pa.⁸ With wellhead rates of return of between 75% and 80%⁸, the asset has the capacity to deliver sustainable and profitable returns. In our view, this paves the way for continued double-digit returns to shareholders [Figure 9].

Figure 9: Shareholder returns look set to improve

Source: Bloomberg for actual data. Forecast data from Macquarie Equity Research as at 20th Feb 2014.
Notes: *Return on Equity defined as Net Profit After Tax / Total Average Common Shareholder Equity.

Conclusion: teaching an old dog new tricks

We believe that you can teach an old dog new tricks. Indeed, the careful application of proven technology to mature oil fields is typically amongst the most value accretive investments that can be made in the energy industry.

Identifying these opportunities from the comfort of your desk is possible. But we believe the real value-add lies not in simply analysing a set of annual accounts but ensuring that detailed bottom-up analysis is regularly supplemented with management meetings and, crucially, visiting the key assets of a company to ensure that they are truly delivering on their targets in a safe and sustainable manner.

Our recent site visit to Patos Marinza clearly indicated that Bankers meets all of our investment criteria and our strategy subsequently established a position in the company.

Figure 9: Not all old dogs will learn new tricks

Source: First State Investments.
Notes: Donkeys are still a common mode of transport in this region.

⁸ Bankers Petroleum Corporate presentation, Feb-14.
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