

# Positive update, but potentially higher tax

## Key takeaways from this morning's management update

Dragon Oil provided an update on its Turkmen operations this morning:

- **Production volumes in line.** Dragon's average gross volume for 3Q08 was 42.3kb/d (+25% YoY%). With two more wells due to be completed in November 2008, the company is on track to achieve its target of (1) drilling eight development wells in 2008 and (2) achieving 25% YoY production growth in 2008 (c.40kb/d average 2008 production).
- **Another milestone in the gas monetisation achieved.** Dragon has been awarded a US\$37mn 15-month contract for the expansion of the Central Processing Facility (CPF), which will double the facility's processing capacity to 100kb/d of liquid and 220mmcf/d of gas. The NPF expansion removes the oil production bottlenecks and is another major step toward gas monetisation.
- **The period-end net cash position at US\$820mn.** The company generated c.US\$160mn cash in 3Q08. The significant increase in the cash balance is due to the strong realized prices and lower than expected capex (US\$300mn capex for 2008 per management's new guidance vs the projected US\$400mn in our valuation). We do not anticipate a material impact of lower capex on our NAV, as there are no implications for our near term production forecasts and lower capex tends to be offset by a lower cost oil recovery base.
- **Potential negative 30p/sh NAV impact of a new Petroleum Law.** The government of Turkmenistan recently introduced a new Petroleum Law. The potential impact of the law for Dragon is a modest increase in the corporate tax rate from the current 20% to 25%. The company is currently assessing the impact of the law on operations and taxation, but if this increase in the tax rate is approved, our NAV would decrease by c.30p/sh to 417p/sh (6% impact).

## Attractive valuation

Dragon currently trades at a c.65% discount to our 445p/sh NAV versus the peer average discount of 55%. The stock also (1) screens cheaply on a P/E and EV/EBITDA basis, trading in a P/E range of 3.5x to 2.4x 2008E to 2013E and an EV/EBITDA range of 1.2x to 0.2x 2008E to 2010E; and (2) is highly cash flow generative with FCF yield of 12% to 33% 2008E to 2013E. The valuation remains attractive under lower long-term oil price and higher discount rate assumptions (see Table 1 on page 3). We reiterate our Buy recommendation, with Dragon offering strong production growth potential, additional upside from gas monetisation, steady newsflow and attractive valuation. **BUY**

Equity | United Kingdom | Oil & Gas Producers  
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# Merrill Lynch

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## Stock Data

Price	155.00p
Price Objective	450.00p
Date Established	1-Oct-2008
Investment Opinion	C-1-9
Volatility Risk	HIGH
ML Symbol / Exchange	DRAGF / LSE
Bloomberg / Reuters	DGO LN / DGO.L



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Refer to important disclosures on page 4 to 5. Analyst Certification on Page 3. Price Objective Basis/Risk on page 3.

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## Positive update, but potentially higher tax

Dragon Oil this morning provided an update on its Turkmen operations. The keys takeaways from the management statement are:

- **Production volumes in line.** Dragon's average gross volume for 3Q08 was 42.3kb/d (+25% YoY%). With two more wells (LAM 22/130 and LAM A/131) due to be completed in November 2008, the company is on track to achieve its target of: (1) drilling eight development wells in 2008 and (2) achieving 25% YoY production growth in 2008 (c.40kb/d+ average 2008 production).
- **Another milestone in the gas monetisation achieved.** Dragon has awarded US\$37m 15 month contract for the expansion of the Central Processing Facility (CPF), which will double the facility's processing capacity to 100kb/d of liquid and 220mmcf/d of gas. The NPF expansion removes the oil production bottlenecks and is another major step towards gas monetisation.
- **The period-end net cash position at US\$820m.** The company generated c.US\$160m cash in Q308. Significant increase in the cash balance is due to the strong realised prices, increased production and lower capex. With the period-end cash position of US\$820m and FCF yield of 12% to 33% 2008E to 2013E, Dragon is well placed to finance an aggressive forward capex programme and potential acquisitions outside Turkmenistan.

Lower than planned (infrastructure) capex (US\$300m total capex for 2008 as per management's new guidance vs. projected US\$400m in our valuation) is mainly due to administration delays and is not expected to have a material impact on our near term production forecasts. Further, we do not anticipate a significant impact of lower capex on our NAV as lower capex tend to be offset by a lower cost oil recovery base.

- **Potential negative 30p/sh NAV impact of a new Petroleum Law.** The government of Turkmenistan recently introduced a new Petroleum Law. The potential impact of the law for Dragon is a modest increase in the corporate tax rate from the current 20% to 25%. The company is currently assessing the impact of the law on operations and taxation, but were this increase in the tax rate be approved, our NAV would decrease by c.30p/sh to 417p/sh (6% impact).

### Exceptionally attractive valuation

Dragon currently trades at a c.65% discount to our NAV estimate versus the peer average discount of 55%. The stock also screens cheaply on a multiple basis, trading on in a P/E range of 3.5x to 2.4x 2008E to 2013E and an EV/EBITDA range of 1.2x to 0.2x 2008E to 2010E;

Our base-case 450p/sh NAV is set at a long-term US\$90 Brent reference price and 14% cash flow discount rate. We outline the potential impact of changes in the oil price and discount rate below. The valuation remains attractive under lower

long term oil price and higher discount rate assumptions.

**Table 1: Sensitivity analysis of Dragon's NAV to the oil price and the discount rate**

	12.0%	13.0%	14.0%	15.0%	16.0%	17.0%	18.0%	19.0%
\$50/bl	302.3	286.5	272.5	260.0	248.8	238.8	229.7	221.5
\$60/bl	351.0	330.6	312.4	296.3	281.9	269.0	257.4	246.9
\$70/bl	405.0	379.4	356.8	336.7	318.8	302.7	288.3	275.4
\$80/bl	458.9	428.3	401.2	377.1	355.7	336.5	319.3	303.8
\$90/bl	512.9	477.2	445.6	417.5	392.5	370.2	350.2	332.2
\$100/bl	566.9	526.0	490.0	457.9	429.4	404.0	381.1	360.6
\$110/bl	620.8	574.9	534.3	498.3	466.3	437.7	412.1	389.0
\$120/bl	674.8	623.8	578.7	538.8	503.2	471.4	443.0	417.5

Source: Merrill Lynch estimates

## Investment thesis

### Dragon Oil

Our key investment themes are (1) strong production growth potential, (2) additional upside from gas monetisation, (3) compelling M&A candidate, and (4) attractive absolute and relative valuation. BUY

## Price objective basis & risk

### Dragon Oil (DRAGF)

Our 450p/sh Dragon Oil Price Objective is set at around our Net Asset Value (NAV). Key assumptions in the construction of our NAV are (1) long term oil price of US\$90/bl (real), (2) Iranian Light-Brent differential of US\$4/bl, (3) US\$/GBP of 1.80, (4) forecast portion of production volumes exported to Iran (80%), (5) production phasing (c100kb/d peak in 2017E), and (5) a 14% discount rate.

We continue to set our European E&P Price Objectives around NAV as we believe (1) this is the only valuation framework, which accurately captures the underlying cashflow and earnings generating ability of the underlying asset bases over time, and (2) that, as such, the shares should trade at a premium or discount to this metric depending upon such factors as management quality/delivery track record, the strength of the macro environment, near/medium-term newsflow potential, prevailing levels of M&A activity in the sector, the likelihood of management delivering value accretive asset deals which this framework specifically precludes, and political risk issues.

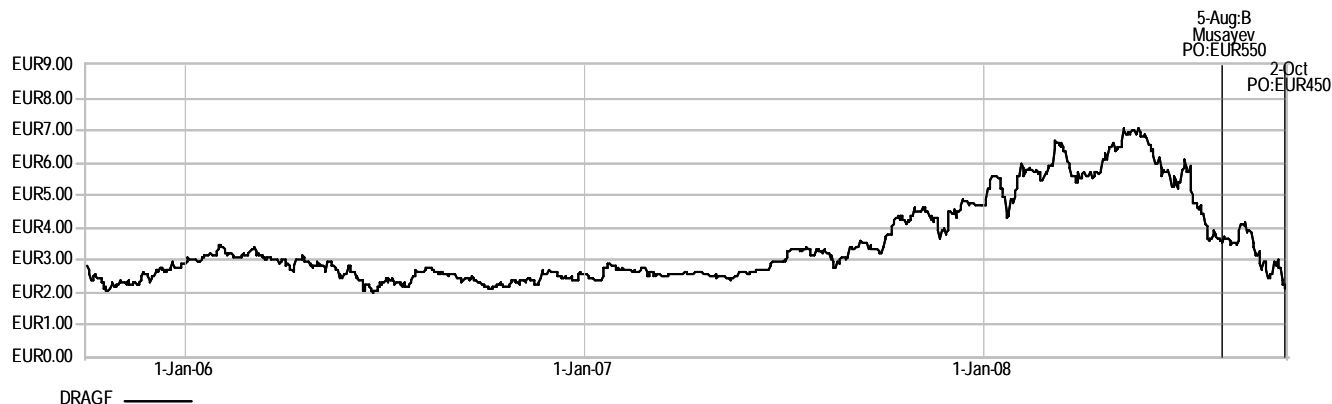
Risks to the attainment of our Price Objective are Brent and Iranian Light oil price, Turkmen gas price, currency (particularly US\$/GBP), Turkmen political/fiscal risk, unexpected reservoir issues, unexpected development kit procurement-induced timing delays and a period of sustained exploration/appraisal disappointment.

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I, Taleh Musayev, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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### DRAGF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of September 30, 2008 or such later date as indicated.

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Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	170	63.43%	Buy	57	37.25%
Neutral	50	18.66%	Neutral	12	30.00%
Sell	48	17.91%	Sell	9	22.50%

### Investment Rating Distribution: Global Group (as of 01 Oct 2008)

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Neutral	858	23.60%	Neutral	240	31.41%
Sell	1130	31.09%	Sell	227	22.02%

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
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Underperform	N/A	≥ 20%

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