

# Dragon Oil

United Kingdom/Oil & Gas Producers  
Investment Research

## Buy

vs

**Share price: GBP 130.00**

*closing price as of 08/12/2008*

**Target price: GBP 340.00**

Reuters/Bloomberg DGO.L/DGO LN

Accounting Standard/Since IFRS/2005

Daily avg. 12 mth n° trad. sh. (th)/vol. (m)	1298	0
Price high/low 12 mth (GBP)	568.00	121.25
Abs. perf.(%) 1/3/12 mth	-14.19	-50.94 -60.15

**Market capitalisation (GBPm) 667**

Current N° of shares (m) 513

**Free float 48%**

(USD)	12/08e	12/09e	12/10e
Sales (m)	739	734	856
EBITDA (m)	504	548	626
EBITDA margin	68.3%	74.6%	73.1%
EBIT (m)	366	372	422
EBIT margin	49.5%	50.7%	49.3%
Net Profit (adj.)(m)	300	294	342
ROCE	34.9%	32.1%	35.2%
Net debt/(cash) (m)	(690)	(929)	(1,263)
Debt Equity	-51.6%	-56.9%	-63.8%
Debt/EBITDA	-1.4	-1.7	-2.0
Int. cover(EBITDA/Fin.int)	(20.9)	(27.2)	(18.4)
EV/Sales	0.4	0.1	nm
EV/EBITDA	0.6	0.1	nm
EV/EBITDA (adj.)	0.6	0.1	nm
EV/EBIT	0.8	0.2	nm
P/E (adj.)	3.3	3.4	2.9
P/BV	0.7	0.6	0.5
FCF yield	22.9%	30.7%	38.4%
Dividend yield	0.0%	nm	nm
EPS (adj.)	0.58	0.57	0.67
BVPS	2.61	3.19	3.86
DPS	0.00	(0.05)	(0.10)



Source: Factset

## Company Description

Dragon Oil is an Oil and Gas Producer with producing assets in Turkmenistan, owned 52% by Ennates National Oil Company. It is expanding oil production and in the process of developing gas for commercial sale which will allow the company to upgrade reserves

## Damsel in Distress Value, no White Knight required.

Dragon Oil is a very profitable, highly cash generative oil and gas producing company operating a long term licence on existing assets with significant further development potential in the Caspian Sea offshore Turkmenistan. We believe the company, which is 52% owned by ENOC in Dubai, meets the combination of positive criteria we look for in assessing the attractiveness of an E&P company, and offers outstanding value:

- ✓ **Production growth.** Dragon Oil is in the process of expanding production capacity which will build on its already demonstrated record of production growth. We cautiously estimate field volumes will grow at 12% CAGR to 2011, and entitlement volumes to Dragon will grow more like 15%
- ✓ **Reserves growth.** Dragon already has a reserve life of 34 years, higher than many OPEC countries, and is expanding and upgrading its drilling programme which offers incremental exploration discoveries and positive revisions from higher recovery rates. In addition, Dragon is already investing towards commercialisation of gas which is presently flared, which we estimate could increase reserve volumes by 50%.
- ✓ **Earnings / Cash flow growth.** Even at lower oil prices, we expect 2% growth in Net Income, 6% growth in Op Cash and 35% in Free Cash Flows over the next three years.
- ✓ **Funding + Opportunity.** Dragon has \$830m cash on its books which we see growing comfortably each year, enough to deliver on its more aggressive drilling campaign, upstream expansion, gas development - and still leave plenty of room for an attractive dividend stream
- ✓ **Distressed valuation.** Dragon is trading at just \$1.37 per barrel of 2P reserves and less than \$1 per barrel of risked reserves. This compares to the \$12 per barrel of 2P reserves which ENI paid for Burren Energy who also had assets in Turkmenistan. Dragon is the cheapest of its peers on consensus earnings multiples, trading at a PE 09 of just 3.4x and EV/EBITDA 09 of 0.2x.
- ✓ **Identified Risks.** Dragon is cheap because (with the sector) it has been dragged down by the rapid fall in oil prices but also on specific risks of a single license in Turkmenistan and because 80% of its crude output is transported via Iran. We see ENOC ownership as mitigating risk, with the license supported by Turkmenistan's wish to demonstrate reasonable governance as it plays off strategic partners, and the strength of the balance sheet able to sustain any interruption in the event of problems in Iran – which if they occurred would have the effect of raising prices and reserve values across the sector
- ✓ **Near term catalysts.** Expansion in production capacity in 2009, plus a more sophisticated drilling campaign is just beginning, and gas reserves are presently being assessed by external consultants to report in the New Year.

**We initiate Dragon Oil with a BUY recommendation and a Target Price of GBP 340p, offering the prospect of significant upside of over 2.5x.**

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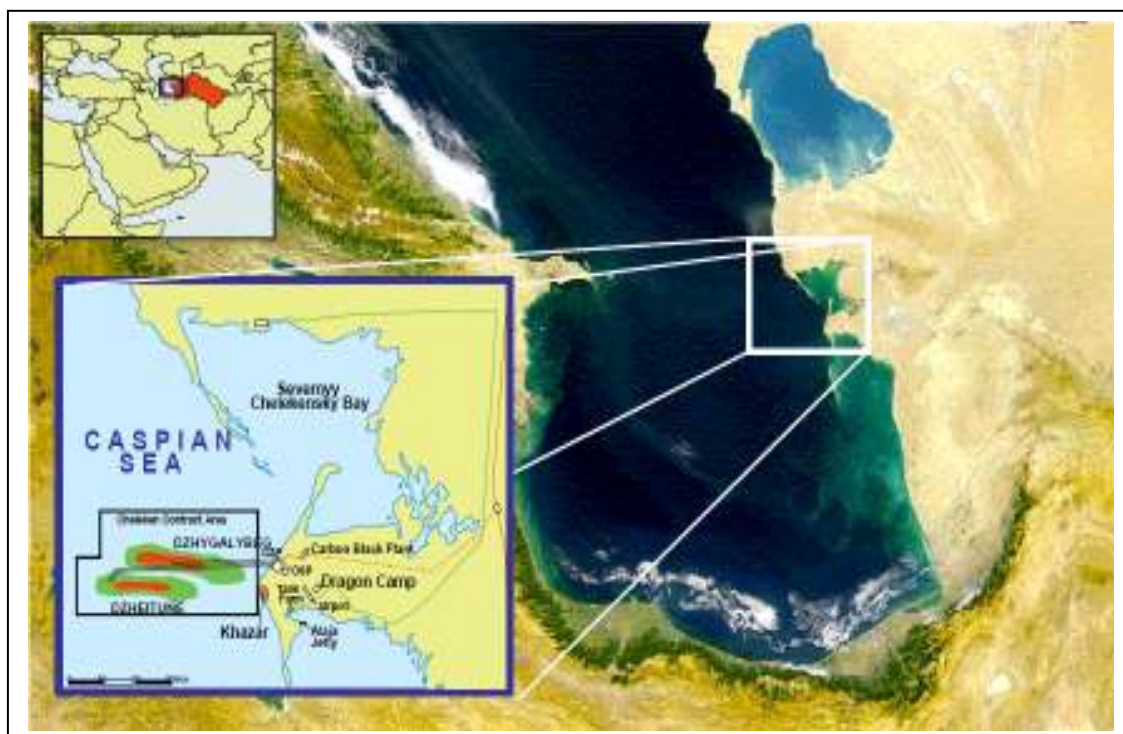
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## Company Profile & Market Environment

### Company overview

Dragon Oil is a non-integrated oil and gas producer which has been producing in Turkmenistan on a Production Sharing Contract since May 2000. The contract area is offshore Turkmenistan, in the Eastern Caspian Sea, with 12 producing platforms across two fields. The PSA is valid until 2025, with the option of a further 10 year extension.



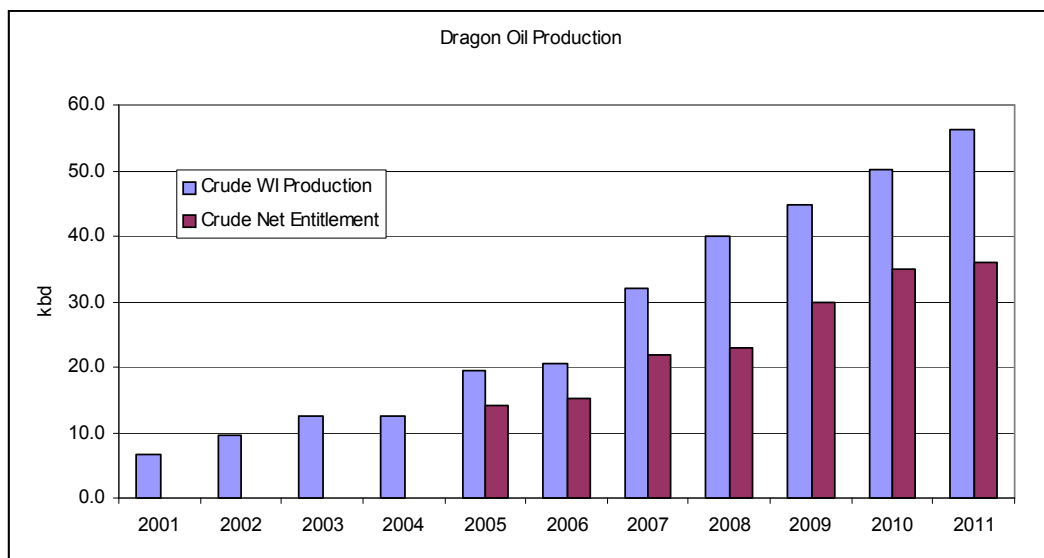
Source: Company Information

Dragon is 51.88% held by Emirates National Oil Company (ENOC), which is wholly owned by the government of Dubai. ENOC is a predominantly downstream company, involved in transportation, refining and marketing (Dubai's upstream company is Dubai Petroleum, also owned by the government). As a downstream company selling fuels at relatively fixed prices into its home market, ENOC gains rather than loses from lower oil prices. CEO Saeed Khoory was quoted in local business daily Zawya in January 2008 noting that, unlike ADNOC (which has substantial upstream assets), "ENOC does not have a strong position in the upstream business and that is why any increase in oil prices is a burden to us". ENOC has only two upstream subsidiaries: Dragon Oil and Dubai Gas (Dugas). ENOC took a majority share in Dragon in 1998, during the last major downturn in the oil price.

Dragon is listed primarily on the London Stock Exchange, where it has reasonably active liquidity, with average volume of over 2 million shares or £3.4m per day over the last 3 months (of a free float of 246 million shares). It also has a Euro-quoted listing on the Irish Stock Exchange, with average volume of 223,000 shares (€0.7m).

## Crude Production

Production volumes have grown from around 7kbd in 2000 / 2001 to 32 kbd in 2007 and are expected to achieve 40kbd for 2008, on a Working Interest Basis. Dragon has increased the number of drilling rigs to three and has a more active drilling programme which it expects to increase production by 15-20% pa over the next three years. We have taken a slightly more conservative assumption of 12% CAGR to 2011, so there is potential for further upside in crude production outlook.



Source: Company Information, NCB Estimates

“Working Interest” volume reflects the ownership interest in the oil fields, and is the more effective indicator of operating performance. The more financially valid indicator is “Net Entitlement” volume, which reflects the amount of crude the company can sell after the adjustments under the Production Sharing Agreement, for royalties paid as crude. This is impacted predominantly by the crude price and the level of investment made by the company which can be recovered under the terms of the PSA. In 2008, Net Entitlement volumes will be lower than those for Working Interest, due to the high oil price in the first half of the year and the lower level of capital spend which can be reclaimed in the PSA until the new capacity is commissioned. Both of these features will reverse from 2009, closing the gap between Working Interest and Net Entitlement, resulting in higher growth for Net Entitlement volumes of 16% CAGR to 2011.

## Crude Marketing and Prices

Crude produced is of high quality, and is sold at a discount of \$1-5 to a benchmark of dated Brent, with the variance also reflecting lag effect so that the discount tends to be higher in periods of rising prices and lower during falling prices. We assume an average discount to Brent of \$3 per barrel.

80% of Dragons marketed volumes are sold via Iran, transported via Neka on the southern coast of the Caspian Sea and released for sale at the Kharg Island export terminal in southern Iran. The remaining 20% is transported across the Caspian to Baku, the centre of the Azerbaijan oil industry where it may be sold to traders or SOCAR, the Azeri national oil company, for onward transportation. While the route through Iran offers the highest netbacks, there are clear risks associated with dependence on this route and Dragon Oil is

actively engaged in developing alternative routes. Baku is the start of the 1.1mbd BTC pipeline operated by BP to the Mediterranean port of Ceyhan, and there are plans being discussed to raise throughput capacity to 1.3mbd or even 1.6mbd which would provide greater ullage for Dragon, and the company is also looking at routes via Machachkala on the Russian coast of the Caspian Sea, an option also being considered by partners in the Kashagan project due to start in 2013.



Source: Company Information

The central ESN forecast for oil prices reflects our conviction that the short term sentiment continues to distort the price of crude in the market, a feature we see as likely to continue into 2009 but not for the full year. Even with zero demand growth in 2009 we foresee a significantly tighter supply / demand balance in the second half of 2009 which will support more realistic prices, and without a return to levels of around \$90 or above, the necessary investments in new capacity required to offset accelerating decline will not be approved leading to further supply concerns. Our long term view is based on \$100 Brent, as detailed in our recent report "Oil Prices – From Overheating to Permafrost!" (31.10.08).

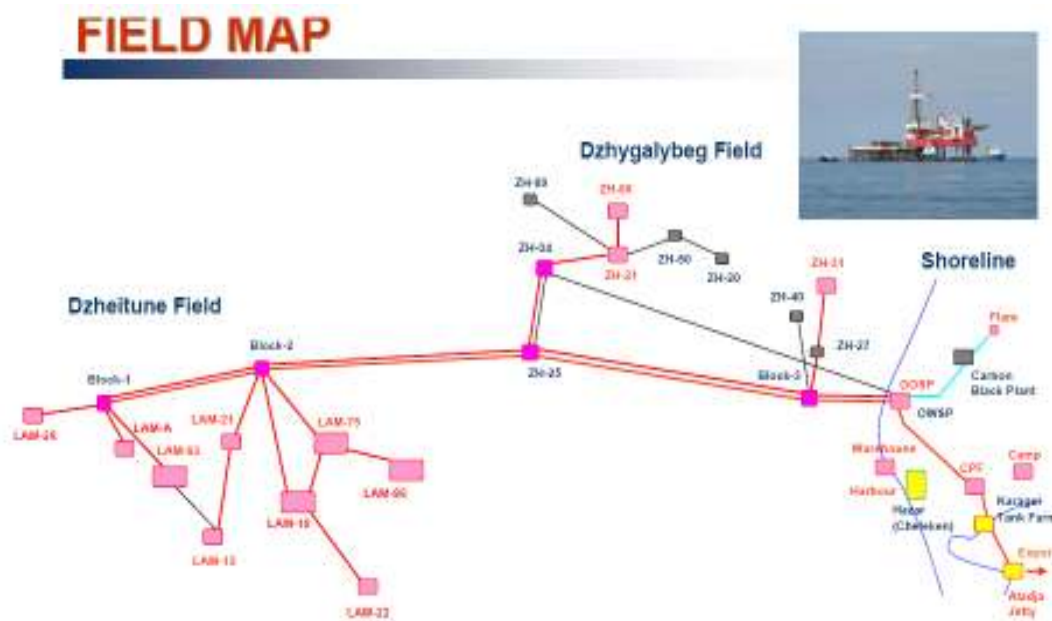
**While Dragon is clear beneficiary of these higher oil prices, we don't see this as a necessary condition for investment. To highlight the upside we see in Dragon Oil from its production growth, reserve position and gas opportunity we have based all our forecasts on a more consensus-based \$70/bbl oil price from 2009 onwards.**

## Crude Reserves

Published 2P (Proved and Probable) Reserves at the end of June 2008 were 283 million barrels. At the expected production rate of 40 kbd, this gives a reserve life of 34 years. This is materially higher than any of Dragon's peers (and indeed most OPEC countries) and gives them a critical advantage of being able to exploit existing assets over a sustained period without reliance on critical exploration success.

Yet we also see potential to add to these reserves further through two developments:

- 1) While most of the contract area has already been drilled, there remain some undrilled areas around LAM A and B, and to the west of the field. Dragon believes that these have the potential to hold additional crude at higher pressure
- 2) Drilling methods employed by Dragon to date have been relatively unsophisticated, using vertical drilling and primary recovery (relying on the pressure inherent in the reservoir itself to drive oil to the surface of the wells). Dragon is now drilling more angled wells, which intersect a wider payzone, and has plans for some basic secondary recovery using water injection. These methods are widely used in the industry, and have been shown to sustain production levels over a longer period and so to increase the ultimate recovery factor of the field. Assuming Dragon could also improve the recovery factor against which it books its reserves, we see the basis of further reserves upgrades over the next couple of years.



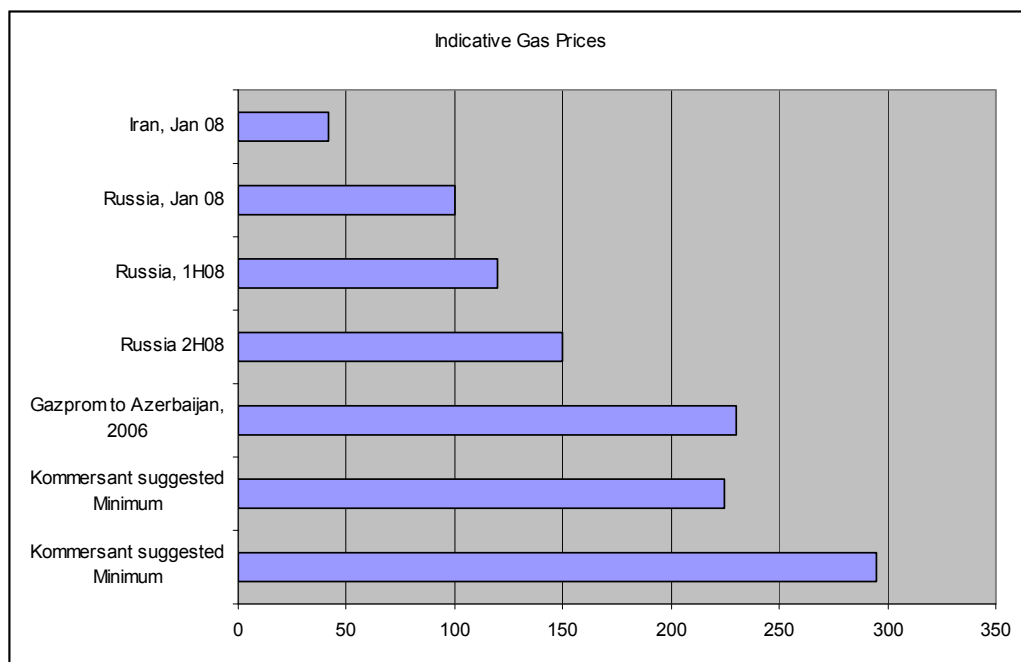
Source: Company Information

While these factors offer upside to existing reserves, we actually do not think the investor needs to rely on this upside potential to feel enthusiastic for this stock, as we argue that Dragon is significantly undervalued against its existing reserves. See valuation section

## Gas Developments

Turkmenistan is a gas-rich country. According to BP's 2008 Annual Statistical Review of World Energy, proved gas reserves are quoted at 2.67tcm (13<sup>th</sup> highest in the world) but BP's estimates have long been regarded as conservative. In October this year, industry consultants Gaffney, Cline & Associates (GCA) was reported to have completed its survey of the South Yolantan-Osman deposit near Afghanistan, which it estimated in the range of 4-14 trillion cubic meters, with a "optimal" figure of 6tcm, which could place Turkmenistan as having the fourth highest gas reserves after Russia, Iran and Qatar.

2008 has seen significant movements in the market and prices for Turkmenistan gas, as Gazprom has become more reliant on sourcing contracts from the Caspian area in the face of competition from China and some of the western majors. In January, Gazprom agreed to raise the price it paid to Turkmenistan from \$100/mcm to \$130/mcm in 1H08 and to \$150/mcm from mid-year. Against this background, Turkmenistan was encouraged to address the low prices being paid by Iran, reported to be just \$42/mcm, and supplies to Iran were cut off in January as Turkmenistan was rumoured to be aiming to use the cover of technical problems to enforce an increase to \$120/mcm. Most Turkmen gas delivered to Iran was being sold on to European customers for around \$300/mcm so the low price was especially galling for Turkmenistan, and it was encouraged to note the knock-on effects as first Turkey then Greece were impacted by reduced deliveries from Iran showing the wider dependency on Turkmen supplies.



Source: *International Oil Daily, Company info*

Over the summer of 2008, another round of negotiations took place between Gazprom (and its former CEO Dmitry Medvedev recently installed as Russia's President) and the Caspian gas producers. In June Russia negotiated a 20-30 year deal in Azerbaijan (at a price not disclosed but presumably higher than the \$120/mcm on existing Azeri contracts and perhaps closer to the \$230/mcm which Gazprom itself had tried to enforce on Azerbaijan in 2006 before its former province switched from importer to exporter). Days later, Medvedev visited Ashkabad to build on the existing agreement increasing the price to \$150 by

agreeing to switch to a formula related to international market prices – the details of which remain obscure. The driver for Russia is the need to secure supplies for its long term delivery contracts both domestically and to Western Europe, in the face of declines in its own production and delays in vital new projects.

At the end of August, in a flurry of activity in the region exacerbated by the tensions in Georgia, Turkmenistan agreed to increase exports to China from 30bcma to 40bcma, an agreement inked during a visit to Ashkabad by President Hu only days after the closing ceremony of the Beijing games, indicating the priority for the Chinese. The move triggered further high level deals in the region as Prime Minister Putin raced to Tashkent in neighbouring Uzbekistan to hammer out a new deal, concerned that Russia might not be able to increase, or even maintain, its existing levels of purchases, including some 50bcma from Turkmenistan.

Turkmenistan is at the centre of the crucible of gas supplies for which Russia, Europe and China are competing for influence, and with most of the gas contracted by the Russians going to Ukraine, they may not be as price sensitive as they will be happy to enforce price rises with their end customer. Against this background, price momentum remains supportive, and the Russian daily Kommersant recently suggested a figure as high as \$225-295/mcm. (Note that Kommersant was bought in 2006 by Alisher Usmanov – head of Gazprom’s Gazprominvestholding subsidiary.)

**Our forecast is based on sales by Dragon from 2011 at \$150/mcm, which we think is conservative.**

### **Gas Reserves – proven, producing, but not yet booked**

Dragon Oil is already producing associated gas, which is presently flared both offshore and onshore, and Dragon is investing in an onshore gas separation unit which will have a capacity of 200 mmcfd, from the end of 2010.

Against the background of the rapidly developing market for gas in the region, and the active investments being made, we believe investors can be confident that gas production will go ahead and a more formal declaration of commerciality is only a question of time. This declaration will be the final element required formally to recognise a proportion of Dragon’s contingent resources of 3.4 tcf (trillion cubic feet) as the gas is already discovered, is being produced (as associated gas which is flared) and investment decision has been made.

However, we would not expect Dragon to book all the 2P reserves, as companies can only book reserves recoverable during the period of the confirmed licence, and with production at the 200mmcfd rate to 2025 implies recoverable reserves of around 1 tcf. Nonetheless, we estimate these to be worth some \$2.5 per boe, a risked NAV of nearly \$300m. See Valuation section below for more detail.

## Investment Summary

Dragon Oil is a very profitable, highly cash generative oil and gas producing company operating a long term licence on existing assets with significant further development potential in the Caspian Sea offshore Turkmenistan. We believe the company, which is 52% owned by ENOC in Dubai, meets the combination of positive criteria we look for in assessing the attractiveness of an E&P company, and offers outstanding value.

### Operational Growth

- **Production growth.**

Dragon Oil is in the process of expanding production capacity which will build on its already demonstrated record of production growth. We cautiously estimate field volumes will grow at 12% CAGR to 2011, and entitlement volumes to Dragon will grow more like 15%

- **Reserves growth.**

Dragon already has a reserve life of 34 years, higher than many OPEC countries, and is expanding and upgrading its drilling programme which offers incremental exploration discoveries and positive revisions from higher recovery rates. In addition, Dragon is already investing towards commercialisation of gas which is presently flared, which we estimate could increase reserve volumes by 50%.

### Financial Strength

- **Earnings / Cash flow growth.**

Even at lower oil prices, we expect 2% growth in Net Income, 6% growth in Op Cash and 35% in Free Cash Flows over the next three years.

- **Funding + Opportunity.**

Dragon has \$830m cash on its books which we see growing comfortably each year, enough to deliver on its more aggressive drilling campaign, upstream expansion, gas development - and still leave plenty of room for an attractive dividend stream

### Compelling Valuation

Dragon is trading at just \$1.37 per barrel of 2P reserves and less than \$1 per barrel of risked reserves. This compares to the \$12 per barrel of 2P reserves which ENI paid for Burren Energy who also had assets in Turkmenistan. Dragon is the cheapest of its peers on consensus earnings multiples, trading at a PE 09 of just 3.4x and EV/EBITDA 09 of 0.2x.

## Valuation

**Our valuation of E&P companies is based upon a detailed estimate of the net present value of risked reserves, and normal investment ratios of P/E and EV/EBITDA.**

On all these measures, we think Dragon Oil is extremely cheap.

### Implied Value of Existing Reserves

Dragon Oil published Proven and Probable (2P) oil reserves of 283 million barrels, as at the end of June 2008.

Dragon has a Market Cap of \$1045m (at a \$/£ rate of 1.45). With no borrowings, cash of \$175m and Term Deposits of \$484m, Dragons negative debt of \$656m, leaving an Economic Value of just \$386.6m

This implies a value of just \$1.37 per barrel of 2P reserves.

<b>2P Oil Reserves</b>	<b>Million bbl</b>	<b>283</b>
Market Cap	£m	720.9
\$/£		1.45
Market Cap	\$m	1045.4
Net Debt	\$m	-658.8
<b>EV</b>	<b>\$m</b>	<b>386.6</b>
<b>EV per Barrel</b>		<b>1.37</b>

This is a significant discount to recent transaction values, way beyond what we might argue could be justified by lack of diversification and political risk. Note also that as developed reserves in a low tax environment, Dragon Oil's reserves have should have an advantage over the "average" barrel, which includes a mix of higher tax and reserves still to be developed.

Including potential gas reserves at probability of 80%, total reserves increase to 426mb, implying an EV of less than a dollar per barrel.

2P Oil Reserves	Million bbl	283
Risked Gas Reserves	Million boe	143.4
<b>Risked Reserves</b>	<b>Million boe</b>	<b>426.4</b>
Market Cap	£m	720.9
\$/£		1.45
Market Cap	\$m	1045.4
Net Debt	\$m	-658.8
<b>EV</b>	<b>\$m</b>	<b>386.6</b>
<b>EV per Barrel</b>		<b>0.91</b>

## Fair Value of Risked Reserves

We use a basic model to calculate the value of reserves allowing for:

- Production profile
- Development and Maintenance Capex
- Sales realisations / Discount to Brent
- Production costs
- Royalties
- Taxes

We are then able to calculate from these inputs what price someone could afford to pay to acquire reserves up front and still make a target return from the long term cash flows. Normally this hurdle rate is 12-15%, but for Dragon we increase this to around 20% to reflect a premium.

The workings and assumptions for Dragon Oils Net Entitlement Reserves are detailed below:

NAV per Barrel Calcs		Turkmen Oil															
Reserves	283 mb	Brent	70 \$/bbl	Royalties	0% of sales	Discount	8%										
Acquisition cost	8.5 \$/bbl	Discount	4%	Interest	5% of debt	NPV	2820.4										
Maintenance Capex	16.0 \$ per bbl	Production	16 \$/bbl	Tax Allow	30% of capex	NPV/CX	107%										
Maint	of capex	Gearing	0% ceiling	Tax	25% of Profit	IRR	19.7%										
Reserve Life at Purchase	17 years	Loan	0 years														
Peak	68 kbd																
Gearing	0																
Year	-1	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Acqn	-2406																
Dev at \$11/bbl	-220	-200															
Capex	-2626	-200.0	-302.2	-347.6	-399.7	-379.7	-360.7	-342.7	-308.4	-277.6	-249.8	-224.8	-202.3	-182.1	-163.9	-147.5	-132.8
Cumul funds ex Int + Tax	-2626	-1987.8	-1326.7	-566.4	307.9	1138.5	1927.5	2677.1	3351.8	3959.0	4505.5	4997.3	5439.9	5838.3	6196.8	6519.5	6809.9
Production Profile	0																
Prod kbd	0	45.0	51.8	59.5	68.4	65.0	61.8	58.7	52.8	47.5	42.8	38.5	34.6	31.2	28.1	25.3	22.7
Prod bpa	0	16.4	18.9	21.7	25.0	23.7	22.5	21.4	19.3	17.3	15.6	14.1	12.6	11.4	10.2	9.2	8.3
Brent	0	70	70	70	70	70	70	70	70	70	70	70	70	70	70	70	70
Avg Realisation	0	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67	67
Revenues	0	1100.5	1265.5	1455.4	1673.7	1590.0	1510.5	1435.0	1291.5	1162.3	1046.1	941.5	847.3	762.6	686.3	617.7	555.9
Production	0	-262.8	-302.2	-347.6	-399.7	-379.7	-360.7	-342.7	-308.4	-277.6	-249.8	-224.8	-202.3	-182.1	-163.9	-147.5	-132.8
Royalties	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pre-tax Cash	0	837.7	963.3	1107.8	1274.0	1210.3	1149.8	1092.3	983.1	884.8	796.3	716.7	645.0	580.5	522.4	470.2	423.2
Non Cash	0	-139.6	-113.3	-130.3	-149.9	-142.4	-135.3	-128.5	-115.7	-104.1	-93.7	-84.3	-75.9	-68.3	-61.5	-55.3	-49.8
Interest Charge		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Pre-Tax Profit	0	698.1	850.0	977.5	1124.1	1067.9	1014.5	963.8	867.4	780.7	702.6	632.3	569.1	512.2	461.0	414.9	373.4
Tax Charge	0	-174.5	-212.5	-244.4	-281.0	-267.0	-253.6	-240.9	-216.9	-195.2	-175.7	-158.1	-142.3	-128.0	-115.2	-103.7	-93.3
Net Tax Allowances	787.7	60.0	90.7	104.3	119.9	113.9	108.2	102.8	92.5	83.3	74.9	67.4	60.7	54.6	49.2	44.3	39.8
Tax Payment		787.7	-114.5	-121.8	-140.1	-161.1	-153.1	-145.4	-138.1	-124.3	-111.9	-100.7	-90.6	-81.6	-73.4	-66.1	-59.5
Post Tax Cash	-2626	1425.3	546.6	638.4	734.2	669.5	636.0	604.2	536.5	482.9	434.6	391.1	352.0	316.8	285.1	256.6	230.9

This implies an NAV of \$8.50 per barrel of crude reserves and \$2.50 per barrel of oil equivalent for the 1mboe gas which could be produced during the license period to 2025.

Using these detailed calculations for NAV of reserves, and adding in the high level of cash which Dragon has on its balance sheet, we estimate a fair value for Dragon Oil of 386p per share. This is approximately 3x Dragons present trading level.

2P Oil Reserves		283
Contingent Gas Reserves	During licence period	143.4
Total Reserves		426.4
Oil \$/bbl	8.50	2405.5
Gas \$/boe	2.50	286.9
Value of Reserves \$/boe	6.31	2692.4
Cash \$m		174.8
Term Deposits		484.0
Fair Value including Net Debt	\$m	3351.2
Long term \$/£		1.70
Market Cap	£m	1971.3
Shares out		511.3
<b>Implied Price</b>	<b>pence</b>	<b>386</b>

With 52% of the stock held by ENOC acting as an obstacle to normal acquisition values, we have looked at the price at which ENOC could buy out minorities in order to capture all the cash flows to make a very attractive 15% return, which we estimate at 293p (See Triggers and Drivers 3)

**Our Target Price is based on an equal blend of the fair value of risked reserves at 386p and the ENOC buy-out case at 293p, to arrive at 340p**

### Multiple comparison

Dragon Oil is trading at the lowest multiple of consensus forecasts of any of the main board listed UK stocks, at PE of just 3.4x in 2009 and 2.9x in 2010 and an EV/EBITDA of just 0.2x in 2009. Because of the strength of its cash flows, we think EV/EBITDA becomes a more difficult measure from 2010 because the company by then could have a negative EV, ie the market cap is lower than just the cash on the balance sheet, never mind the value of the reserves.

At our target price of 340p, Dragon still has a PE of only 9.4x and EV/EBITDA of 3.4x in 2009.



**Peer Group Valuation**

	Last Price	Change 1M %	Change YTD %	EV/EBITDA 08	EV/EBITDA 09	PE 08	PE 09	Yield	P/B
<b>Cairn</b>	<b>1568</b>	-6.6%	-49.0%	16.2x	5.9x	100.2x	28.7x	0.00%	1.8x
<b>Dana</b>	<b>833</b>	-13.3%	-40.2%	1.9x	2.6x	6.1x	10.9x	0.00%	1.5x
<b>Imperial</b>	<b>1026</b>	-3.7%	-13.7%	92.2x	23.2x		25.2x	0.00%	2.8x
<b>Melrose</b>	<b>190</b>	-13.3%	-30.4%	2.2x	2.5x	3.7x	5.1x	0.75%	1.1x
<b>Premier</b>	<b>770.5</b>	-8.5%	-41.2%	1.5x	1.9x	7.3x	14.7x	0.00%	1.8x
<b>Salamander</b>	<b>106.25</b>	-18.1%	-57.0%	4.7x	2.1x	22.3x	6.3x	0.00%	0.5x
<b>Soco</b>	<b>1419</b>	-2.6%	-35.5%	11.3x	7.7x	30.3x	17.3x	0.00%	4.6x
<b>Tullow</b>	<b>489.75</b>	-13.0%	-24.8%	6.5x	9.1x	19.9x	25.5x	0.63%	6.2x
<b>Venture</b>	<b>360.25</b>	-14.6%	-54.5%	2.0x	1.7x	4.5x	4.6x	1.26%	1.8x
<b>Dragon Oil</b>	<b>130</b>	-11.7%	-61.4%	0.6x	0.2x	3.3x	3.4x	0.00%	0.6x

Source: Bloomberg consensus, ESN estimates

## Triggers & Swot Analysis

### Triggers & Drivers

#### ■ Production growth

Dragon has already announced peak production volumes of nearly 44kbd at its interim presentation in August, and is actively engaged on several areas to continue to increase this by the end of the year.

- Increased to three rigs by end 2008 (1 jack-up and 2 platform based rigs)
- More sophisticated drilling programme starting 2H08 including higher angle wells (not mentioned in 1H interims)
- On track with new 30 inch trunk line to shore facilities and gas separation raising capacity to 100kbd by November 2009 (75kbd crude plus 25 kbd liquids)

We see significant opportunity to emphasise progress and demonstrate potential at or ahead of 2009 results.

#### ■ Gas commerciality and reserve potential

Gaffney, Cline and Associates are presently studying potential gas reserves in the Chelekan licence and are expected to report in the New year. Against the background of active negotiations and increasing prices for Turkmen gas, Dragon are already investing in equipment necessary to commercialise the gas it produces but presently flares, and we high prospect of declaration of commerciality over the next six months.

#### ■ Upstream restructuring and strategic position

We like Dragon for the very strong cash position it generates which in itself we believe has the potential to be a trigger in the near- to medium- term, as Dragon's growing net cash position has the potential to equal its total market cap within two years. We believe that ENOC should be looking at capturing these cash flows by buying out remaining shareholders and could offer a substantial premium on present values. We estimate a 50% premium to the share price could net ENOC a 28% IRR over ten years even before the benefits of residual value; we think they could offer as much as \$4.00 per share (293p at present rates) and return 15%. We believe the attractions of capturing these cashflows will look increasingly attractive for the government of Dubai as the call on cash to finance the emirate's growth strategy becomes more direct.

Alternatively, we think ENOC/Dubai could realise even greater gains by considering selling its stake to another oil company, which would probably trigger a full bid for the remaining 48.12% minorities. We estimate the price payable for reserves to generate a 15% return to an external acquirer as equivalent to 386p per share, and take a 20% discount to this to generate our 310 pence target. Note that this implied value of \$xx.x per barrel of reserves is below the price paid in 2007 by ENI for Burren Energy, who held xx& of their reserves in Turkmenistan.

## SWOT Analysis

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> <li>▪ Existing production with track record of growth and further upside</li> <li>▪ 34 years reserve life</li> <li>▪ Very strong balance sheet, cash generation</li> </ul>	<ul style="list-style-type: none"> <li>▪ Single production asset in Turkmenistan</li> <li>▪ 80% of production presently via Iran</li> </ul>
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> <li>▪ Race to sign gas at increasing prices in Central Asia</li> <li>▪ Ample cash to commence dividend stream</li> <li>▪ Strategic options for majority holder</li> </ul>	<ul style="list-style-type: none"> <li>▪ Corporate governance concerns</li> <li>▪ Iran “closes for business”</li> <li>▪ Divert cash flows to wholly new area</li> </ul>

## Risks and Sensitivities

### ▪ Interruption in deliveries via Iran

With 80% of crude volumes being transported through Iran, Dragon Oil is clearly directly exposed to the threat of this route closing for political or even military reasons. At present, Dragon operates with Iran and is able to sidestep the threat of US sanctions as it has no ambitions to operate where these sanctions could have more effect. (However, this is a significant obstacle to Dragon as an acquisition target for other major oil companies for whom sanctions over Iran would be more damaging). While Dragon is actively trying to reduce risk by finding alternative routes, we think that it would not be able to avoid volume risk in the event of Iran effectively shutting for business. (We think margin risk on volumes through Azerbaijan and/or Russia would be low (higher cost per barrel than Iran, but we would expect prices to spike if flows through Iran were affected in general). However, Dragon has cash on its balance sheet equivalent to 18 months revenues at \$70 on 70% of all its volumes so even if it paid full costs upstream it would have a comfortable cushion on which to maintain operations without needing any debt to tide it over, and meanwhile we think the value applied to oil reserves which support our valuation methodology would materially increase.

## ■ Corporate Governance and License issues in Turkmenistan

Turkmenistan has a complex political legacy and environment. Until his death in 2006, the country was a dictatorship under Sapamurat Niyazov, a bureaucrat of the Communist Party of the Soviet Union who took control in 1985 and then declared President for Life in 1999 by a parliament which had taken office only a week before composed of candidates hand-picked by Niyazov himself. Anecdotes abound to the absolute control exercised by Niyazov (renamed “Turkmenbashi”), from renaming the names of the week after his family and rotating statues permanently facing the sun (or vice-versa), to the significantly more sinister allegations of human rights abuses and intolerance of political dissent. Power remains concentrated with the new president, Gurbanguly Berdymunkhammedov, elected in 2007 in a vote condemned by many observers as fraudulent, but there are indicators of at least some progress towards the opening of the political process, with a new constitution which at least on paper enables the formation of political parties. For investors, the key concern is stability and the ability to exercise the rights of ownership, and in this area the record has been more encouraging. As concluded by the United States Energy Information Administrations country briefing; “Since Berdymunkhammedov became president, there have been signs of a more business-friendly environment, and international competition for Turkmenistan’s hydrocarbon industry has intensified”. However, such competition itself, involving Russian, Western and possibly Chinese interests, is not always inductive to the rights of small companies so Dragon has to demonstrate ability to maintain its position, although it is helped by majority ownership of a key oil-producing country. Dragon’s Production Sharing Agreement was signed in November 1999 and terms have been maintained on both sides allowing increasing investment.

## ■ Subordination to majority shareholders interests

Investors will question whether minority shareholders can achieve close to fair value if the majority is held by a foreign government entity. We would argue that ownership by the Dubai Government via ENOC is neutral to positive, as the government will want to demonstrate acceptable corporate governance standards; otherwise there would be reputational risk which would compromise Dubai’s long term ambitions to create an international financial centre in the state, and more immediately could affect access to international markets for project finance.

Longer term, we think Dragon could form part of a desire by Dubai to float an energy company on its local index, rather than on London and Dublin markets. We can see a scenario where ENOC could buy minorities to delist in London, capture internal cash flows and have a ready vehicle to IPO on the DIFC at a later stage. We see this strategy as sensible and consistent with Dubai’s long term aims – and a catalyst for existing minorities rather than a threat.

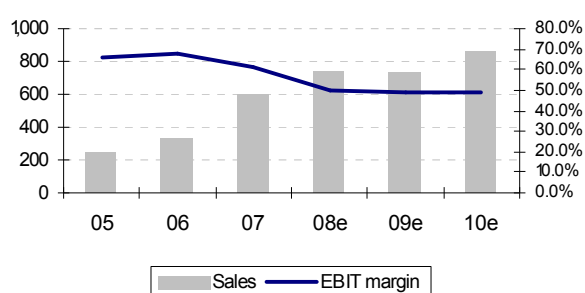
## Financials

### P&L Analysis

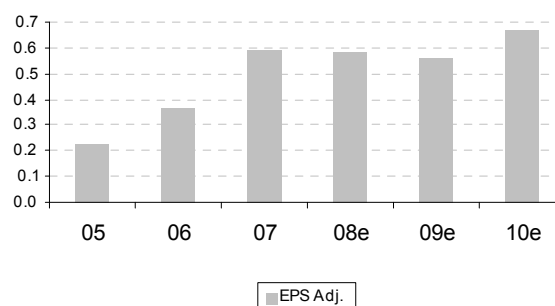
The key drivers on the Profit and Loss are:

- Net Entitlement Volumes – See Production Volumes, Page 5
- Average Crude Realisations – See Crude Marketing and Prices, Page 6
- Cash Operating Costs per barrel – We expect these to continue to increase on a unit basis despite lower cost pressure in the industry in general, as local costs increase, production operations become more technically challenging and distribution costs increase to reduce dependence on the Iran route
- Depreciation Charge per barrel – We expect these to stable on a unit basis on growing volumes
- Administration Charge – We assume continued increase, at 15% growth
- Hedging Costs / Benefits – Dragon Oil took a charge of \$91m in 1H08 for hedging losses at the high market prices see in this period. With average floor and ceiling prices of \$45 and \$102 per barrel respectively, we do not expect further material hedging adjustments on our \$70 oil case.
- Finance Income – Interest income on estimated cash balance
- Tax Rate – The maximum rate in Turkmenistan is 25%

**Sales, EBIT margin**

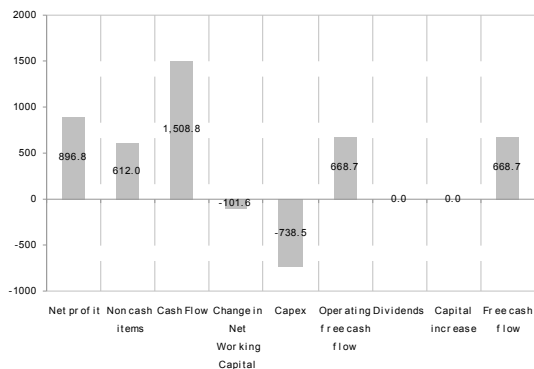


**EPS development**

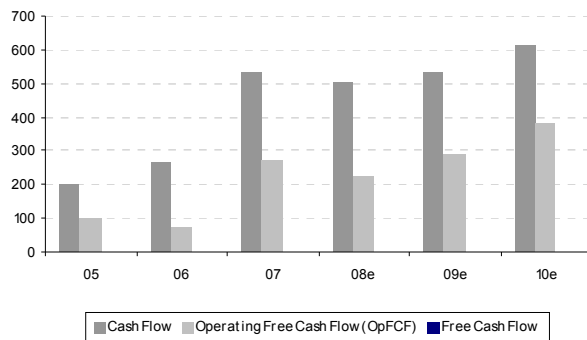


## Cash Flow and Returns

### Breakdown of aggregate 5 yrs Free Cash Flow

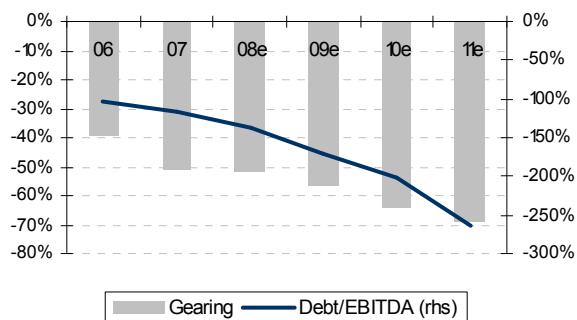


### Cash Flow Development

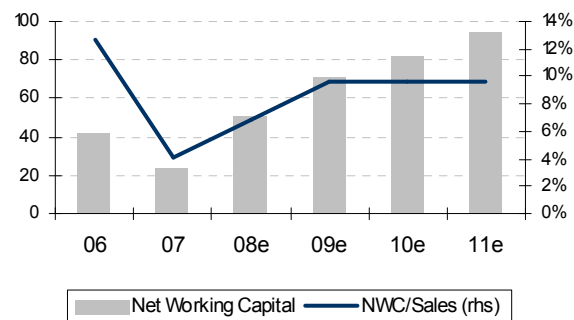


Source: Company data

### Gearing, Debt/EBITDA

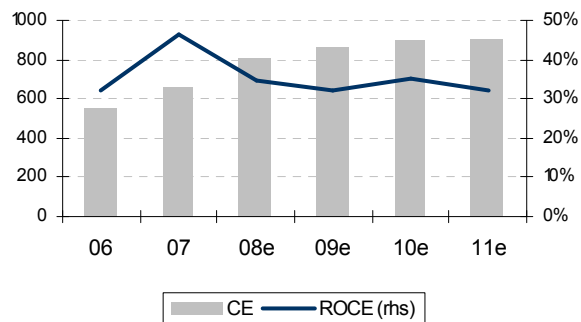


### NWC, NWC/Sales

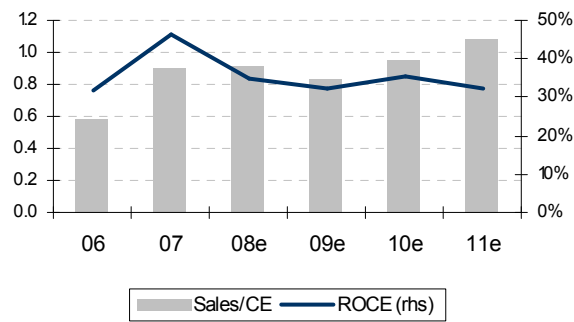


Source: Company data

### ROCE & CE



### Sales/CE, ROCE



Source: Company data

**Dragon Oil: Summary tables**

PROFIT & LOSS (USDm)	2006	2007	2008e	2009e	2010e	2011e	CAGR 11/06
<b>Sales</b>	<b>325.1</b>	<b>596.6</b>	<b>738.8</b>	<b>733.7</b>	<b>855.9</b>	<b>983.7</b>	<b>24.8%</b>
Cost of Sales & Operating Costs (excl. Pers. Expenses)	-30.1	-86.1	-212.2	-160.7	-200.7	-335.6	
Personnel Expenses	-12.2	-19.2	-22.1	-25.4	-29.2	-33.6	
Non Recurrent Expenses/Income	0.0	-24.3	0.0	0.0	0.0	0.0	
<b>EBITDA</b>	<b>282.8</b>	<b>467.0</b>	<b>504.4</b>	<b>547.5</b>	<b>626.0</b>	<b>614.5</b>	<b>16.8%</b>
<b>EBITDA (adj.)*</b>	<b>282.8</b>	<b>491.3</b>	<b>504.4</b>	<b>547.5</b>	<b>626.0</b>	<b>614.5</b>	
Depreciation, Amortisation & Write Downs							
<b>EBIT</b>	<b>221.3</b>	<b>365.1</b>	<b>365.9</b>	<b>372.3</b>	<b>421.6</b>	<b>391.1</b>	
EBIT (adj.)*	221.3	389.4	365.9	372.3	421.6	391.1	
Net Financial Interest	12.0	19.2	24.2	20.1	33.9	35.9	
Other Financials	0.0	0.0	0.0	0.0	0.0	0.0	
Associates							
Other Non Recurrent Items							
<b>Earnings Before Tax (EBT)</b>							<b>12.9%</b>
Tax	-46.4	-80.3	-90.5	-98.1	-113.9	-106.8	
Tax rate	19.9%	20.9%	23.2%	25.0%	25.0%	25.0%	
Discontinued Operations							
<b>Minorities</b>							
<b>Net Profit (reported)</b>	<b>186.9</b>	<b>303.9</b>	<b>299.6</b>	<b>294.3</b>	<b>341.6</b>	<b>320.3</b>	
Net Profit (adj.)	186.9	303.9	299.6	294.3	341.6	320.3	
<b>CASH FLOW (USDm)</b>							
Cash Flow from Operations before change in NWC	269.5	531.2	504.0	543.8	612.8	603.3	17.5%
Change in Net Working Capital	-41.5	-24.0	-26.5	-19.8	-11.7	-12.3	
<b>Cash Flow from Operations</b>	<b>228.0</b>	<b>507.2</b>	<b>477.5</b>	<b>524.1</b>	<b>601.1</b>	<b>591.0</b>	
Capex	-15.8	-236.5	-250.0	-220.0	-220.0	-220.0	
Net Financial Investments	0.0	0.0	0.0	0.0	0.0	0.0	
<b>Free Cash Flow</b>	<b>72.1</b>	<b>270.7</b>	<b>227.5</b>	<b>304.1</b>	<b>381.1</b>	<b>371.0</b>	<b>38.8%</b>
Dividends	0.0	0.0	0.0	25.5	51.1	102.2	
Other (incl. Capital Increase & share buy backs)							
<b>Change in Net Debt</b>							
NOPLAT	177.3	307.9	281.0	279.2	316.2	293.3	
<b>BALANCE SHEET &amp; OTHER ITEMS (USDm)</b>							
Net Tangible Assets	512.8	639.2	753.9	798.7	814.3	810.9	
Net Intangible Assets (incl. Goodwill)	0.0	0.8	0.8	0.8	0.8	0.8	
Net Financial Assets & Other	0.0	0.0	0.0	0.0	0.0	0.0	
<b>Total Fixed Assets</b>	<b>512.8</b>	<b>640.0</b>	<b>754.7</b>	<b>799.5</b>	<b>815.1</b>	<b>811.8</b>	<b>9.6%</b>
Net Working Capital	413	24.1	50.6	70.4	82.1	94.3	
Shareholders Equity	754.3	1,060.4	1,338.6	1,634.6	1,980.2	2,355.5	25.6%
<b>Minorities Equity</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	
Net Debt	-296.2	-543.2	-690.3	-929.4	-1,263.5	-1,622.8	R-
<b>Provisions</b>	<b>196.7</b>	<b>343.0</b>	<b>384.1</b>	<b>398.4</b>	<b>451.7</b>	<b>460.3</b>	
Other Net Liabilities or Assets	-100.6	-106.1	-227.0	-231.0	-271.3	-287.9	
Net Capital Employed/Invested	554.2	664.1	805.3	869.9	897.2	906.1	
<b>Total Market Cap</b>	<b>1,704.5</b>	<b>2,278.1</b>	<b>991.1</b>	<b>991.1</b>	<b>991.1</b>	<b>991.1</b>	
Enterprise Value (EV adj.)	1,408.3	1,734.8	300.8	617	-272.4	-631.7	
<b>MARGINS AND RATIOS</b>							
Sales growth	30.7%	83.5%	23.8%	-0.7%	16.7%	14.9%	
EBITDA growth	36.9%	65.1%	8.0%	8.5%	14.3%	-1.8%	
EBIT growth	35.9%	65.0%	0.2%	17%	13.2%	-7.2%	
<b>EBITDA margin</b>	<b>87.0%</b>	<b>78.3%</b>	<b>68.3%</b>	<b>74.6%</b>	<b>73.1%</b>	<b>62.5%</b>	
EBIT margin	68.1%	61.2%	49.5%	50.7%	49.3%	39.8%	
<b>Debt/Equity (gearing)</b>	<b>-39.3%</b>	<b>-51.2%</b>	<b>-51.6%</b>	<b>-56.9%</b>	<b>-63.8%</b>	<b>-68.9%</b>	
Debt/EBITDA	-10	-12	-14	-17	-2.0	-2.6	
Interest cover (EBITDA/Fin.interest)	nm	nm	nm	nm	nm	nm	
ROCE (adj.)	32.0%	46.4%	34.9%	32.1%	35.2%	32.4%	
WACC	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	
<b>ROCE (adj.)/WACC</b>	<b>nm</b>	<b>nm</b>	<b>nm</b>	<b>nm</b>	<b>nm</b>	<b>nm</b>	
EV/CE	2.5	2.6	0.4	0.1	nm	nm	
OpFCF/EV	5.1%	15.6%	75.6%	493.1%	-139.9%	-58.7%	
EV/Sales	4.3	2.9	0.4	0.1	nm	nm	
<b>EV/EBITDA</b>	<b>5.0</b>	<b>3.7</b>	<b>0.6</b>	<b>0.1</b>	<b>nm</b>	<b>nm</b>	
EV/EBITDA (adj.)*	5.0	3.5	0.6	0.1	nm	nm	
EV/EBIT	6.4	4.8	0.8	0.2	nm	nm	
EV/EBIT (adj.)*	6.4	4.5	0.8	0.2	nm	nm	
P/E (adj.)	9.1	7.5	3.3	3.4	2.9	3.1	
P/BV	2.3	2.1	0.7	0.6	0.5	0.4	
<b>FCF yield</b>	<b>4.2%</b>	<b>11.9%</b>	<b>22.9%</b>	<b>30.7%</b>	<b>38.4%</b>	<b>37.4%</b>	
Payout ratio	0.0%	0.0%	0.0%	-8.7%	-15.0%	-31.9%	
<b>Dividend yield (gross)</b>	<b>0.0%</b>	<b>0.0%</b>	<b>0.0%</b>	<b>-2.6%</b>	<b>-5.2%</b>	<b>-10.3%</b>	
<b>PER SHARE DATA (USD)</b>							
<b>EPS (reported)</b>	<b>0.36</b>	<b>0.59</b>	<b>0.58</b>	<b>0.57</b>	<b>0.67</b>	<b>0.62</b>	<b>11.3%</b>
<b>EPS (adj.)</b>	<b>0.36</b>	<b>0.59</b>	<b>0.58</b>	<b>0.57</b>	<b>0.67</b>	<b>0.62</b>	<b>11.3%</b>
BVPS	147	2.07	2.61	3.19	3.86	4.59	25.5%
DPS	0.00	0.00	0.00	-0.05	-0.10	-0.20	R-

Source: Company, NCB Stockbrokers estimates. \* Where EBITDA (adj.) or EBIT (adj.) = EBITDA (or EBIT) +/- Non Recurrent Expenses/Income  
2005 restated as IFRS proforma

## ESN Recommendation System

The ESN Recommendation System is **Absolute**. It means that each stock is rated on the basis of a **total return**, measured by the upside potential (including dividends and capital reimbursement) over a **12 month time horizon**.

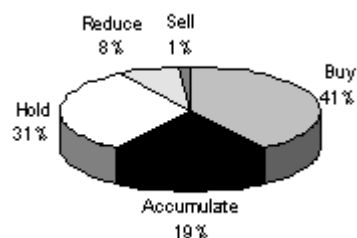
The ESN spectrum of recommendations (or ratings) for each stock comprises 5 categories: **Buy, Accumulate (or Add), Hold, Reduce and Sell (in short: B, A, H, R, S)**.

Furthermore, in specific cases and for a limited period of time, the analysts are allowed to rate the stocks as **Rating Suspended (RS)** or **Not Rated (NR)**, as explained below.

### Meaning of each recommendation or rating:

- **Buy:** the stock is expected to generate total return of **over 20%** during the next 12 months time horizon
- **Accumulate:** the stock is expected to generate total return of **10% to 20%** during the next 12 months time horizon
- **Hold:** the stock is expected to generate total return of **0% to 10%** during the next 12 months time horizon.
- **Reduce:** the stock is expected to generate total return of **0% to -10%** during the next 12 months time horizon
- **Sell:** the stock is expected to generate total return **under -10%** during the next 12 months time horizon
- **Rating Suspended:** the rating is suspended due to a capital operation (take-over bid, SPO, etc) where the issuer of the document (a partner of ESN) or a related party of the issuer is or could be involved or to a change of analyst covering the stock
- **Not Rated:** there is no rating for a company being floated (IPO) by the issuer of the document (a partner of ESN) or a related party of the issuer

NCB Stockbrokers Ratings Breakdown

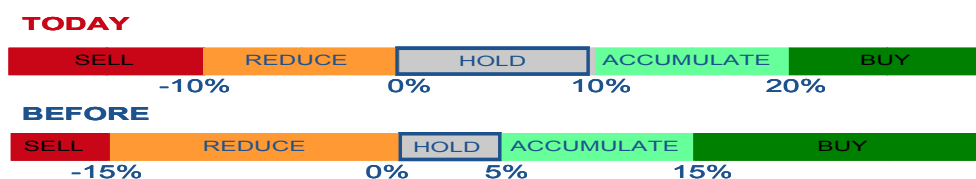


### History of ESN Recommendation System

Since **18 October 2004**, the Members of ESN are using an Absolute Recommendation System. Prior to then, ESN followed a Relative Recommendation System to rate any single stock under coverage.

Since **4 August 2008**, the ESN Rec. System has been amended as follow.

- Time horizon changed from 6 months to 12 months
- Recommendations Total Return Range changed as below:



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