ERSTE

Oil price set to climb up, refining still lags behind

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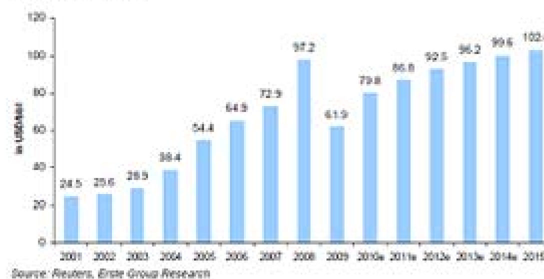
- Global demand for crude oil on the up; long-term price forecast at USD 102.6/bbl
- Downstream segment under pressure, complex refineries (MOL, INA) to benefit
- EU likely to offset its low gas reserves by unconventional gas exploration – resources concentrated in northern Europe, Poland and Romania
- OMV remains top pick; Petrom, MOL – Accumulate; INA - Buy

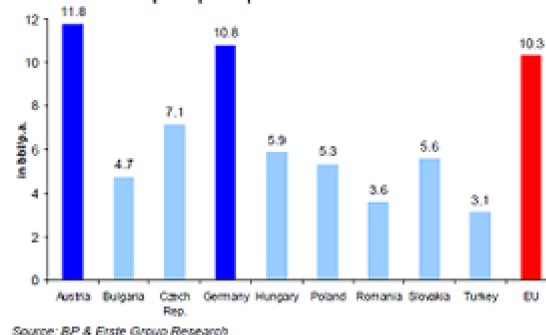
Oil sector

Erste Group analysts expect the crude oil price to head upwards, while over the past 12 months it fluctuated within the broad range of USD 64–87/bbl. “We forecast an oil price average for the end of 2010 of USD 79.8/bbl, rising to USD 86.8/bbl at the end of 2011 and USD 102.6/bbl long-term (end of 2015),” comments Thomas Unger, Oil & Gas analyst at Erste Group.



Source: Reuters, Erste Group Research

In terms of factors that would influence the crude oil price in the future, OECD crude oil stock remains high and should act as a buffer to volatility. Additionally, there seems to be little risk of supply shortages within the next 2-3 years, as the production of oil is comfortably keeping pace with the growth of consumption. “The global demand for crude oil is up again (+2% compared to the 2009 average), expected to further increase both short- and mid-term,” Unger adds. Overall, this points to the fact that energy efficiency programs in developed nations will be more than offset by the anticipated strong growth in emerging markets (especially China). Population dynamics and macroeconomic convergence will thus continue to help increase crude oil consumption. At the same time, increasing production, exploration and development costs are bound to inflate the crude oil price.



Source: BP & Erste Group Research

9/27/2010 Company	Curr.	Mcap (EURmn)	Current price	Target price NEW	Target price OLD	Upside potent.	Recommendation NEW	Recommendation OLD	Performance (EUR terms) 1M	3M	6M	12M
INA	HRK	2,249	1,640	2,200	1,888	34.1%	Buy	Accumulate	0.0	-4.1	-7.3	-1.4
Kulczyk Oil Ventures	PLN	154	1.56	2.00	–	28.2%	Buy	--	-3.1	-12.4	--	–
Lotos	PLN	1,030	31.35	32.00	25.00	2.1%	Hold	Reduce	5.3	2.8	4.0	27.9
MOL	HUF	7,727	20,500	24,400	18,500	19.0%	Accumulate	Hold	-1.7	10.2	0.8	31.3
OMV	EUR	8,028	26.88	36.50	39.00	35.8%	Buy	Buy	3.7	7.5	-1.5	2.1
Petkim	TRY	1,158	2.30	2.54	2.40	10.4%	Accumulate	Accumulate	6.5	10.1	28.4	49.8
Petrom	RON	4,411	0.33	0.38	0.32	14.8%	Accumulate	Accumulate	-0.6	9.3	-2.9	27.9
PKN	PLN	4,381	40.49	43.00	30.00	6.2%	Hold	Reduce	4.1	8.0	4.6	35.0
Tupras	TRY	4,602	36.50	40.00	39.50	9.6%	Hold	Buy	7.4	17.7	9.0	48.4
Unipetrol	CZK	1,564	212.00	191.00	140.00	-9.9%	Reduce	Reduce	-5.7	13.4	35.2	49.7

Source: Erste Group estimates

In Europe, crude oil demand could continue to decline by around 0.7% pa by 2020, given the stricter EU regulations for CO2 emissions in transportation. Additionally, more pressure on consumption is to come from the shift to electrically powered cars. In 2020, this should translate into approx. 4mn tons of less crude oil consumed. “The CEE

region has significantly lower per capita crude consumption, albeit with wide differences between countries (see graph). Among the CEE6, Poland and Romania seem to have the most upside potential – at 60% of the EU average, there would be extra demand for 13.5mn tons of crude oil or 2% of the EU total," the Erste analyst also points out.

On the downstream side, the majority of companies posted significant losses in the downturn and record only modest profits at the moment. Going forward, the situation is to remain rather gloomy. Erste Group analysts see several factors that should influence the capacity utilization, margins and investments in the European refining segment: the long-term shift of consumers from gasoline to diesel cars; EU CO2 emissions curbs in transportation; car electrification (hybrids); and energy efficiency programs. In particular, Europeans continue to increase diesel cars prevalence. Consequently, the European trade balance in distilled products is negative for diesel and positive for gasoline. Clearly, those refineries with higher complexity and ability to produce a high percentage of middle distillates should benefit in Europe. In the universe of companies analyzed by Erste Group, MOL has probably the best position (Bratislava refinery), while INA is also modernizing its refining assets in Sisak and Rijeka.

Gas segment

The European gas market is somewhat specific, as it is characterized by long-term contracts and a very dense pipeline network. There are currently three key sources supplying the region with gas – the North Sea (Norway, the Netherlands, and the UK), Russia and the Middle East/Africa. Historically, Russian gas was mainly fuelled to the CEE region, while Western Europe had to rely on the other two sources. Despite many comments concerning European dependence on Russia, the EU produced 58% of its consumption (total 464 Bcm in 2009), according to BP.

On the other hand, the EU has only negligible share of global natural gas reserves, with the largest share belonging to Norway (approx. 10 years of consumption and 17 years of production). Thomas Unger explains: "On the global scale, EU reserves represent a negligible amount, as the majority of currently known reserves are in Russia (CIS) and the Middle East. However, things could change with unconventional gas exploration. Europe has every incentive to boost its gas resources, as it is likely to run out soon, while it also wants to curb CO2 emissions (gas emits half the CO2 of coal) and increase its energy security. The distribution of resources seems to be concentrated in the northern parts of Europe – the North Sea, Sweden, the UK, Germany, France, Poland and the Baltics, but also in the Carpathians (Romania)"

In what regards gas transportation, many projects are likely to be postponed given that gas prices are significantly down at the moment. However, liquefied natural gas will continue to play an ever-more important role (Ukraine plans a 10 Bcm LNG terminal, while Poland and the Baltic states would also like to build terminals). Nonetheless, liquefied natural gas will always be more expensive than local production and conventional gas export via pipelines.

There seems to be a relatively abundant amount of gas (unconventional) that is quite fairly distributed. The drop in demand, increasing liquefied natural gas supply (with gas transforming into a tradable commodity) and shale gas developments lead to natural gas price pressures. On the other hand, CO2 emissions curbs in Europe induce electricity producers to switch from coal to alternatives, with gas-fired plants being the fastest available alternatives (approx. three years to construct, half the CO2 emissions). Naturally, energy demand in Asia should also help balance the supply/demand of NG. We remain fairly optimistic about the NG price prospects in the medium term, with an estimated price of USD 5.5-6.5/Mcf.

Erste Group analyst's recommendation and target price overview:

- OMV is one of our top picks and we reiterate our Buy recommendation. Although OMV shares are not getting the attention they deserve, we remain convinced that the company will be able to continue with its strong operating performance. Our changed valuations methodology produces a new target price of EUR 36.5, down from EUR 39 previously.

- Petrom's target price moved up by 19% to RON 0.38 per share, from our previous target of RON 0.32. With this elevation and the sustained friendly environment for upstream assets, we feel confident with our Accumulate recommendation. The increase in the target price was induced by an overhaul of our estimates. Romania plans to dispose of a 9.8% stake in Petrom on the market, thus boosting the free float. After that transaction is completed, a EUR 600mn capital increase is very likely in 2011. However, we have not included it in our estimates so far, as it is not final yet.

- INA has been lagging behind its oil & gas peers for the past 12M, due to its low liquidity and the weak macro recovery in the Balkan region. However, INA's financial and business prospects are very encouraging. The key drivers for profitability growth should come from refinery modernization (higher utilization), growing hydrocarbon production and cost savings measures. Our 12M target price is HRK 2,200/share - Buy recommendation.

- MOL is a fully-integrated oil and gas company with an increasing upstream capability, thanks to the recent INA consolidation. Growing hydrocarbon prices, increased production, a gradual refining and petchem recovery, and a stable gas business should lead to solid EBIT growth dynamics. We increased our 12M target price from HUF 18,500 to HUF 24,400, prompting an Accumulate recommendation for MOL.
- Unipetrol has been one of the best-performing stocks in Prague in 2010. From an operational point of view, Unipetrol returned to profit, mainly thanks to the strong petchem segment. However, we see little room for additional improvement in margins in 2011. We have increased our 12M target price from CZK 140 to CZK 191, but we maintain our negative stance on the company, with a Reduce recommendation.

Report CEE Oil & Gas [pdf; 1.7 MB]

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