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HOW INDEPENDENT OIL & GAS COMPANIES CAN MAKE THEMSELVES A MORE ATTRACTIVE INVESTMENT PROPOSITION

INTERVIEW WITH

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What do investors look for in an investment opportunity?

AD: The first and foremost factor that investors are looking for is sizeable resources, either proven, probable or possible. And that is always in relation to the market value of the company. If you are looking at a company with proven reserves, ideally you want to buy them at the most attractive price. The market cap of the company should be low in relation to its proven reserves and that would make the company very desirable for investors who share the belief that oil prices are on a rising trend. The second consideration is the management team, their expertise, their track record, not only in the industry, but more specifically in the areas of operation of the company. And, in addition to that, their development plans, the activity of the company going forward; if it's a high impact exploration programme, if it's a lower risk development programme or a pure enhancement. So these three elements are risked in different ways by investors to assess the likely addition to reserves and the upside in valuation that can be offered in due course, of course assuming the project is a success. This is how the professional analysts work to establish a valuation of the company as well as a potential target valuation if everything goes to plan and turns out as expected. These are the three layers that make an oil company a desirable investment.

There are different classes of investors. There are some investors who look to pure exposure to the oil price, these are upstream companies, companies that are focussed on identifying resources, developing them and bringing them to the market. And there are others who might have a more balanced approach, vertically integrated - the likes of BP, Shell and the international super majors, that have a mix in their portfolio of not only upstream operations, but also other assets such as storage, transportation, refining, chemical processing, etc. In these operations, there is also the benefit of dividend income.

In terms of the more speculative investors who are looking for the biggest possible exposure to oil prices / the markets - they will be focussing on the earlier stage, either pure exploration or early stage development companies, who are dealing with the more risky wells with high prospectivity but also much higher risk of success. If the company hits the target and finds very large volumes of oil and gas its market valuation could potentially multiply several times over, but if they miss the target and drill a dry hole that puts a great big hole in the balance sheet because these wells tend to be very expensive, therefore the market value of the company collapses. Most of the sensible exploration stage companies who act as developers of new licence areas or potentially very large targets spend the initial money to do the seismic survey and interpretation of the target in order to define where the well should be drilled. Once this has been clarified and defined they put it out to tender to the larger middle-cap companies or the majors and invite them to join them in a joint venture arrangement, whereby the larger company pays for all, or most, of the exploration expenditure and in some cases including the back costs of the developer, in order to gain a significant percentage if the exploration results are successful. So, if BP comes in and farms into the licence areas of a small exploration company and they pay the $50-$60m required to drill a fairly deep-water well, if they strike oil, they'd probably expect to have 75 to 80% of the final oil to be extracted as they provided most of the financing. A smaller company might achieve a very high impact result because 20% of a very large discovery, at no extra cost to them, could be many times over the current market value. That also works for the larger companies as they employ the smaller companies' ability in identifying frontier licence areas and new targets and then leverage this expertise on their balance sheet but not having to invest in the human resources to go in risky countries and assess a large number of projects.

CW: That partly depends on the investor and what market they're interested in and how much risk they are happy to carry. A couple of key considerations for oil investors are a strong team leading the company with credibility and a good track record who can turn an opportunity into fruition. But, as well as that, they need a thorough plan with demonstrable robustness and one the company can deliver on.

Does it matter whether an independent has a finance system?

CW: Absolutely. Having a finance system in place demonstrates that a company is serious. They've laid the foundations for a company that is aiming to grow, the tools are in place that demonstrate that they've got the financial rigors in place that the modern market and an astute investor requires. Small oil and gas companies often become very dependent on spreadsheets that have become very complicated. They often get to a stage where the management of the spreadsheet is a dark-art requiring the touch of an in-house magician to keep them functioning. Robust finance systems implemented by oil and gas experts allows a management team to have a clear, up-to-date and precise snapshot of the company's current financial situation - What's come in, what's gone out and critically, what the company is committed to spending. This information allows a company to manage everyone's expectations and their financial position, with no surprises for them or their investors.

Modeling is also a key benefit of a finance system. Capturing and analysing the data from current and past projects in a robust manner, allows companies to produce more effective plans and accurate forecasts. It also enables companies to demonstrate to investors that a company has delivered against past models, adding to a company's credibility.

An investor has to be confident that a company is going to look after their money and use it effectively. By having good systems and processes in place, companies can demonstrate to the investor that systems can support and enforce financial controls as well as giving companies the ability to respond quickly and confidently to any auditing queries. Responding quickly and concisely makes a significant difference - hesitate and eyebrows are raised and questions are asked.

AD: It does matter of course. You want to see a certain transparency. You want to see competency at the helm, with management that are able to account for every item and investors that don't throw money down a dark hole leaving it to management to distribute without any proper accounting procedures. The reports of the company need to account for the capital expenditure items and general administrative expenses, so that ultimately, when investors view the annual reports and accounts they get a fairly clear picture of where the money went. So that is absolutely necessary. The systems have to be more sophisticated the larger the operation grows, you need to account for the existing production and the cash flow generated from that, you need to clearly show what money goes into the future investment programme and the capital expenditure to add to the reserves and add to production in years to come or to attract joint-venture farming partners. It is very important to show full transparency and very important for corporate governance. Corporate governance is one of the first things investors look at. If we have a feeling that the accounts are wishy washy and don't show a true picture of the operations we wont invest in it. The company has no accountability to shareholders to show exactly where the money goes.

Regardless of how small or large, a company should have a very transparent accounting system, and audited accounts by auditors who give a true and fair view of the company. That's absolutely the minimum requirement. As the company grows larger the systems have to become more sophisticated and more descriptive so investors can see how the operations breakdown - what comes from production and what goes into future development.

Do you think a company can be investment ready without a system?

CW: Good systems that are well implemented add credibility to an organisation. An investor is going to be looking for a good return on their investment. Everyone recognises that oil and gas is not a risk-free investment, so the potential returns have to be high. You might be attracting funding today, but part of the longer term strategy might be to go to IPO to raise more money and for each stage a company will require greater robustness. If, on day-one a company implements the robustness of systems and processes that would normally be expected at a later stage of development, that company has the opportunity to lift their head above the competition. Oil and gas is a highly competitive market in every aspect. Companies are competing for the best senior staff, they are competing for the best geologists and they are competing for the investment. It's a challenging marketplace and companies have to demonstrate to investors that they're more worthy of investment than the competition for the same pot of cash. Part of that is demonstrating that they've got the team in place, as well as the systems and processes to be the company they aspire to be in three or five years time.

Investors want to see that companies have a thorough understanding of an opportunity and how much it's going to actually cost. One way to demonstrate this thorough understanding is to show that it's been done before, although that alone is not enough - investors need to see details that prove it's been done before and what the associated costs were. When a company runs a campaign they capture all the actual costs and can analyse and understand them. From these actuals companies can produce an economic model for future projects and demonstrate a true understanding of the costs at the various stages.

How does a finance system help a small independent?

CW: Ideally independents will show that they have a team with a track record of success and they are focussed on adding value to the company. Senior management need to be focussed on growing the company, show that they have connections and they can make deals happen. To demonstrate effectiveness they need to have a good back office in place so that they don't get sucked into administration tasks and looking after the day-to-day back office function. A system can take that burden away from staff, so that the management can really focus on making deals happen.

Why do small independents implement systems? What are their main drivers?

CW: When they start up, they think they just need basic accounting and they buy an off the shelf package, but oil and gas companies quickly recognise that these accounting packages really don't cut the mustard. There are key characteristics to oil and gas accounting that are unique. The joint venture arrangements are complicated legal agreements. At various stages throughout the project they'll have different partner shares and different costs that can be charged to partners. At some stage in the project one partner might not be responsible for any of the costs at all and that can be entirely different at another stage of the project. Off-the-shelf accounting packages can't handle those types of situations. In the early days small companies often build a complicated spreadsheet, which quickly becomes unmanageable.

Sometimes companies move away from off-the-shelf packages in favour of an accounting solution aimed at more complex organisations, but although being more robust, they still don't handle all of the intricacies of oil and gas, like joint venture accounting or the complexity of multi-currency. For example a company's head office might be operating in one currency, services might be procured locally in another currency and they may need to report in dollars - meaning every transaction might need to hold three different currencies to ensure the delivery of the accounting requirements.

Often a system implementation is recommended by the company's auditors, having recognised some issues around their accounting procedures, which they believe a fit-for-purpose oil and gas implementation would make a real difference to that company. Perhaps it would help them manage their growth, manage their compliance or perhaps it would demonstrate to investors that they're robust enough to actually receive the investment they're looking for.

What would turn an investor off?

AD: Very large contingencies that are not accounted for. Very large provisions for working capital and general administrative expenses for a small company that should be running a very tight budget. These elements indicate that there could be a lot of wasted money along the lines. They have not tightened the budget enough or focussed on budget items enough to have a clear expectation of the costs to come. I want to see exactly what goes into the ground and what goes into cash-burn which is the overhead - the staff that are involved in pursuing operations. Of course, you do expect cash-burn because without the key people and the technical expertise the projects will never materialise, but the costs expended on that expertise and the personnel have to be reasonable and in context of international practice. So if I see a small company paying extraordinary bonuses and share options to its executives before they have any success I would never buy their shares. Investors like companies that run a very tight budget because it means their executives are happy to invest their time and effort for little remuneration for the prospect of greater reward down the line when they actually find what they're looking for.

CW: A company that can't demonstrate they are in control - or even worse, a company showing that they are out of control. All aspects of the oil and gas business are fiercely competitive. A company must be able to put a pitch to an investor that is better than anyone else's, one that offers a better return. Having a system in place ensures the management team have up-to-date information at their fingertips, giving them the ability to make informed decisions quickly and effectively, based on facts rather than assumptions.

If an opportunity was presented that wasn't quite up to standard, would you work with that company and provide feedback?

CW: Investors invest in companies that have thought through their plans and have robust financial models that they can be confident in. They're not business coaches, they're not looking to improve people, they want the best people in place from day one. Second chances don't often come along. Accounting processes must be implemented before approaching an investor. IT and finance systems are a key enabler to delivering sound financials and sound economic models that will get buy in from investors.

AD: First of all we are very selective when we're looking at projects because that's the risky end of the spectrum - that's when things mostly go wrong. If we see any warning lights, we'll simply walk away. As prospective investors, it's not really our place to question management. We might raise the question, but it's not our place to put pressure on the management to change their ways. But generally these warning lights would turn us off, because it shows from the outset that the management do not have the understanding of how to run a business and how to make it a success and how to attract investors into participating in the capital. If the management doesn't have the experience to run a tight ship then we don't want to be with them. We will not try to change their ways in order to bring them in, even if there's an attractive asset, because if the management is not right the asset can be destroyed very quickly.

How long does investment take? Can it be quick?

AD: It depends how sufficiently defined the business plan and the vision of the company are. If they've done their homework it should be a fairly quick process and we can place an investment within a week. If we need to engage our petroleum engineer to visit a site and view technical reports, it doesn't take longer than a week or perhaps ten days. If everything is in place, investors can take a decision fairly quickly, but if things are not in place we simply say that we need this and that and the other and until you have provided us with that information we can't make any decisions. Sometimes it can take years for companies to come back with revised plans.

CW: If you can put an attractive proposition to the investor that they're convinced by, they will want to act quickly. Investors will not want to lose a good opportunity to another investor. It's important to put a good business case to them and to have robust systems and processes in place, so if investors do have queries a company can immediately respond and close the deal. Taking time is not an option, oil and gas companies need to be able to act quickly.

What type of reports would you expect to see and with what frequency?

CW: Capturing data at source, automating financial processes and being able to deliver that information in a presentable format is paramount. Hesitation leads to doubt. Having good financials in place speeds up monthly closing, allowing the management team to focus on the bigger picture. Automating financial controls means a company can respond, addressing any concerns an investor might have quickly.

AD: The financial accounts so that one can see the financial position of the company, in terms of the balance sheet and profitability, if any. And then probably equally important is the reserves report. If a company doesn't have a report on the reserves it should have at least an internationally acceptable consultant who has been engaged by the company. These reports form the basis of the initial business, to see, in discussion with the management team, if the company has the necessary foundations to qualify for an investment. You'd then proceed to more detailed due-diligence to see the economic viability. These Reports should at least be updated annually. With regards to reserves reports, these should be updated as soon as the necessary drilling has been completed and the results have been validated. At that stage you'll be able to update the picture on the nature of the reserves and the likely value of them.

Are there any reports that are requested with more regular frequency?

AD: Typically companies provide a management update every three months to investors and shareholders to report progress and delivery on objectives. On certain occasions where there are significant events that have happened to the company the management should report immediately to investors on the likely impact of these events. So there are no hard and fast rules on the frequency of reports, but at least I'd expect a quarterly report on progress and more detailed reports on financial performance and the technical side of the company on an annual basis.

CW: In oil and gas the unexpected can happen and often does happen. The management team should always have a core set of financial reports that they can run at any point to enable a timely response to any situation.

What financial controls would you expect to see in place?

CW: The best companies don't really need to think about their controls on a daily basis. The key financial controls are supported, controlled, enforced and recorded by their financial systems. An example is the delegation of authorities, where enabling the right people to spend money in the right way, against approved budgets has a massive impact on the efficiency of the operation. Not wading management down in unnecessary paperwork. Staff aren't attracted to oil and gas companies for the administration - they join a company to explore and develop oil production. Systems and controls are important for making people more satisfied and better at their jobs, as well as having the potential to increase an investor's returns.

AD: I don't think you'd look to apply what is necessary with industrial companies or consumer goods companies. It's not as if you want them to maintain certain solvency ratios or service thresholds. The financial controls have to be set in the context of adhering to the stated objectives and delivering the intended programme within budgets. The financial controls are the regular reporting of management to investors, then it's up to investors to verify that the targets have been met.

Is there anything that independent oil and gas companies aren't doing or could do better?

CW: The key thing is realism. Companies need to ensure they can pull a plan together with robust systems in place. Models should be challenged before going to investors.

Companies also need to be able to act fast and complete exploration and development in the most efficient and fast manner possible. Having an effective system in place will enable management to focus on what they need to do.

AD: The more detail the companies can present to the investor the better. The ones that present very generalistic plans without any stated objectives or without any specific targets are unlikely to attract the attention of serious investors. Investors want to see a very thought through and detailed action plan of the company going forward. Not only in terms of the cost of the programme, but most importantly what is the cost benefit - For the amount of money that is intended to be spent, what is the likely success, what is the likely return? I think this is what some smaller companies fail to deliver.

Other than the obvious, what other benefits do investors offer to small independents?

AD: It depends on the investor and it depends on the interest they intend to take in the company. In running our retail portfolios we are effectively passive investors in the companies we invest in and therefore do not take a close interest in managing the company. We may suggest things in periodic meetings with the management and then see in subsequent reports or meetings how the management has performed. But, we are unlikely to become dynamically involved in the management of the company. Whereas if we were to become involved as a significant minority shareholder in a smaller company, which occasionally we do through other structures, then we would seek to have a presentation with the board and be much more actively involved in the management of the company and steer its direction. So there are different approaches and it depends on the nature of the investment and the size of the investment. If you have a tiny percent of the company, you can't expect to direct the management in how to run the company. Very often though, even as passive investors because we see the management teams of many companies we get a thorough view of the market and how perhaps the market conditions might affect the programme of one particular company, we offer suggestions or an indication of how their approach might redevelop.

How should an independent present themselves for investment?

AD: They have to present the value of their assets in a very realistic and sensible way and not overestimate the likely success of their programme or the likely size of their reserves. There's always the tendency and inclination by smaller companies to over-blow the size of their licence area or size of their reserves. They always claim they could potentially have an elephant in the field. Then this is more likely to disappoint down the line, than exceed the expectations. It's always better to be realistic and sensible when presenting the valuation of the assets and the way they might be approached. Then going back to the planning of the company - it has to be as detailed as possible, to show that they are not shooting a blank shot without thinking it through. They have engaged reasonable studies, engaged professional people who have experience, not only in the industry, but more specifically in the location and the licence area and they have received at least preliminary cost estimates for the elements of expenditure. And that's the best way to give comfort to investors that plans will be met and that the actual target might be bigger than everyone thinks. Every investor wants to buy something that appears to be undervalued and is likely to exceed expectations. That's the mantra of most investors.

CW: One of the most important things about being independent is that it's not about what the company is today, you're presenting the company that you're aspiring to be in the future. To do that you need to show that you can add real value to the organisation over the coming years. You need to have a strong team behind you, both a management team, and if you're doing exploration, an operations team who can analyse the seismic data.

Companies need to present themselves as the company they intend to be, whilst also being realistic. Small companies need to invest early in an efficient and scalable system, reducing the administrative overhead longer term, which would be better spent on exploration.

Are investors interested in a company's IT plans?

CW: Having a robust finance system that has been implemented specifically for oil and gas, ticks one of the boxes in the requirements list and forms a very good foundation. Auditors are increasingly recommending systems be put in place to enable companies to present themselves to the marketplace effectively and to make sure accounting practices are robust.

A good finance system and robust processes address the specific key requirements and complexities of oil and gas. This can be the difference between an effective system that helps to grow the business and make it more effective, and one that is simply a data repository and doesn't support the core business. Investors should certainly be interested in well implemented systems.

AD: In the oil and gas sector we are much keener to see that the company has competent interpretation of the studies they conduct, whether it's seismic surveys or results from drilling programmes. We want to see that they have competent engineers and geologists that can read these maps and steer the company the right way to the right location with the right approach for the project. There is a technical aspect to it and there are some computer based technological systems to interpret the seismic survey, interpret the mapping and interpret the physical location of the assets. But I don't know if you can classify this as Information Technologies, it's more to do with the competence of the person who's using the software and interpreting the information coming out of it.

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