

Greenland calling

With mature oil resources in the North Sea, Alaska and elsewhere seeing declining output oil firms are looking to new areas. Cairn energy is one such firm as it looks to Greenland for the next major resource discovery. The company has been very successful in India and the geological signs in Greenland are encouraging. We therefore rate Cairn Energy a buy.

Headed by former international Rugby player, Sir Bill Gammell, Cairn Energy has proven to be incredibly successful since its foundation in 1988. The overall strategy of the business is to go after “high-potential” exploration plays and take them forward to commercial reserves. This obviously creates huge value if big finds are made.

The “company maker” for the group was the discovery of the Rajasthan fields in India after buying Shell’s operations in the country. This is the biggest onshore energy resource found in India for two decades with at least a billion barrels of oil.

The focus now is on Greenland which Cairn believes holds the same, if not more, potential for major oil and gas discoveries. Given Cairn’s history such grandiose predictions cannot be taken lightly.

Furthermore, this view is backed by a US Geological Survey (USGS) in mid 2008. The USGS estimated that the province running along the West of Greenland may contain one to ten billion barrels of oil and six to 100 trillion cubic feet of gas.

The first three offshore Greenland exploration wells that Cairn has drilled in 2010 have also encountered oil and gas which is impressive given that the global success rate for wild cat strikes is about 1 to 9. Thus Greenland oil and gas is not a pipedream and Cairn is the leading player in the race to identify and commercialise a major resource there.

The attractions of Cairn Energy are therefore that it is a well capitalised company with the potential to discover a significant resource in a politically stable country. The group’s previous exploration success and the encouraging geological signs in Greenland add to the attractions. This is of course at a time of high energy, and particularly oil, prices.

It should be remembered though that Cairn Energy is more risky than other oil firms given its focus on discovering oil in unchartered geographies. However, the strong existing asset backing for the group and its initial success in Greenland help ameliorate this somewhat.



Taking a look at the daily chart of Cairn Energy we can see that although we have quite a short sample of price action the 400p level looks to be providing horizontal support. The recent pullback from the January 11th high looks corrective in nature.

We would now target a move higher above the downtrend resistance and 50 day moving average. Should this take place we would expect to see a swift move higher to test the January high. The daily RSI looks to be heading higher having put in a double bottom at the 40 level.

Out of India?

While the success of Cairn Energy has been principally driven by a significant discovery in India the group is now looking to sell the bulk of its position in the country. This is as the CEO, Bill Gammell, received an offer he wasn't able to refuse from Vedanta Resources in 2010.

The transaction, if completed, would give Cairn Energy around \$9bn which the group would use to fund Greenland exploration activities, look for oil elsewhere and also return a "substantial proportion" to stockholders. It would also turn Vedanta into diversified resources group with output stretching from oil to base metals.

However, the transaction may now fail to complete as the Government of India (GoI) is seeking certain preconditions in order to approve the deal. These principally relate to Cairn India starting to pay royalties on its production which of course reduces the value of the business to Vedanta.

The standoff is continuing but, in our view, and the market is likely to perceive the failure of the deal as a negative for Cairn Energy. However, in our view since the transaction was initiated the value of Cairn India has increased substantially due to higher oil prices and so the fallout is lower than it might have been.

Cairn Energy has put a mid-April deadline on the deal and so we are likely to gain some insight into whether it will go ahead soon. It is notable that the Indian Cabinet looks set to become the decision making body on the deal which may help its chances of completion.

At the moment there appears to be a stalemate as Cairn India said in their last set of results that a change of ownership should in no way affect their value i.e. having to pay royalties or not. The question is who blinks first but India does need to encourage foreign direct investment and this deal is being closely watched.

Into Greenland

An interesting aspect of Cairn's transaction to sell the bulk of its holding in India is that a condition would be that the firm doesn't explore in India, or neighbouring countries, in the future. Given that India and the region was the driver for the businesses success this looks like a significant sacrifice.

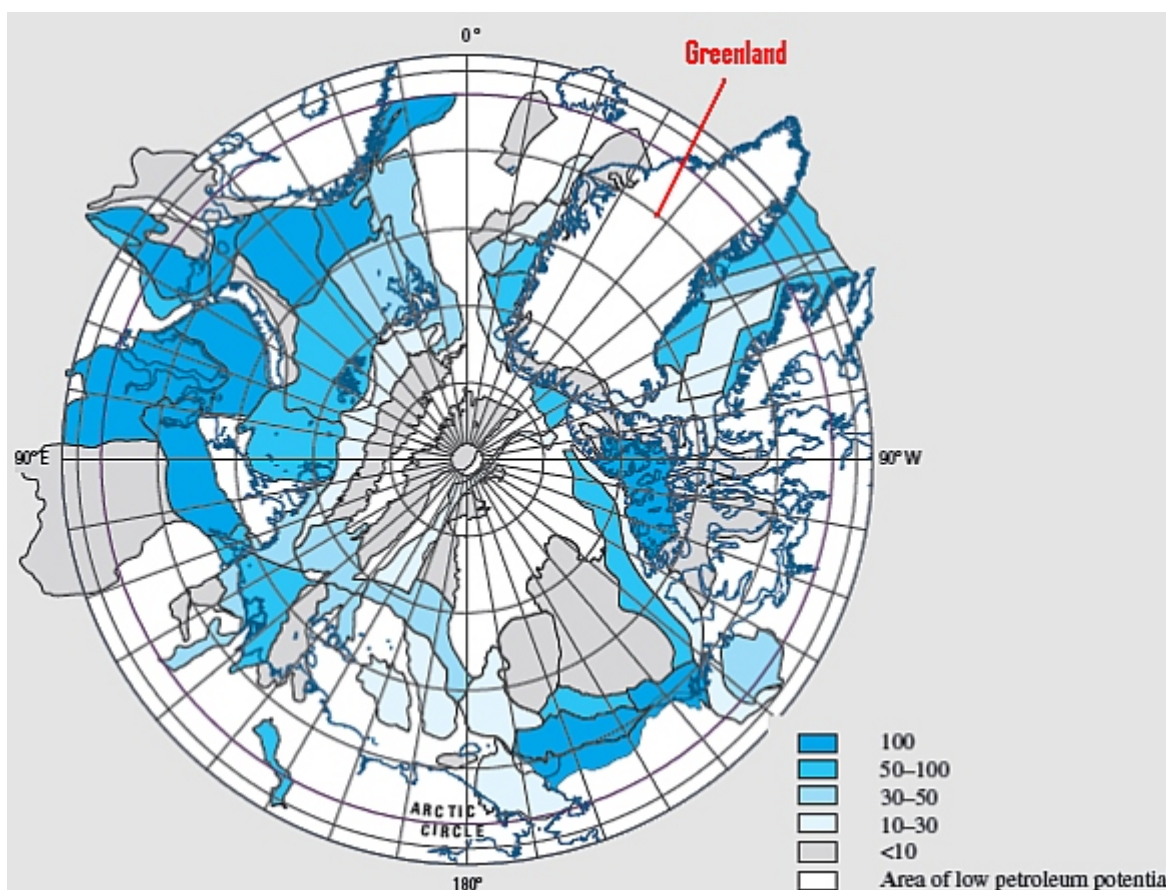
It might be taken to suggest that Cairn Energy is very optimistic on its Greenland opportunity. The less favourable interpretation is that CEO, Bill Gammell is a risk taker who prefers exploration to production.

In any event the focus of the group is clearly moving to Greenland which is an autonomous country within the Kingdom of Denmark. With a population of only 56,452 it is the least populated country in the world and the largest island that is not a continent.

The name was supposedly inspired to attract settlers with cold weather conditions clearly provide a challenge. However, Cairn has recently demonstrated that it is possible to operate an oil rig in the country for all the months of the year.

As was the case in India, Cairn appears to be ahead of the pack. The group has drilled a third of all offshore exploration wells in Greenland and the first wells in the Greenland arctic for nearly 35 years.

The following figures shows the USGS survey results for the Arctic region. The colours represent the probability of a petroleum resource:



The important point is that the survey shows that the West Coast of Greenland has a greater than 50% chance it will contain oil and gas resources. This is to the right of the red pointer which identifies Greenland.

The West Greenland/East Canada Province appraisal is estimated at 17.1 billion barrels of oil equivalent, consisting of 7.3 billion barrels of oil, 51.8 trillion cubic feet of gas and 1.2 billion barrels of natural gas liquids. These are significant numbers.

Cairn Energy has eleven blocks along the west coast of Greenland. The company has since being granted the licences over the blocks, been conducting seismic surveys to determine potential targets for drilling and has also completed three exploration wells. The following figure shows the location of Cairn Energy's Blocks.



The company's interest in each block varies as follows: Atammik 87.5%, Lady Franklin 87.5%, Sigguk 77.5%, Eqqua 77.5%, Saqqamiut 82%, Uummannarsuaq 82%, Salliit 82%, Pitu 87.5%, Napariaq 87.5% and Ingoraq 87.5%. Cairn Energy recently increased its stakes in Atammik and the Lady Franklin fields from 40% to the 87.5% they are at now through the purchase of Encana corporation.

A 2D seismic survey of approximately 2,500 kilometres has been completed on the Eqqua block and approximately 7,500 on the four southern blocks. These surveys bring the total 2D seismic survey data to over 30,000 kilometres.

Cairn Energy has now drilled one third of all exploration wells drilled for offshore Greenland and the first wells in the Greenland Arctic for almost 35 years. The company indicated the programme was undertaken to demonstrate to the Greenland Government and oil industry participants that drilling operations can be successfully and safely carried out in the region.

Exploration in Greenland is in its infancy and consequently to have encountered both gas and oil in the three well exploration drilling campaign – in Sigguk Block and Disko Bay area- of 2010 is encouraging.

It should be recognised, though, that Cairn is cautious on these initial discoveries as it alludes to in its recent (27th January 11) trading update:

“The wells found both gas and oil although significant reservoir rocks were not encountered”.

Cairn Energy indicated it will continue to evaluate all the data acquired to determine a 2011 drilling programme. Final selection of prospects and well targets for the year will be made in May.

Cairn then intends, with the approval of the Greenland Government, to drill at least four wells in 2011. To do so it has secured the use of a drill submersible and drill-ship. Such activity clearly isn't cheap with the 2010 drilling programme costing US\$400m.

However, after winning exploration blocks in December Cairn Energy now has acreage of 102,000 square km in Greenland. Thus it should have a reasonable chance of finding a significant energy resource.

The bottom line on Greenland is that it is highly prospective and offers the potential for meaningful upside. The sale of Indian assets does potentially cloud the picture as it is uncertain if this will proceed. However, the value of these is underpinned by the increase in the price of oil.

In our view, Cairn is an excellent play on the discovery of significant frontier oil reserves given its prior success, the political stability of Greenland and the potential of the geology. However, it should be remembered that Cairn has meaningful risk attached to it due to the significant costs involved in offshore exploration.

Accordingly, Cairn Energy we recommend Cairn Energy as a buy to all members.

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Snapshot CNE

Cairn Energy Plc

Cairn Energy's activities are focused on oil and gas in India, and exploration in Greenland. The company operates in India through its 62.4% owned Cairn India Limited (CIL). CIL is listed on the Bombay stock exchange and generates a strong cash flow.

Capricorn Oil is a wholly subsidiary with core assets in Greenland, Mediterranean and South Asia. The company has been very successful exploring in South Asia where it has made more than 40 oil and gas discoveries. Cairn made a major oil discovery in Northwest India in 2004.

Market Capitalisation: GBP5.9bn

	FY1	FY2
Price to Earnings	13.1	11.9
Dividend Yield (%)	0	0
Price to Book	3.2	2.5
Return on Equity (%)	23.3	23.7

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