Santos in Asia pivot as takeover talk swirls

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AUSTRALIAN producer Santos is emerging as a potential takeover target as its share price takes a hammering from falling oil prices. But the $11.5 billion company is on the defensive and has even outlined a bold move outside of Australia, which raises questions about the quality of domestic opportunities, analysts say.

Speculation is rife as low oil prices hit share prices across the oil and gas sector. But Santos, whose shares have fallen 33% to around A$10 ($8.56) from roughly A$15 in September, could be particularly attractive for its exposure to Papua New Guinea's emerging gas province, as well as Australian unconventional opportunities, and the start-up of its domestic liquefied natural gas (LNG) export project.

The *Australian Financial Review*'s Street Talk column said recently: "Santos is looking more and more vulnerable as a target."

Cheap takeover targets in some sectors of the market have already driven merger and acquisition activity across the globe to seven-year highs, data from Thomson Reuters show. Overall, 494 deals worth over $1 billion or more have been announced so far in 2014, more than any year since 2007, the data showed – with more likely before the year is out.

But the Adelaide-based company, which is leading the Gladstone liquefied natural gas (GLNG) export project in Queensland, is on the defensive as the commodity price environment becomes more uncertain. The company surprised the market by recently announcing hybrid debt financing to improve near-term liquidity.

Prices plummet

Although the company is changing its production mix, Santos is still a low-margin producer and highly sensitive to commodity prices.

"Oil prices have effectively fallen 30% in three or four months, which has surprised us all and been far faster than we, or anyone else, expected," David Knox, the company's chief executive told investors in Sydney.

He said GLNG, which is 90% complete, remains on budget at $18.5 billion and on track to start-up mid 2015. Thirteen spot cargoes have already been pre-sold to market.

The company is upbeat about the performance of coal-bed methane, which underpins the 7.8 million tonne per year (t/y) export plant, but analysts at Wall Street research firm Bernstein remain skeptical on the underlying resource and flow rates.

French major Total and Malaysian national oil company Petronas are among the partners in GLNG.

Santos went to great lengths to highlight the abundance of opportunities within Australia, but the major move was Santos' pivot to southeast Asia, noted Neil Beveridge, an Asian oil and gas specialist at Bernstein.

"At best, this suggests a lack of capital discipline with a bias for growth over returns; at worst, it suggests that the Australian growth opportunities are not as good as they seem causing Santos to look further afield," said Beveridge.

Takeover target: Poor performance has made Santos vulnerable

The pivot to Asia is driven by a positive view on long-term gas pricing in the region, as well as opportunities created by the pullback of US majors who are retreating to North America. Not forgetting, in Bernstein's view, the more limited organic expansion opportunities in Australia, given high costs and the stranded nature of some of the assets.

Santos said it will concentrate on PNG, Indonesia, Vietnam, Bangladesh and Malaysia, where a high-risk exploration strategy will focus on material oil and gas prospects with four to five wells planned each year.

The company remains positive on Asian gas and global LNG markets, estimating a 120 million t/y supply gap by 2025. Santos is a partner in PNG's maiden LNG export plant, which looks ripe for expansion and remains one of the most competitive export projects to start up in recent years.

Australia's largest domestic gas supplier also remains upbeat on the unconventional opportunities at home. While gas in place could be huge, Beveridge doubts the commerciality of unconventional gas in Australia, given high costs, low flow rates and increased competition from other lower cost gas supply.

Santos is focused on the Cooper, Amadeus and McArthur basins, which they believe are most prospective and where a sizeable footprint has been established. But only the Cooper, home to the country's first commercial shale-gas well operated by Santos, has established infrastructure.

Within the Cooper, scant progress has been made in unlocking the REM shale or other tight gas plays with flow rates on horizontal multi-stage fractured wells at 3 million cubic feet per day or less. Given the well costs this does not seem economic, analysis from Bernstein shows.

Production guidance for 2014 is 54 million barrels of oil equivalent (boe). Next year the company aims to pump between 57 million and 64 million boe. Its long term goal to deliver some 80 million to 90 million boe by 2020 remains unchanged. ●