Egypt Macro Update
On Eni's Gigantic Gas Field

فـــاروس
PHAROS

Eni Discovers the Largest Natural Gas Field in Egypt and the Mediterranean Sea

Italian oil major, Eni, discovered the largest natural gas field in Egypt and the Mediterranean Sea. The field is estimated to hold around 30 trillion cubic feet of natural gas, which is almost half of Egypt's proven reserves. According to BP Statistical Review of World Energy, Egypt's proven natural gas reserves were estimated at 65.2 trillion cubic feet as of end 2014. Accordingly, in terms of both absolute and relative sizes, the discovery is material and has almost fully eliminated risks of acute energy shortages in Egypt over the medium-term.

Yet, It is Deepwater and Fully Owned by Eni, So Likelihood of Cheaper Gas Prices is Low

According to Eni's press release, the firm holds a 100.0% interest in the concession and the lean gas is located at a depth of 1,450 meters (cc 1.5 km). Combined, these two pieces of information mean that the cost incurred by the Egyptian government to purchase production from Eni will be significantly higher than existing onshore or shallow water concessions in which the Egyptian government holds an interest.

First, in old concessions, the Egyptian General Petroleum Corporation (EGPC) typically holds title to around half of a crude oil or natural gas field's output in exchange for granting the concession to the foreign partner. Accordingly, if the foreign partner sells its share for USD 4.0/MMBTU to the government and the government's share in the concession is close to 50.0%, the weighted average cost of natural gas is USD 2.0/MMBTU (0.5 x USD 4/MMBTU + 0.5 x USD 0/MMBTU). In the case of Eni's discovery, the concession is 100.0% owned by the foreign partner, which will automatically nearly double the cost of procurement. It is worth noting that the government has lately granted full ownership stakes to foreign partners in compensation for sizable payment arrears.

Second, the investment and operating costs of developing a deep-water field are high. According to industry norms, fields up to 400 m in depth are classified as shallow water, up to 1,500 m in depth are classified as deep-water and deeper than 1,500 m are classified as ultra deep-water. The bulk of Egypt's gas production is currently produced in onshore fields (e.g., Western Desert or Upper Egypt) and shallow water concessions in the Mediterranean. Despite this fact, the government has lately agreed with several foreign partners to increase the maximum price paid for procuring natural gas above the historic ceiling of USD 2.65/MMBTU to levels close to USD 3.5-4.5/MMBTU. Hence, the cost of procuring natural gas from Eni's deep-water field as well as from the North Alexandria Concession currently developed by BP and its partner (5.0 trillion cubic feet of reserves) will likely be even higher.

Accordingly, given the higher marginal cost of procurement due to the foreign partner's full stake and the deep-water nature of the field, we expect the medium to long-term natural gas prices charged to heavy users in the industrial sector to remain consistent with our projections of USD 8.0/MMBTU.

31 August 2015

Hany Genena, CFA
hany.genena@pharosholding.com

Government's Stake in the Concession is Higher than 60.0%

We had noted in our flash comment sent earlier this morning that Eni's stake in the concession is 100.0%, which is the percent implied by Eni's press release. However, we understood from sources privy to the matter that Egypt's stake in the field is above the 60.0% mark. We are in the process of contacting Eni for further clarify on its equity stake in the concession and will update our readers once further information is available. Based on the revised information up to this moment, the following implications are worth noting:

First, the weighted average cost of procuring natural gas from the foreign partner will likely remain low. Based on the revised ownership figures, Egypt will receive its share for free and buy the share of the foreign partner for around USD 5-6/MMBTU (a figure that has not yet been disclosed), depending on the terms of the concession agreement. Accordingly, there is a strong possibility that the price of natural gas charged to industrial customers will remain stable over the medium-term at or around the USD 7/MMBTU mark. An outright beneficiary from stable natural gas cost and supply in the medium-term would be Ezz Steel. In our latest Ezz Steel update, we had expected the cost of natural gas to rise to USD 8/MMBTU over the medium-term.

Second, given Egypt's stake, there is room for exporting natural gas to generate short-term foreign currency inflows. We remind readers that Egypt has nearly suspended natural gas exports since 2014 due to acute supply shortages and diversion of production to electricity generation stations. Instead, the country has turned into a net importer in 2015YTD. Hence, with this material shift in the medium-term outlook, we believe significant downward pressures on the EGP have significantly subsided but still expect more rounds of soft devaluations to maintain competitiveness versus EM peers.

Third, the discovery will unlock the value of capacity expansions across Egypt's industrial sector. It is critical to note that several listed industrial firms (such as Ezz Steel, GEMMA, and Lecico) have suspended part or all of their capacity expansion plans due to political and economic risks, including the risk of natural gas shortages. Accordingly, we expect significant capacity expansion plans to be revived over the coming 6-12 months and expect foreign direct investment (whether greenfield or acquisitions) to recover sharply in sync.

Equity Valuations Attractive at Current Levels, Near-term Volatility Remains a Risk

Based on the above, we believe downside risks to the valuation of Egyptian equities have materially subsided. Yet, short-term headwinds to stock prices still exist, due to 1) persistent short-term foreign currency shortages and 2) volatile global equity and commodity markets. Yet, with the significant shift in Egypt's energy outlook, the duration of any significant selloff will be very short lived, in our view.

31 August 2015

Hany Genena, CFA
hany.genena@pharosholding.com

Disclaimer

This Report is compiled and furnished solely for informative purposes to be considered by the intended recipients who have the knowledge to assess the information contained herein. Pharos Research ('Pharos') makes no representation or warranty, whether expressed or implied, as to the accuracy and/or completeness of the information contained herein or any other information that may be based on the data/ information enclosed. Furthermore, Pharos hereby disclaims any and all liabilities of any nature relating to or resulting from the use of the contents of this Report. This Report shall not be approached as an investment solicitation nor shall it be considered as legal or tax advises. Pharos highly recommends that those viewing this Report seek the advice of professional consultants. None of the materials provided in this Report may be used, reproduced or transmitted, in any form or by any means, electronic or mechanical, including recording or the use of any information storage and retrieval system, without written permission from Pharos.