

PetroKazakhstan:

An Alternative to Alternative Energy

by *Tim Erikson*, m100 member

With oil prices reaching all-time highs of over \$60 per barrel, and oil stocks rising, are there any oil companies that are still good investment opportunities?

PetroKazakhstan Inc. (nyse: PKZ), a mid-cap Canadian based oil and gas company with operations in Kazakhstan, has seen its share price rise from just over \$2 per share at the end of 1999 to over \$36 by the end of June 2005. But recently, following a string of tax disputes with the government, a gas flaring issue and disputes with Lukoil regarding a joint venture, the stock has been beaten down due to uncertainty.

This past spring PKZ plunged from \$40 to near \$25 per share due to two primary issues: a temporary reduction in oil production due to a government-mandated elimination of gas flaring, and a dispute with Lukoil regarding a joint venture. The market clearly overreacted, as both issues are short-term in nature and neither hurt the underlying value of the company. The sell-off did create a buying opportunity for investors.

The Republic of Kazakhstan passed a law banning the flaring of gas from oil wells. As a result, PKZ has temporarily curtailed production by 40% from 150,000 barrels/day (bopd) to near 90,000 as it completes upgrades. 20,000 bopd should be restored this August, with the balance expected to be restored by June 2006.

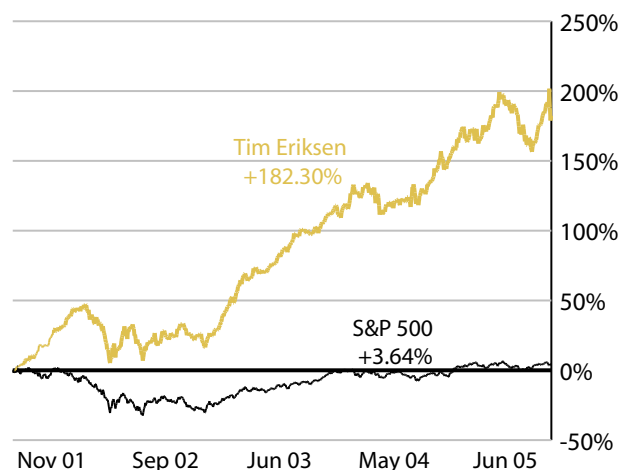
A lot of negative press has been generated about PKZ regarding its dispute with Lukoil. PKZ has said little, claiming it is abiding by the confidentiality clause in their joint venture agreement, whereas Lukoil has been more outspoken. PKZ sued Lukoil for \$200 million for failing to abide by the JV contract. Lukoil has filed a countersuit. Ultimately, I expect PKZ to win, but even if it loses, any settlement is unlikely to damage PKZ very much. At worst, the JV will export all of its production instead of selling a portion to PKZ's refinery at lower local market prices. PKZ can easily shift production from its nearby fields to its refinery. The change would probably hurt earnings by a maximum of 5-10%.

The market has historically valued PKZ at around 6X current earnings, primarily due to country risk. PKZ has had numerous disputes regarding royalties, taxes and below market price sales, yet to-date all have been resolved at a negligible cost to the company. PKZ has

The Author's Performance

Cumulative Return since Inception (1/17/01 to 6/30/05)

Tim Erikson: +182.30% S&P 500: +3.64%



shown that it can successfully operate in a challenging environment. Yet today, instead of trading at 6X normal current earnings, the company is trading at 6X temporarily depressed earnings and only 3X estimates for 2006 based on oil at \$52 per barrel.

PKZ's earnings power was clearly seen in the Q1-05, when it earned \$2.16 per share when oil prices averaged just \$48 per barrel. It wasn't obvious and therefore, probably overlooked by many, that PKZ's earnings in Q1-05 were approximately \$0.30 per share lower due to a hedging program that will expire at the end of 2005. PKZ could have earned nearly \$2.50/share in Q1. Since there were no unusual items, PKZ could be earning \$10/share for 2005 at \$48 per barrel oil. Oil prices are currently higher, and a new export route to China is expected to be operational by mid 2006, which will reduce PKZ's transportation costs by up to \$7 per barrel of exported oil.

The company has also been repurchasing shares and increasing its dividend. It has maintained reserve levels despite increasing production in recent years, and PKZ believes that there is the potential for discoveries of nearly one billion barrels of oil on land which it owns exploration rights. PKZ had over \$380 million in cash at the end of Q1 and just \$170 million of debt. As a low cost producer it will be profitable even if oil prices fall dramatically.

In the last week of June, PKZ received buyout proposals which hopefully shows PKZ is undervalued and has the potential to generate attractive returns for shareholders.