Analyst Comment

NBK CAPITAL

August 11, 2010

DANA GAS (DANA.AD)

12-Month Fair Value: AED 1.01
Last Close (11 August, 2010): AED 0.75
Recommendation: Buy - Risk Level: 4

- **2Q2010 revenue comes in line with our estimate.** Net revenue of AED 304 million increased 49% year-on-year (YoY) and 6% quarter-over-quarter (QoQ); reported net revenue was just 2.5% above our forecast of AED 296 million. While net revenue from Egypt moderately beat our model, this was somewhat offset by a slightly worse-than-expected volume performance from DANA's Iraqi Kurdistan operations.

- **Profitability improves significantly.** (1) Gross profit (excluding depreciation) of AED 282 million increased 61% and 10% compared to 2Q2009 and 1Q2010, respectively. Gross margin improved to 93% in 2Q2010 (86% in 2Q2009 and 90% in 1Q2010) versus our estimate of 89%. (2) EBITDAX of AED 256 million increased 71% YoY and 14% QoQ translating into an EBITDAX margin of 84% versus our estimate of 77% (which was in line with 1Q2010 margin of 78%). EBITDAX margin was significantly lower in 2Q2009 at 74%. The outperformance in EBITDAX in 2Q2010 relative to our model was driven by a lower cost of sales, lower G&A expenses at 9% of net revenue (vs. our estimate of 12% of net revenue, which was held flat relative to 1Q2010 and the average witnessed over 2007-2009), and lower exploration expenses (which came in well below management guidance). Much like 1Q2010, DANA also benefited from a relatively "clean" quarter as the increased top line was able to flow into the bottom line without being significantly impacted by volatile and one-off expense items such as exploration and impairment expenses confusing the picture. (3) Total comprehensive income, however, declined to a loss of AED 180 million versus a profit of AED 173 million in 1Q2010 given an AED 213 million unrealized loss on DANA's stake in MOL's stock (3.16 million shares). However, we note that on a cumulative basis, DANA still enjoys a total unrealized gain of AED 297 million on this investment.

- **The company' balance sheet remains strong.** Cash and bank balances stood at AED 722 million as of June 30, 2010 (AED 645 million as of March 31, 2010), which translates into a net debt-to-shareholders' equity ratio of 0.33x. Moreover, DANA's investment in MOL (held as an available-for-sale financial asset) was worth AED 964 million as of end-June. *These liquid assets, in conjunction with our estimate that the company will enjoy positive free cash flows from 2011 onward, leads us to our view that DANA remains financially strong with no pressing need to sell assets in order to meet obligations in the near-to-intermediate term.*

- **However, collecting on receivables in Kurdistan remains a challenge.** The company's receivables from the Kurdistan region in Iraq increased sequentially by USD 17 million or 27% to USD 79 million (48% of total receivables). Thus, DANA continues to remain affected by the dispute between Iraq and the Kurdish regional government concerning oil (and liquids) payments to foreign companies. This is a risk we first highlighted in our initiation report, *"Growing in the Gas Patch," (December 9, 2009)*. We continue to believe that a resolution will eventually be reached between the Iraqi and the Kurdish regional governments, which could pave the way for prompt payments to foreign energy companies, such as DANA. The company's receivables from Egypt declined from USD 94 million in 1Q2010 to USD 80 million (49% of total receivables) in 2Q2010; moreover, DANA received a payment of USD 25 million in July and August on the company's Egyptian receivables.

- **Major projects remain in line with our model.** (1) Egypt: Dana Gas's production for 2Q2010 was 41.7 kboe/d (or 3.8 mmboe), an increase of 19% and 6% on a YoY and QoQ basis, respectively. The company's Egyptian volumes remain in line with our estimates. After a string of eight successes in 2009 (out of 12 wells drilled), DANA has drilled three successful gas discoveries in 1H2010. The company did encounter one dry-hole during the first quarter and has written off AED 7 million in exploration expenses in 1H2010. DANA plans to drill a total of 14 wildcats in 2010 and is targeting a 20% YoY growth in Egyptian volumes this year, in line with our estimate; management guidance for 42.2 kboe/d for 3Q2010 also remains in line with our model.

(2) The Kurdistan region of Iraq: Progress remains consistent versus our modeled forecasts, with the company supplying gas to the Erbil/Bazian power stations and selling condensate at market rates. Dana Gas produced 1.06 mmboe in the second quarter of this year, an increase of roughly 88% YoY and 9% QoQ. We continue to expect LPG production to start in late 3Q2010, with the second train coming on line in mid-1Q2011.

- **The Iran gas contract continues to remain in limbo.** This project has been in the news recently given media reports stating that Iran had cancelled the contract, to which DANA's partner Crescent responded by stressing that the deal remained valid and was still in active international arbitration. Thus, visibility into the timing of this project remains uncertain and has not changed materially since our initiation report on the company. *We note our fair value estimate for DANA does not include any impact from the UAE gas project (the Iran contract).* However, we do stress that if this deal does get cancelled, we could see a significant impact on DANA's share price given that the company is holding close to USD 1.1 billion in assets (mostly in intangibles) related to this contract.

- **The partial farm-out/sale of Egyptian assets remains on track and could act as a catalyst in late 2010.** During the conference call, management revealed that preliminary bids have been received and are currently being evaluated, with an outcome likely before year-end 2010. As previously detailed (*"Flare for Success," [May 27, 2010]*), our DCF valuation for Egypt does not account for this potential sale but we believe that such a transaction could act as a significant catalyst for DANA's share price.

- **Net-net, we view the DANA's 2Q2010 results positively and maintain our "Buy" recommendation with a 12-month fair value target of AED 1.01 per share.** Our fair value target is 35% above DANA's August 11 closing price of AED 0.75. Given the company's improved profitability in 2Q2010, we will be monitoring DANA's cost profile closely over 2H2010 to ascertain if this margin improvement is sustainable. For now, we maintain our estimates and fair value. We continue to believe DANA has an attractive risk/reward profile and we reiterate our "Buy" rating.

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Related Research

- Dana Gas Analyst Comment - 23 June 2010
- Dana Gas Update - 27 May 2010

RISK AND RECOMMENDATION GUIDE

RECOMMENDATION	UPSIDE (DOWNSIDE) POTENTIAL
BUY	MORE THAN 20%
ACCUMULATE	BETWEEN 5% AND 20%
HOLD	BETWEEN -10% AND 5%
REDUCE	BETWEEN -25% AND -10%
SELL	LESS THAN -25%

RISK LEVEL				
LOW RISK				HIGH RISK
1	2	3	4	5

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