InterOil laden by 'risk, opportunity'

With a potential big gas find on the horizon, is the company's stock undervalued?

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CALGARY -- The last few weeks have been a roller coaster ride for **InterOil Corp.**, a TSX-listed company that operates a refinery and distribution network in Papua New Guinea and is seeking to develop a liquefied natural gas export project there.

Speculation over the company's prospects pushed the stock to a record high of $47.06 in late June, before plunging more than 50 per cent when interim drilling results didn't immediately confirm that its gas reserves can be commercially developed.

Then, news that the company had shored up its loans, as well as a recommendation upgrade from brokerage firm Raymond James, caused prices to bounce back. The stock closed Friday at $27.25 on the Toronto Stock Exchange and at $25.99 (U.S.) on the American Stock Exchange.

InterOil's current operations include a 32,500-barrels-a-day oil refinery across the harbour from the Papua New Guinean capital, Port Moresby, as well as a local distribution network comprising fuel depots and terminals. However, it's the liquefied natural gas plans for the country that have sparked investor interest and the question of where the stock might head next is eliciting some wildly divergent responses.

Wayne Andrews, a Houston-based analyst for Raymond James, now ranks the company a "strong buy," saying the market misinterpreted InterOil's drilling results at its Elk-2 well, which is expected to provide some of the gas for the $4- to $6-billion (U.S.) LNG plant an InterOil-led group, including Merrill Lynch and Clarion Finanzis, is seeking to build there.

Mr. Andrews argues that although the results don't yet confirm gas from Elk can be delivered, they do verify the existence of a large gas column - which is still positive for a well that is of "extreme importance to the company." InterOil is expected to reveal more definitive exploration results from the Elk field in August that should provide more clarity on the prospect's potential.

Consequently, the recent drop in InterOil's share price means the potential of the Elk prospect, the firm's many other gas prospects and its stake in the LNG plant is now substantially undervalued, said Mr. Andrews, who has a target price for the company of $45 (U.S.) a share.

"While there is some risk, this is a fantastic opportunity with significant upside potential," said Mr. Andrews in an interview. "The company has deep-pocketed partners and the infrastructure in place in Papua New Guinea to take advantage."

In stark contrast, **Sam La Bell**, analyst at **Veritas Investment Research**, said the upstream results and LNG plans "should not overshadow the current financial and operational problems facing the company." The analyst at the Toronto-based independent research firm also flags concerns held by the U.S. Securities and Exchange Commission over how InterOil has accounted for its exploration costs, as well as the company's unorthodox corporate structure, which includes companies registered in the Cayman Islands and the Bahamas.

Most importantly, he notes in a report that InterOil's refining and distribution assets in Papua New Guinea "aren't a reliable source of cash," although they have been more profitable recently, and notes that its core operations "barely cover the company's fixed costs and overhead." The company has debts of around $200-million on its balance sheet.

"InterOil is banking on its gas exploration fields and LNG project to attract enough capital to keep itself solvent," **Mr. La Bell** said. He estimates that a 30-per-cent stake for InterOil in a completed LNG project would be worth an extra $27-$28 (Canadian) a share to the company, but believes there is only a 50-per-cent chance that the development will move forward.

"InterOil's interests could conceivably be worth $40 [Canadian] per share to a strategic buyer, but the company is in a poor bargaining position because of weak cash flows and debt problems. On balance we believe the speculative risks built into this stock do not warrant building a position above $20," he said. "Excitement over the LNG project and possible upstream gas will wear off as negotiations drag out and InterOil sells its interests to meet its commitments."

InterOil spokesman David Larson said that while companies of InterOil's size will face operational and financial challenges, the company was meeting its commitments through completing its promising drilling program at Elk and making ongoing improvements to the profitability of its refinery and downstream operations.

"Merrill Lynch and Clarion Finanzis continue to support the LNG project, while there is substantial value in the Elk discovery," he said. "I think some people don't really understand what we've achieved in Papua New Guinea so far."

Nevertheless, there's also not enough data yet to be able to judge whether InterOil will be able to deliver on its promises, said Jim Jarrell, president of Calgary-based Ross Smith Energy Group.

"It's very early in InterOil's evaluation of these complex structures, and it's way too early to say there's enough resources in Elk to support an LNG project," he said.