

PetroKazakhstan: time to stay or time to go?

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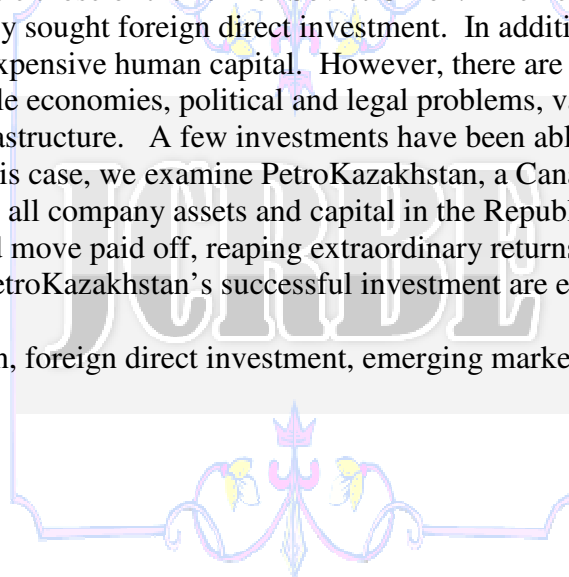
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Abstract

The emerging markets have lured many investors over the past several decades. These new markets offer high potential returns and with them high risks. Some of the markets that have held great promise are those of the former Soviet Union. The new post-communist governments have actively sought foreign direct investment. In addition, some states are rich in natural resources and inexpensive human capital. However, there are many uncertainties in these markets including unstable economies, political and legal problems, vague laws, extensive corruption and weak infrastructure. A few investments have been able to succeed even against the odds of failure. In this case, we examine PetroKazakhstan, a Canadian-based oil and energy company, which invested all company assets and capital in the Republic of Kazakhstan. For PetroKazakhstan the bold move paid off, reaping extraordinary returns for the shareholders. The major factors affecting PetroKazakhstan's successful investment are examined.

Keywords: risk and return, foreign direct investment, emerging markets, oil industry



Introduction

In the summer of 2005, Bernard Isautier, CEO of Petrokazakhstan Inc. received a tender offer for PetroKazakhstan from China National Petroleum for \$4.18 billion, or \$55 per share (Pottinger et al., 2005). Mr. Isautier, who himself owned 3.1 % of the shares in PetroKazakhstan, had to decide whether he should recommend shareholders to accept or to reject the offer (From Canadian Bankruptcy to the Riches of Kazakhstan, 2005). The cash offer represented a 21% premium over the current share prices (Pottinger et al., 2005). The company had seen tremendous growth from small beginnings in the 1980s. Petrokazakhstan was in a rather unique position in that it was officially based in Calgary, Canada, managed from London, England, but had all its assets in Kazakhstan (Austen, 2005).

Company History Prior To Its Entry of Kazakhstan

In 1986 Brana Oil and Gas Ltd., formerly a Canadian oil and gas company listed on the Alberta Stock Exchange, spun off a subsidiary, Hurricane Hydrocarbons Ltd (Hurricane Hydrocarbons Ltd., 2003). For the first few years, Hurricane Hydrocarbons was a tiny player in the industry, producing only 60 barrels of oil a day (Verburg, 1999) and with \$1 million in debt (Ewart, 1996). The company's fortunes began to change when an ambitious oil executive named John Komarnicki was appointed to lead a new management team at Hurricane in 1989 (Hurricane Hydrocarbons Ltd., 2003). With the insignificance of Hurricane in the industry, Komarnicki accepted his new challenge with relish. His number one goal was to dramatically increase Hurricane's production total. Komarnicki realized that becoming a legitimate industry stalwart with western Canadian oil fields would take too long. Instead, Komarnicki turned to international oil and gas opportunities. This would be an aggressive strategy offering greater growth potential as well as greater risk (Hurricane Hydrocarbons Ltd., 2003). He decided to use the firm's "engineering, geological and a geophysical know-how to build a solid base" (Cope, 1992) for the international expansion. In addition, Komarnicki worked on cutting costs and repaying debt by cutting overhead costs and replacing salaries with "various forms of sweat equity" (Cope, 1992).

Komarnicki and his management team began looking for a suitable market to accomplish the company's goals. At roughly the same time that Hurricane was looking for international investments, the breaking apart of the Soviet Union provided opportunities. For the first time in nearly a century, vast tracts of oil-producing fields were opened up for Western investment. Komarnicki saw great potential in the Republic of Kazakhstan. Oil production was one of the country's principal industries with claims to more than 5 billion barrels of crude oil reserves (Background Notes: Kazakhstan, 2007). Kazakhstan became an independent republic in 1991 and shortly after the Kazakh government invited western oil producers to help develop the country's rich oil reserves. Komarnicki was one of the first to accept the invitation (Hurricane Hydrocarbons Ltd., 2003).

Background Information on Kazakhstan

Kazakhstan is a former Soviet Republic that gained independence in 1991 when the Soviet Union dissolved. The country is landlocked with the 9th largest landmass in the world. Its population was 15.1 million in 2005. Kazakh is the state language and Russian an official

language. Most business, however, is conducted in Russian (Background Note: Kazakhstan, 2007).

After becoming independent, the country went down a path of reform under its long-time president Nursultan Nazarbayev (from 1991 to today). The country was successful in changing from a Soviet command economy to a market economy. Kazakh citizens are allowed to own land and means of production, the Kazakh currency, the tenge, has been freely floating since 1998, and the country is open to foreign direct investment. Also, the banking system is now considered solid and comparable to those in Central Europe (CIA World Factbook, 2007).

This economic reform originally led to an economic decline in the early 1990s. However, since the mid 1990s, the country has seen rapid economic growth largely fuelled by natural resource exports. Economic growth rates have averaged around 9% since 2000 (Background Notes: Kazakhstan, 2007). The vibrant oil and gas sector also attracts most of the FDI in Kazakhstan, contributing to further growth of the economy. This growth allows the government to have only little debt (CIA World Factbook, 2007).

Politically, the country changed to a constitutional republic with a strong presidency. Presidential elections are held every 7 years. Presidents have a two-term limit with the exception of the current president Nursultan Nazarbayev who can be re-elected for life. He has extensive decision-making powers. He won 91% of votes in the 2005 elections. The opposition party holds only 1 seat in parliament (Background Note: Kazakhstan, 2007).

The legal system is based on Islamic and Roman law (Stalbovsky and Stalbovskaya, 2006). However, legal provisions are often weak and contradictory and law enforcement is considered inconsistent, leading to uncertainty for foreign investors. "Legislation in this country is best described as a work in progress" said Terrance Powell, Hurricane's director of public affairs and government relations (MacKinnon, 2004). Disputes regarding taxation and collection of revenues are frequent. The government shows a tendency to get involved in the business environment. For example, "amendments passed in 1999 to the Oil and Gas Law require mining and oil companies to use local goods and services" and the "2005 Production Sharing Agreement Law" mandates that the state oil company be a minimum 50% participant in new offshore projects" (Doing Business in Kazakhstan, 2007). The bureaucracy is seen as cumbersome and corruption is widespread. For example, 'facilitating payments' are often paid to ensure that goods will go through customs (Doing Business in Kazakhstan, 2007). Transparency International gave Kazakhstan a score of 2.6 (out of 10 for a corruption-free country) on the corruption perception index, indicating that corruption is considered a serious problem in Kazakhstan (Transparency International, 2005).

The Heritage Foundation publishes an index that measures economic freedom. Kazakhstan went from an overall score of 39 (defined as repressed) in 1998 to 51.1 (most unfree) in 2005 indicating a general improvement in the business environment in Kazakhstan. This score compares to 70 (mostly free) in 1998 and 75.6 (mostly free) in 2005 for Canada (Heritage Foundation, 2007). Various measures of the economic and political environment are listed in Table 1 for both Kazakhstan and Canada. The table highlights the vast differences in the business environments of Kazakhstan and Canada (which is similar to other developed economies).

Petrokazakhstan's Operations in Kazakhstan

Beginning in 1991, Hurricane started operations in the Republic of Kazakhstan through a joint venture agreement with two Kazakh partners, Yuzhkazneftegaz and Yuzhkasgeologia who owned 50%, and a German partner, Deilman Erdöl Erdgas AG, which owned 40% and Hurricane owned the remaining 10% stake in the joint venture (Boras, 1994). Hurricane was to provide the capital and technology and was to receive a share in the oil output. This led to Turan Petroleum Joint Enterprise (TPJE) in the South Turgai Basin where it began to develop three partially delineated fields and by 1993 gained interest in the newly discovered South Kumkol field (PetroKazakhstan Inc : 40-F: For 12/31/2003; SEC File 1-31448). Hurricane's revenue in 1993-94 was only \$259,409, insufficient to finance the expected cost of the oil field development of \$300 million (Shiry, 1994). In 1994, Canadian Occidental Petroleum Ltd. bought Deilmann Erdol Erdgas AG's share in the joint venture and contributed to the operation of the project. Hurricane was hoping to raise an initial \$3 million required for its share in the project and pay most of the other costs out of cash flows (Shiry, 1994). The company was able to raise \$4 million via the private placement of special warrants to Canadian institutional investors (Investment News, 1995).

During 1996 the Kazakh government started to privatize its oil and gas industry. This gave Hurricane the opportunity to win a bid for its joint venture partner, Yuzhneftegaz, the state-owned oil production cooperative, for \$120 million, an extremely favourable price (Ewart, 1996). Yuzhneftegaz produced 50,000 barrels a day and held reserves of 500 million barrels (Ewart, 1996). This deal was very beneficial for Hurricane, making it Canada's largest oil company based on reserves of conventional oil (Boras, 1996).

Hurricane's stock price went from \$2.90 to \$6.30 after the purchase was announced (Ewart, 1996). At the time of the purchase, Hurricane's market value was about \$56 million. Hurricane was able to pay the purchase price in four instalments and was able to raise the funds after the deal was signed. To cover the last instalment, Hurricane used a private placement of special unit purchase warrants. Hurricane's profits in the first year after deal was completed were \$8.1 million, compared to net income of \$18,000 in the year before (Thomas, 1997).

Thus, "Hurricane Hydrocarbons got Kumol for what Mr. Jandosov calls a "ridiculously low" price at a time when corruption was rampant in the country, leading to lasting suspicions that company paid a bribe to make the deal go through...the price per proven barrel of roughly 30 cents was a fraction of the market rate..."It is most reasonable to presume that if an unimaginably low price was paid for an asset like this, that it wasn't the whole price. Some other money went some other way" (said Mr. Jandosov, who oversaw the privatization of Kazakhstan's oil resources in the 1990s). PetroKazakhstan, however, rejects the suggestion that there was anything untoward about the way Hurricane acquired its assets. Mr. Powell says that while corruption was rampant in the country at the time of the sale, the company has always followed a strategy of staying clear of the palm creasing that other companies took part in." (MacKinnon, 2004).

The Yuzhneftegaz subsidiary was renamed Hurricane Kumkol Munai and became Hurricane's only major asset (Hurricane Hydrocarbons Ltd., 2003). The Kumkol field produced 60,000 barrels a day. Hurricane sold its production to the local market in east Kazakhstan and used the Shymkent (short for Shymkentnefteorgsyntez) refinery to process its crude (Hurricane

Hydrocarbons Ltd., 2003). In addition to the oil field, the deal included “a 920,000 hectare farm with sheep and camels, a soccer team, a children’s camp and a road construction crew - all of which were owned by the state oil company to support its 5,000 workers. Hurricane continued to own and manage those assets, in part to guarantee supplies” (Verburg, 1999).

Hurricane was the only producer in the area and Shymkent was Hurricane’s only buyer, a good relationship that soon fell apart. In 1998, Chevron Corporation had the ability to supply the Shymkent refinery with 70,000 barrels of crude per month (Hurricane Hydrocarbons Ltd., 2003). Shymkent took advantage of having two suppliers and negotiated a lower price with Hurricane. The problem was that there were no easy alternative ways to sell the oil, i.e. the infrastructure was lacking. There were no good roads or pipelines that could be used to get the oil to another market. This drastically cut into profit margins for Hurricane and shareholders on the NASDAQ and Toronto exchanges dumped Hurricane’s stock causing a stock price plunge of 25 percent in two days (Hurricane Hydrocarbons Ltd., 2003). Komarnicki responded by announcing an expansion beyond the local Kazakhstan market possibly into China and Turkmenistan. In order to accomplish the exporting, Hurricane invested in rail transportation and pumped oil through hundreds of miles of pipelines running south from the Shymkent refinery (Hurricane Hydrocarbons Ltd., 2003).

In 1998, Komarnicki abruptly resigned after nine years as Hurricane’s CEO. He had grown the company enormously. It was the second largest foreign oil producer in Kazakhstan, with interest in eight oilfields yielding revenues of \$168 million (Hurricane Hydrocarbons Ltd., 2003). Komarnicki’s departure was well timed. Hurricane’s pricing problems with the Shymkent refinery worsened, world oil prices slumped and Russian oil imports in Kazakhstan further depressed domestic oil prices. In 1999 Hurricane was forced to seek court protection from its creditors, whom it owed about \$200 million, after it ran into trouble with the refinery and its stock price sank to 20 cents a share (MacKinnon, 2000). It looked bleak for Hurricane Hydrocarbons but for Bernard Isautier, the new CEO, it was a company with a spectacular set of oil fields and great potential. Isautier believed that political changes in Kazakhstan would help the business climate to improve and thus Hurricane to prosper. Isautier took the job with no salary receiving only stock options, reflecting his optimism in the company (Hurricane Hydrocarbons Ltd., 2003).

Hurricane continued to be the sole supplier of the Shymkent refinery which proved problematic to the relationship between the Kazakh government and Hurricane. The Kazakh government alleged monopolistic activities at the Shymkent refinery causing Hurricane to threaten international arbitration at the U.N. (Hurricane Hydrocarbons Ltd., 2003). A turn around for Hurricane came a year later in 2000 when it struck a deal with Central Asian Industrial Holdings (CAIH), an investment affiliate of a Kazakh banking group. CAIH acquired 33 percent of Hurricane which provided the capital for Hurricane to purchase 88 percent of the Shymkent refinery for \$51 million (MacKinnon, 2000). Additionally, the firm was able to secure financing from European investors (From Canadian bankruptcy to oil riches in Kazakhstan, 2005). This agreement enabled Hurricane to be free from court protection by paying its bondholders \$87 million (Hurricane Hydrocarbons Ltd., 2003). Having controlling interest in the Shymkent refinery helped Hurricane reverse its fortunes. In addition, oil prices started to rise. It began investing to develop the oil fields and in one year, Hurricane increased its net profit from \$8.5 million to \$155 million and was able to repay its creditors quickly (Hurricane Hydrocarbons Ltd., 2003). Hurricane wanted to use some of the profits to buy the remaining 12 percent of the Shymkent refinery; however, more problems arose at the Shymkent

refinery and Hurricane battled hard to just keep control (Hurricane Hydrocarbons Ltd., 2003). Nurlan Bizakov, the former chairman of Shymkent, refused to accept being fired by Hurricane and launched an intense battle to be reinstated as the chairman, including an armed takeover of the refinery (Parkinson, 2000). As Hurricane was fighting to keep Bizakov out it was faced with another challenge. CAIH launched a hostile takeover to obtain a controlling interest of 23 percent of the company (Hurricane Hydrocarbons Ltd., 2003). With Isautier at the helm, Hurricane's management prevailed and CAIH withdrew its \$125 million bid in July 2001 (Hurricane Hydrocarbons Ltd., 2003).

As oil prices began to soar in the 2000s, Hurricane Hydrocarbons' assets also soared in value. Hurricane's common shares were listed on the New York Stock Exchange in 2002 and in 2003 Hurricane's name was changed to PetroKazakhstan to reflect the fact that its entire operations were in Kazakhstan. Production continued to increase and the company drilled five appraisal wells during 2003, which confirmed the estimates that the potential of the field was high (McKinley, 2004). The company entered into a contract with the Tehran Refinery in Iran that helped PetroKazakhstan obtain a maximum sales price for its crude while minimizing the transportation costs (McKinley, 2004). PetroKazakhstan's common shares began trading on the Kazakhstan Stock Exchange in 2004 (PetroKazakhstan Stock Exchange Listing, 2004). Year over year, PetroKazakhstan saw its production continue to increase along with its revenues and income. Compared to the industry, PetroKazakhstan had much higher profit margins, confirming the company's ability to be a low cost producer (McKinley, 2004). The production and reserves graphs are shown in Figures 2 and 3 and the financial highlights are displayed in Table 2.

Despite or possibly because of the financial success, PetroKazakhstan faced several disputes with the Kazakh government. In 2001, Hurricane Hydrocarbons was accused by Kazakh officials of failing to pay \$107.3 million in taxes, a charge which company officials denied (Kazakhstan Claims Tax Fraud, 2001). In 2003 Kazakh officials and the Agency for Regulation of Natural Monopolies and Protection Laws (ARNM), presented allegations against PetroKazakhstan and its distributors. The alleged charges stated that the company and its distributors collected \$91 US million in "unjustified revenues" by selling some of its refined products at higher than local market prices (PetroKazakhstan Inc. – Anti-Monopoly Court Decision, 2004). Kazakhstan's Law on Unfair Competition, which was ratified in 1998, identifies unfair competition "as an act or agreement by any legal entity or government body aimed at obtaining unjustified advantages by eliminating or limiting the competition" (Doing business in Kazakhstan, 1999). Some examples given by the Kazakh government were: price-fixing agreements, public distribution of false information, as well as patent or other intellectual property violations. The law enables ARNM to investigate claims and impose sanctions (Doing business in Kazakhstan, 1999). According to the court decision PetroKazakhstan was to repay the "monopoly profits" and these revenues would be transferred to the state budget (Dabrowski, 2003).

PetroKazakhstan commented that those allegations and charges were without justification, that a highly competitive market exists for oil products in Kazakhstan and that existing state's prices were not reflecting current world prices. In addition the prices were competitive with Russian exports and those charged by the two other refineries in Kazakhstan (PetroKazakhstan Inc. – Anti-Monopoly Court Decision, 2004). PetroKazakhstan also stated that under the terms of the Shymkent Refinery Privatization Agreement, it had the right to sell any and all of its products in Kazakhstan and abroad at free market prices. PetroKazakhstan and

its distributors attempted to appeal the court decision issued by the Astana City Court without success. Although the company deemed the price fixing allegations as unjustified, the company's stock substantially fell on the Toronto Stock Exchange when the allegations became public (Dabrowski, 2004).

PetroKazakhstan was also involved in a dispute with its joint venture partner Russia's Lukoil. PetroKazakhstan accused the management of Turgai Petroleum, a company jointly owned with Lukoil, that they failed to supply adequate amounts of oil production to the domestic market. Due to the construction of a new pipeline, Turgai became capable of exporting its oil and obtained prices on average \$8 higher per barrel than those in the domestic market (PetroKazakhstan Dispute with Lukoil Whacks Company's Stock Price, 2004). According to its agreement with the Kazakh Government, PetroKazakhstan was obligated first to provide sufficient supply of oil domestically and only then it was able to divert the remainder of its production to exports. Lukoil's actions motivated by greater profits violated PetroKazakhstan agreement with the state's government. Due to the dispute, the production at Turgai Petroleum was halted for several days (Turgai stops Kumkol exports, 2005). Lukoil in turn sued PetroKazakhstan for \$220 million in international courts (Lukoil, Turgai Petroleum bring counter-suit against Petrokazakhstan, 2005). To help the firm deal with these disputes, PetroKazakhstan hired Jean Chretien, Canada's former prime minister, as a special adviser for international relations. His success in resolving the dispute was limited (From Canadian Bankruptcy To the Riches of Kazakhstan, 2005).

Overall, PetroKazakhstan has been very successful, but also faced some challenges ahead. Given this state of affairs, should Bernard Isautier, CEO of Petrokazakhstan Inc. recommend the shareholders to accept or reject the offer by China National Petroleum? Defend your answer.

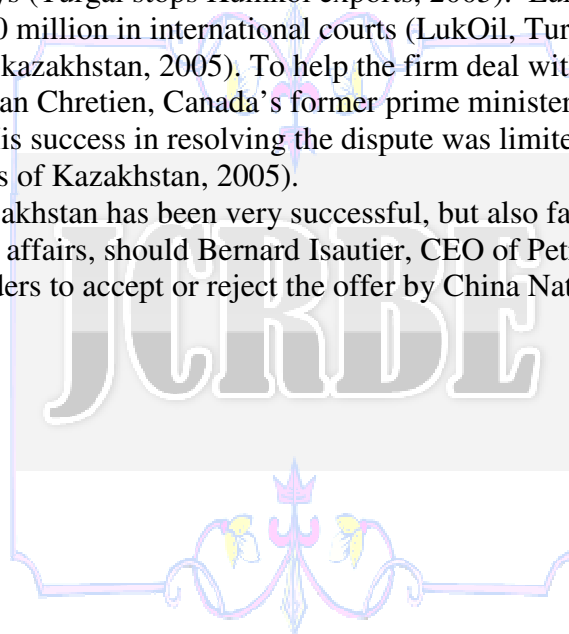


Table 1. Canada and Kazakhstan: A Comparison

	<i>Canada</i>	<i>Kazakhstan</i>	<i>Information Source</i>
Total population (2005)	32 million	15.1 million	CIA World Factbook
Population growth rate	0.869%	0.239%	CIA World Factbook
Land area	9.98 million sq km	2.7 million sq km	CIA World Factbook
Major languages	English, French	Kazakh, Russian	CIA World Factbook
Major religions	Christianity	Islam, Christianity	CIA World Factbook
GDP in USD (2006)	2.7%	53.6 billion	CIA World Factbook
GDP (PPP) in USD (2006)	1.178 trillion	143.1 billion	CIA World Factbook
GDP (PPP) per capita in USD (2005)	35,600	9,100	CIA World Factbook
Literacy rate	99%	98.4%	CIA World Factbook
Life expectancy at birth	80.34	67.22	CIA World Factbook
Human Development Index 2003	0.945 (rank 5)	0.761 (rank 80)	World Bank
Political Risk Index (2006)	9.5	6	Country Watch
Corruption Perception Index (2005)	8.4 (rank 14)	2.6 (rank 107)	Transparency International
Proved oil reserves (2005)	178.8 billion bbl	9 billion bbl	CIA World Factbook
Oil exports	2.274 million bbl/ day	1 million bbl/ day	CIA World Factbook
Proved natural gas reserves (2004)	1.603 trillion cu m	1.841 trillion cu m	CIA World Factbook
Natural gas exports	104 billion cu m	7.01 billion cu m	CIA World Factbook
Government Effectiveness (2004) (+2.5 to -2.5)	1.96	-0.63	Worldwide Governance Indicators
Political Stability (2004) (+2.5 to -2.5)	1.13	-0.11	Worldwide Governance Indicators
Regulatory Quality 2004 (+2.5 to -2.5)	1.57	-0.89	Worldwide Governance Indicators
Freedom Ranking (1=free, 7= not free)	Political rights =1 Civil liberties = 1 Overall: free	Political rights =6 Civil liberties = 5 Overall: not free	Freedom House

Table 2. Financial Highlights for PetroKazakhstan (expressed in millions of \$)

		Six Months Ended June 30								
		2005	2004							
Gross Revenue		1,012.10	731.6							
Net Income		304.4	209.5							
Cash Flow		350.8	253.9							
Shares Outstanding	73,996,350	80,597,166								
				Year Ended Dec 31						
		2004	2003	2002	2001	2000	1999	1998	1997	
Gross Revenue		1,642.40	1,117.30	825.40	603.1	523.2	155.2	175.9	168.3	
Net Income		500.7	316.9	161.4	169.3	154.9	8.5	-229.3	27.8	
Cash Flow		560.5	400	216.8	194.7	179.4	17	0.6	58	
Shares Outstanding	76,223,130	77,920,226	78,956,875	80,103,784	79,808,673	44,512,359	44,242,138	42,825,862		

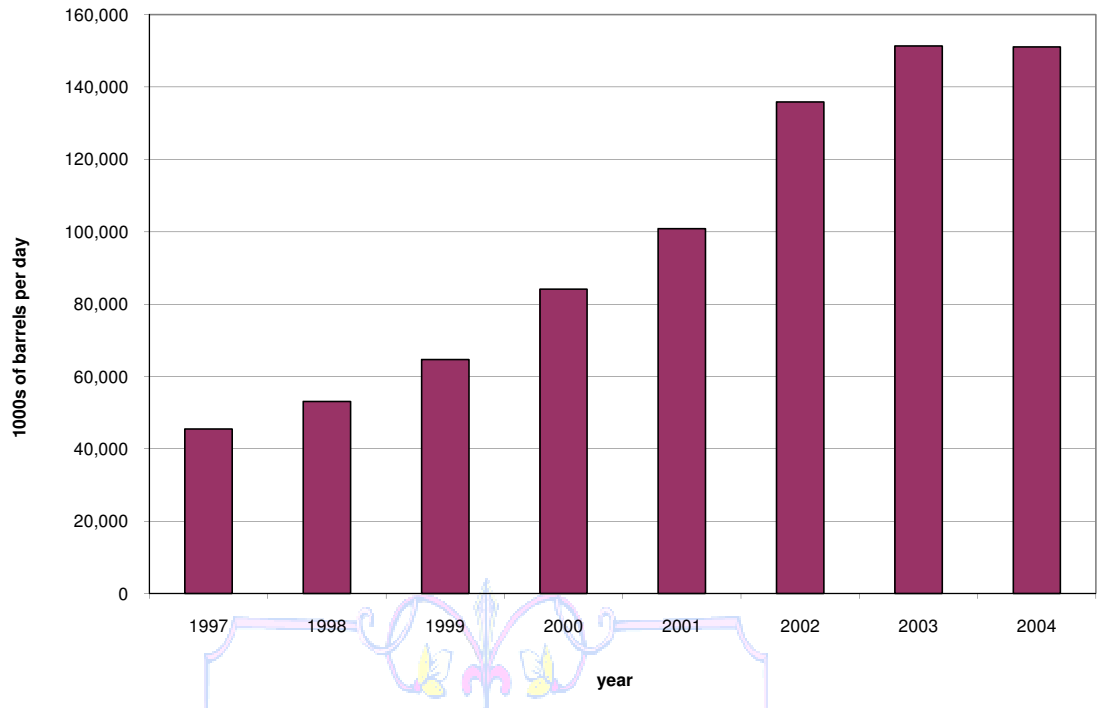
source: PetroKazakhstan, Annual Reports, 1997 – 2004.

Figure 1. Stock Price History of PetroKazakhstan



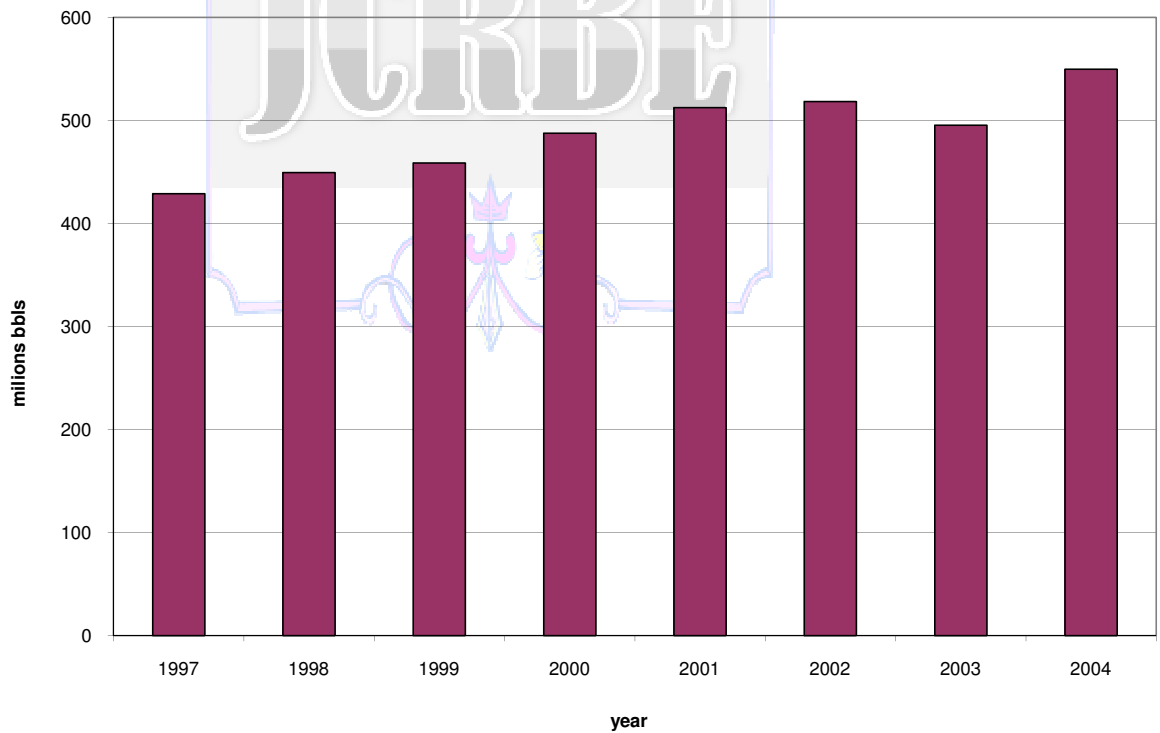
Source: Datastream

Figure 2 PetroKazakhstan Oil Production



Source: PetroKazakhstan, Annual Reports, 1997 – 2004.

Figure 3: PetroKazakhstan Proved Oil Reserves



Source: PetroKazakhstan, Annual Reports, 1997 – 2004.

Suggested Questions and Answers

1. What are the risks that the oil and gas sector face? How do these risk change when the investment is a foreign direct investment (FDI)? How do these risk change when the foreign direct investment is in an emerging market?

Oil and gas are non-renewable resources as well as commodities. These characteristics affect the risks faced by firms in the oil and gas industry. First, prices are determined based on demand and supply in the world markets. Thus, each firm in the industry cannot differentiate its product but rather has to take the price that is set in the market place (i.e. is a price taker). Second, oil and gas supply is inelastic in the short-run, implying that prices may fluctuate considerably with changes in demand. Therefore, the oil and gas sector is subject to price fluctuations depending on the demand situation. Third, increases in the long-term output require firms to find new oil and gas wells, a risky and time consuming venture. Forth, the oil and gas sector has to deal with many environmental issues from pollution to greenhouse gas emissions.

When firms go abroad, these basic risks are unchanged. However, going international may add additional risks to the firm. The firm may face additional legal and environmental obligations not faced at home. Also, operating in a foreign market may introduce exchange rate risk to the operations of the firm. Entering emerging markets may lead to additional political, legal and economic risks not faced in the domestic markets as is illustrated in the PetroKazakhstan case. Firms may have to deal with demands for bribes. Also, the legal system may not be well developed with contradictory laws that are often not consistently enforced. A good source to learn more about foreign markets and their specific risks are the Background Notes by the US Department of State: <http://www.state.gov/r/pa/ei/bgn/>.

2. Hurricane Hydrocarbons, under the leadership of John Komarnicki, invested in Kazakhstan instead of western Canada. How could the high risk of this project (compared to previous projects) be incorporated in this capital budgeting decision?

Hurricane Hydrocarbons had been investing domestically in western Canada. John Komarnicki believed that to grow production dramatically and in a timely fashion that Hurricane would have to look to international markets by developing oil fields in emerging markets. This move would hold much greater potential and greater risk. To incorporate higher risk into the capital budgeting framework one of two approaches can be taken: 1) use a risk-adjusted discount value or 2) make a certainty equivalent adjustment. With approach (1) the rate of return is adjusted for the uncertainty in future cash flows. For Hurricane, the future cash flows would have a higher uncertainty due to the fact that they were cash flows being generated in an emerging market. Thus, the rate of return used in the evaluation, would be higher than that used in previous Canadian ventures. Hurricane could have chosen to use approach (2), the certainty equivalent method. Using this method, the risky future expected cash flow would be adjusted making it equally desirable to a certain (risk-free) future cash flow. The higher risk of operating in an emerging market would lead to smaller certainty equivalents. Incorporating either method would have allowed Hurricane's financial managers to determine if the potential return was worth the additional risk.

3. Several times Hurricane Hydrocarbons raised capital through issuing warrants. Why do you think investors were willing to buy warrants?

A warrant is a corporate security that gives the holder the right, but not the obligation, to buy shares of common stock directly from the company at a specified price for a specified time period. In 1994 and 1996 Hurricane Hydrocarbons raised needed capital through the use of a private placement of special unit warrants. These warrants gave the investors the opportunity to share in the possible future growth of the stock without directly owning the stock. By buying the warrant the investor leverages the investment which enhances the potential return. The investors may have been willing to purchase the warrants but, not the stock outright, due to the high risk of Hurricane Hydrocarbons.

4. When valuing the shares of PetroKazakhstan, how would you incorporate the political risk faced by the firm?

Clearly, the additional political risk faced by the firm relative to domestic firms would imply that a larger discount factor needs to be applied to the expected future cash flows. The difficulty arises in determining exactly the size of the discount factor. In PetroKazakhstan's case, the firm traded at 6 times earnings, while Russian integrated oil companies traded at 10 times earnings and the average international integrated oil company traded at 16-18 times earnings (MacNamara 2004). This indicates that the financial markets considered Kazakhstan to be a riskier investment location than even Russia despite Kazakhstan's progress in terms of economic reforms.

5. PetroKazakhstan listed its shares on multiple exchanges. What are advantages to multiple listings?

PetroKazakhstan was listed on the Toronto Stock Exchange, the New York Stock Exchange, the Frankfurt Stock Exchange, the London Stock Exchange and the Kazakhstan Stock Exchange. By cross-listing the shares, the company had access to more capital needed for growth. In addition, cross-listing can increase the recognition and exposure of a company to investors around the world. By listing on the Kazakhstan Stock Exchange the company was attempting to build relations with Kazakhstan investors and supporting their new market economy. The New York Stock Exchange has the most stringent requirements regarding listing and disclosure. For investors, this is certainly a benefit allowing better transparency of the company.

6. Why do you think Bernard Isautier, CEO of PetroKazakhstan Inc., recommended to his shareholders to accept the offer by China National Petroleum?

The shareholders of PetroKazakhstan had been on a wild roller-coaster ride from the beginning. During the first years as Hurricane Hydrocarbons Ltd., the shareholders received very little return on their investment. Then under the leadership of Komarnicki, in the late eighties, the company took a leap of faith and entered an emerging market increasing risk substantially. Hurricane began to prosper in the early nineties but by 1998 the company was beginning to experience major problems. In addition oil prices slumped on the world market pushing Hurricane into court protection from its creditors. It was not until Hurricane's new

CEO, Bernard Isautier, took the helm that shareholder once again saw a stock price on the rise. Throughout the 2000s, production and profits increased and so did the stock price. Isautier was so confident in turning Hurricane around that he took his compensation in stock options in his first years as CEO. This decision certainly paid off for Isautier. When the company received a tender offer from China National Petroleum, Isautier owned 3.1% of the shares. And, the offer was at a 21% premium over current share prices. Not surprisingly, Isautier recommended that the shareholders accept the offer – a substantial premium for a company that had weathered the ups and downs of the oil industry and an emerging market for almost twenty years. When the acquisition took place, PetroKazakhstan was still embroiled in disputes with the Kazakh government and joint venture partner Lukoil. For the shareholders, it was time to go. A good place to access the annual reports for information about Hurricane Hydrocarbons Ltd. and PetroKazakhstan is the website for the Canadian Securities Administrators at http://www.sedar.com/homepage_en.htm.

Epilogue

In 2005 PetroKazakhstan was once again being courted by suitors. China National Petroleum and India's state-owned Oil and Natural Gas Company were vying for the acquisition of PetroKazakhstan. Both India and China, the world's two most populous countries, were increasingly importing oil and thus competing for oil resources. China National Petroleum outbid India's Oil and Natural Gas Company by offering a steep price of nearly \$8 for each barrel of estimated oil reserves in the ground. The total deal paid \$4.18 billion to the shareholders of PetroKazakhstan. This was \$55 per share and a 21.1 percent premium over the stock's trading price. More than 99 percent of the shareholders approved the acquisition. Each shareholder received \$54 per share owned and one share per share owned in a new company that was spun off of PetroKazakhstan and led by Isautier. This became a huge payday for both the shareholders of PetroKazakhstan as well as their CEO Isautier, who owned 2.3 million shares (Bradsher, 2005).

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