INSTITUTE OF ENERGY FOR SOUTH-EAST EUROPE

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IENE Company Profile

*A new series of IENE occasional communications is launched today focusing on the organisation,activities and performance of prominent companies and corporations of the energy sector active in the broader SE European region.For the first such Company Profile we have chosen the well known Italian oil company ENI following the publication of a timely analysis in the **Financial Times** of July 7 and authored by **James Politi***

Eni: A pipeline to profit

Italy's largest company focuses on oil exploration and production but may be too exposed to risk

On June 4, Claudio Descalzi, the chief executive of Eni, Italy's largest oil and gas company, took a short drive in an armoured, escorted 4x4 from Tripoli's main airport to the temporary offices of Fayez al-Sarraj, Libya's UN-backed prime minister, at Abusita naval base.

Mr Descalzi, a 61-year-old veteran of exploration and production in Africa, saw around him a fairly "normal" situation, despite the civil war that has raged in the country for the past few years. "There were people out and about, there were cars circulating. It wasn't so different from the Libya I knew," he says.

But for Mr Descalzi, who had not been to Libya since 2014 and had not met senior government officials in the country since the 2011 collapse of Muammer Gaddafi's dictatorship, there was a deeper reason to be relieved at the improving picture in the North African country.

A modicum of stability in Libya would reassure investors that the chances of turmoil closing about 20 per cent of Eni's production were finally receding, removing one of the company's main sources of geopolitical risk.

"There has been a change and it has been a positive change," Mr Descalzi says. "We went and we spoke to the prime minister. This hadn't happened for years. It was the first time since the Arab spring where there was an institutional interlocutor."

Mr Descalzi's comfort may only be temporary, since Mr Sarraj's government remains fragile, and chaos could intensify again at any time.

But it highlights Mr Descalzi's efforts to reshape Italy's largest company by market capitalisation, and its most high-profile multinational.

Eni chief executive Claudio Descalzi at a refinery in northern Italy © Alberto Bernasconi

Not only has the company had to deal with the collapse in crude oil prices but it has also confronted increasing political tension and even violence in countries where it is active, producing some of the most testing times and biggest lossesin Eni's corporate history.

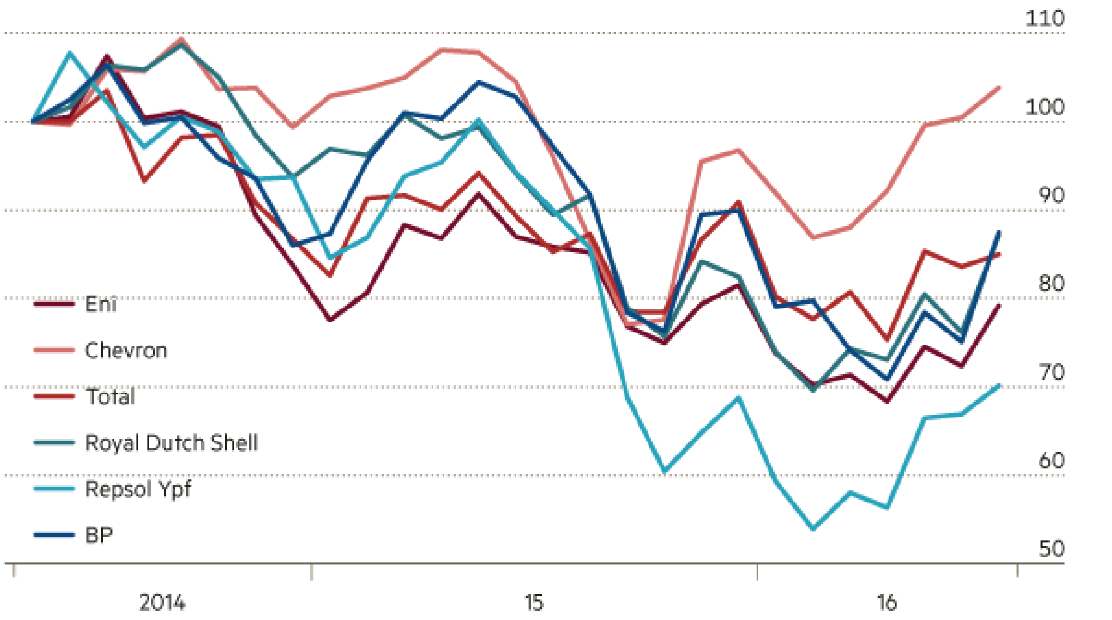
Eni's fate in such a difficult environment is being closely tracked by Matteo Renzi, Italy's reformist prime minister, who has been a champion of the company since his rise to power in 2014, and is facing political pressure elsewhere due to mounting problems in the country's banking sector.

It was Mr Renzi who picked Mr Descalzi for the top job and the premier has sought to support the company through a range of domestic and foreign policy levers, including several visits together to key African countries in its portfolio such as Nigeria, Mozambique, the Republic of Congo, Angola and Ghana.

"Eni today is a fundamental piece of our energy policy, our foreign policy and our intelligence policy," Mr Renzi said in an interview shortly after taking office, raising eyebrows for the blunt acknowledgment of the extent to which the destinies of the company and Italy's national interest were intertwined.

Eni's share price

Against competitors (rebased, in euro terms)



Source: Thomson Reuters Datastream

FT

"Eni has not had such a close relationship with the government since the days of [Enrico] Mattei," says Giulio Sapelli, a professor of economic history at the University of Milan, referring to the company's founder who died in an air crash near Milan in 1962.

Upstream bet

Eni's ability to succeed may largely depend on a big bet placed by Mr Descalzi in response to the drop in crude oil prices. This involves the company no longer being a sprawling Italian energy conglomerate but a smaller group focused on its core expertise of exploration and production activities — known as the upstream business. The shift in focus included the completion of exits from Snam and Galp, the Italian gas distribution company and the Portuguese energy group. But it also meant paring down its stake in Saipem, a pipeline operator, which helped reduce Eni's leverage by removing about €5bn in debt from its balance sheet.

"We are very comfortable because in the last couple of years we have been so successful in exploration, in production, in discovering and developing new fields," Mr Descalzi says.

Last year's discovery of Zohr, a gasfield off the coast of Egypt in the Mediterranean Sea, in a spot where other companies had tried and failed to find anything, bolstered Eni's rationale for the move by highlighting its exploration prowess. And the recent rebound in crude prices — to $49 a barrel this week from a low of $27 in January — has also been welcomed.

So far, the government is backing the decision. "We think that the real value-added of Eni — the heart of its savoir faire and its business — is really in the upstream and we need to value that and to give it the needed visibility for investors," says Fabrizio Pagani, a senior official at the Italian finance ministry and an Eni board member.

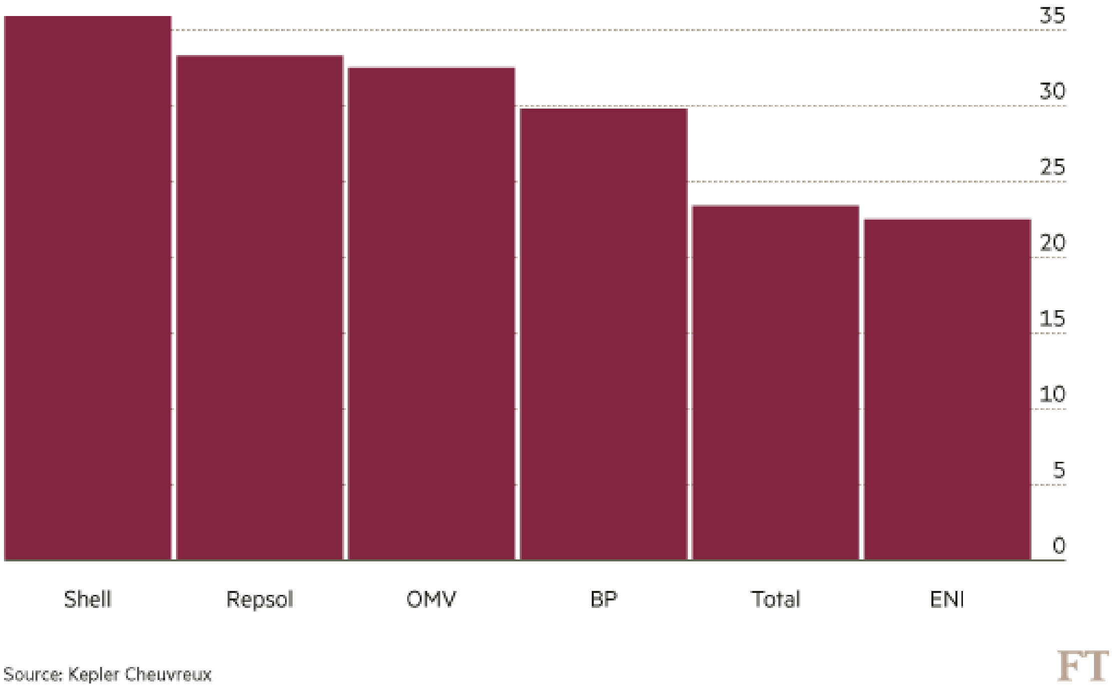
Some, however, are concerned that this could leave Eni even more exposed to any new downturn in crude oil prices, or a prolonged period at current levels.

"I am worried that the decision to bet just on upstream will be lethal for the company," says Leonardo Maugeri, a former Eni senior executive and a senior fellow at Harvard University. "While other majors have the capacity to weather the storm by taking advantage of midstream [transportation] and downstream [refining] sectors, Eni cannot do this," he adds.

Eni's retort to that criticism is that it has not just refocused on exploration and production, but made it more efficient. Between 2014 and 2015, Eni cut its capital expenditure by 17 per cent, mainly by axing new projects. It also reduced its operating expenditure, such as the cost of supplies and support vessels, by 13 per cent. And the company has guided investors to expect more austerity, with capital expenditure falling a further 21 per cent by 2019 and the break-even cost of new projects falling from $45 a barrel of oil equivalent in 2015 to $27 in 2016.

Eni's technical costs are lower than its peers'

$ a barrel, 2015



Source: Kepler Cheuvreux

"In a nutshell Eni has been one of the better cost cutters. Their cost per barrel is among the lowest of their group," says Hamish Clegg, an analyst at Bank of America Merrill Lynch.

In addition, Mr Clegg says Eni's E&P activities are changing to place a priority on lower cost projects with a shorter time to market than some previous developments.

One example, he says, is the Nené phase 1 project in Congo, where it found oil and began production within a year, by using an existing rig that was suitable for the development rather than building a bespoke but more expensive solution. Zohr, too, fits that bill, since the Egyptian offshore gasfield is located near existing infrastructure which means it can quickly be brought to market once production begins in 2017.

If all goes well for Eni, it will be able to cash in on its exploration successes through the sale of stakes in some projects — including Zohr and a large gasfield in Mozambique — to other producers.

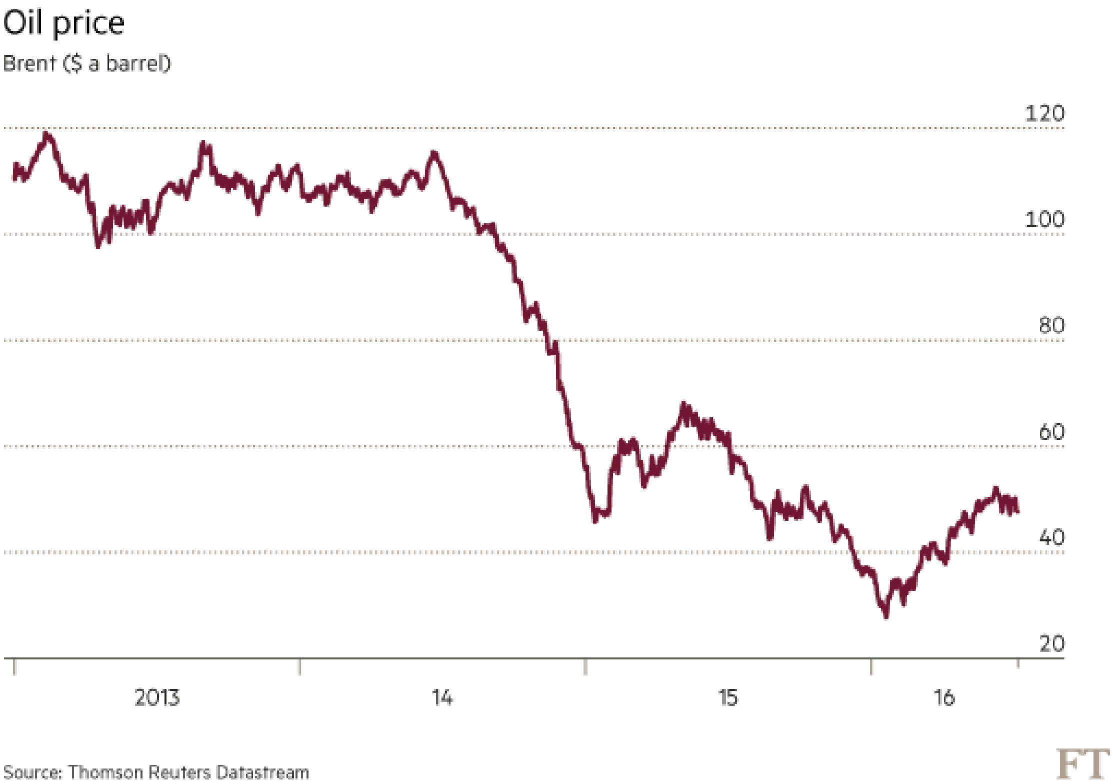
"I'm positive. It's quite difficult to sell producing assets today … but our assets are good assets," Mr Descalzi says.

"It's a bit like the *catenaccio* style in football," says Andrea Greco, a journalist at La Repubblica who has co-authored a book on Eni called *The Parallel State*, referring to the traditionally defensive tactics of the Italian national team. "They are looking for some easy, conventional developments, which they can quickly sell."

Investor demands

While most analysts have bought into Mr Descalzi's strategic shift, some doubt whether he will be able to execute it as well as he hopes, which could leave the company vulnerable. Bitter memories linger among investors of the delays and cost overruns that dogged Eni's Kashagan project in Kazakhstan, a joint investment with other oil majors, which was discovered in 2000 but is only now expected to start producing large quantities of oil after pipeline repairs.

"[Eni] has been truly successful explorers but why has that not led to better returns? Can [Eni] generate enough free cash flow to pay its dividends at $65-per-barrel prices by 2018? This is possible but I think there's a much higher chance of a dividend cut than for other majors," says one sceptical analyst, who declined to be named.



Eni was one of the first big oil majors to cut its dividend in 2015, to €0.80 per share from €1.12, and many analysts believe that the company will be able to maintain that level, including Kepler Cheuvreux, which declared it "safe" in a recent note. But if that is not the case, a second cut would be a bitter blow for investors, including Mr Renzi's government.

One question dogging Mr Descalzi is whether geopolitical turmoil could end up undermining the success of his new exploration model and cost-cutting drive.

Since Mr Mattei's era, Eni has prided itself on extracting hydrocarbons from poor countries with difficult governments. But this is often seen as a reason why its shares trade at a discount compared with peers that have more activities in safer, advanced economies.

That conundrum has only intensified in recent years. Mr Descalzi's early days in office coincided with the Ukraine crisis, stoking tension with Vladimir Putin's Russia, with whom his predecessor Paolo Scaroni enjoyed close ties. Eni pulled out of SouthStream, a controversial pipeline project which the Russian president ultimately cancelled, and shifted its emphasis decisively towards Africa, which is expected to generate the majority of the company's production between 2016 and 2020, according to data from Kepler Cheuvreux.

Africa, however, has its own problems. While Eni has managed to keep pumping gas out of Libya and Mr Descalzi's Tripoli visit shows that conditions have improved there, security remains a wild card.

In Egypt, the Zohr discovery has been marred by a rise in tension between Rome and Cairo over the brutal murder of Giulio Regeni, an Italian doctoral student, as well as the threat of terrorism in the country, which has hurt the economic outlook.

In Nigeria, Eni has suffered attacks and supply disruptions, and Mr Descalzi is the subject of an investigation by Italian prosecutors into alleged corruption in connection with an oil project. He denies any wrongdoing.

Geopolitical risk

For some, this is all too much. "The company is essentially a prisoner of Africa," says one former executive. "They have concentrated all of their business in areas of the world which are not particularly stable," he adds.

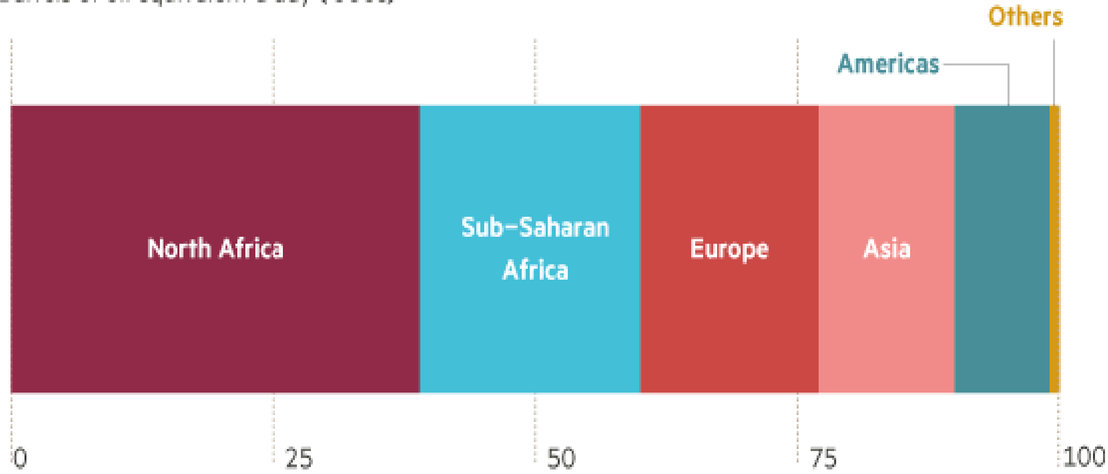
Mr Pagani of the Italian Treasury says Eni should not "divest" from Africa, "but investing in other areas would be something to consider".

Mr Descalzi insists it is doing just that, through a "strong diversification" towards East Asia, with budding projects in Vietnam, Indonesia and Myanmar.

And he notes that Eni has a presence in Latin America as well as the US and Canada, the UK and Norway. But he does not feel any urgency to go much further. “There are a lot of countries with geopolitical risk and I think you must have the skills, rules, processes and security to cope with it,” he says. “That is a plus for Eni, because we grew up in difficult situations”.

Eni’s hydrocarbons production forecast, 2020

Barrels of oil equivalent a day (‘000s)



Source: Kepler Cheuvreux

The fear at Eni is that moving into safer OECD countries would undermine a key competitive advantage. “They’re not making chocolates, they are not cultivating roses, they are oil and gas men,” says Mr Sapelli, who is also a researcher at the Enrico Mattei foundation, a think-tank. And Italy shows that developed nations can pose challenges too: a judicial inquiry halted production at a big Eni oilfield in southern Italy this year, and the populist, environmentalist Five-Star movement is rising in the polls to challenge Mr Renzi.

Ultimately, Mr Descalzi’s goal is to transform Eni into a leaner, more agile oil and gas company, which can also begin to integrate renewable energy into its portfolio to meet global emissions reduction standards. Eni shares have underperformed European peers such as BP, Shell and Total, over the past two years — partly because of concerns over geopolitical risk — but more analysts have a “buy” rating on the company’s shares than a “sell” rating now, suggesting confidence in the course he is taking.

Eventually the company could become an appetising merger partner for an oil major. That would put the Italian government on the spot over whether it might be willing to give up control. But Mr Descalzi is leaving no room for such talk at this stage.

“We are very proud of our culture, we are very proud of the achievements we’ve made, and that is our strength. We are quite inaccessible,” he says.

The “IENE Company Profile” is an occasional communication published by the Institute of Energy for SE Europe in its effort to broaden the dialogue on current energy issues of regional and global interest. A Company Profile, as the name implies, focuses on a particular company engaged in one or more areas of activity in the broad energy field. The scope of the “Company Profile” is to focus on the achievements and prospects of prominent energy companies and organizations which through their work paradigm could provide inspiration for leadership, strategy and innovation. Material used for a Company Profile may come from published sources but also from original input contributed by IENE's staff and research associates.