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Harbour's revised $10bn bid for Santos may still not be enough

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The revised $10.4 billion bid by Harbour Energy for Australian liquefied natural gas (LNG) producer Santos looks at first glance like a winning hand, but it's still probably got the odds stacked against it.

The US private equity firm's fourth bite at the Santos cherry since August last year values the Adelaide-based company at a 28 per cent premium to the close on April 2, and is 43 per cent higher than the first attempt.

Recognising that this is a serious bid, Santos' board has decided to "engage further with Harbour", the company said in a statement to shareholders.

This is sensible, but shareholders should consider whether they want to sell out just as Santos is finally starting to reap the benefits of its investments, and the prospects for further improvement are getting brighter.

The Harbour offer values Santos at A$6.50 a share, a level the company last traded at in July 2015, at a time when the price of LNG and crude oil was falling, putting the company under pressure just as its massive Gladstone LNG plant in Australia's Queensland state was starting up.

When Santos was last at A$6.50 a share, Brent crude oil was around $58 a barrel and the spot price of Asian LNG was about $7.80 per million British thermal units (mmBtu).

These prices matter for the bid as the bulk of Santos' revenue is either in oil-linked longer-term LNG contracts, spot LNG prices, or in crude for the company's small oil output.

Brent crude ended last week at $67.74 a barrel and spot LNG was about $7 per mmBtu, although it's worth bearing in mind that LNG prices typically are weakest during the shoulder seasons between the winter and summer peak demand periods.

Spot LNG prices surged to $11.50 per mmBtu in early January, the highest in more than three years, as China bought additional cargoes to meet winter demand. _______

While future spot LNG prices are uncertain, the chances are that China will continue to boost its imports as part of efforts to reduce the use of polluting coal for winter heating.

On crude oil, the success of Opec and its allies in draining global inventories and boosting prices has led to a market consensus that prices are more likely to rise than fall over the medium term.

This means Santos is likely to receive higher revenues for its LNG from the Gladstone plant and its share in LNG operations in Darwin and Papua New Guinea, as well as for its domestic natural gas and oil output in Australia.

It's these revenue streams that Harbour Energy is eyeing, and it must be taking the view that Santos' share price has yet to reflect the brighter medium and longer term outlook.

For this reason the revised offer may not quite be enough, especially if Santos' existing major shareholders and the analysts they rely on start to re-rate the stock in line with expectations for higher crude and LNG prices.

The Santos share price did kick higher on the new Harbour Energy bid, jumping more than 5 per cent after the revised offer, but at its close of A$5.88 on April 6, it's still some way below the indicative value of the offer.

Rather than reflect that Harbour Energy is overpaying, this more likely shows that investors don't believe the bid will clear the regulatory hurdles in its way.

The deal will be subject to Australia's Foreign Investment Review Board, which may have concerns about a key domestic oil and gas producer falling into foreign hands.

Even if the board does greenlight the deal, the chances are that the Liberal Party-led federal government of Prime Minister Malcolm Turnbull will decline final approval.

Domestic energy policy is a hot issue in Australia, with consumers and industry angry and disillusioned at sharply rising prices for electricity and natural gas.

Any suggestion that a private equity company buying Santos would somehow be bad for consumers and industry would put tremendous pressure on a government that is trailing the opposition Labor Party in opinion polls.

And it wouldn't be hard to make such an argument as it's likely that Harbour Energy is focused on the LNG jewels in the Santos crown and not that interested in developing domestic natural gas supply.

Also, a debt-laden deal carries the risk of huge cost-cutting, with related job losses, another issue that would be exceedingly touchy in Adelaide, a city still reeling from the loss of Australia's car assembly plants.

These factors make it unlikely that Harbour Energy's offer will get over the line, at least in its current form.

It's possible that it could win political approval, if Harbour Energy agrees to whatever conditions are placed on the deal, but it's also possible that Santos' shareholders may want the offer sweetened a little more.

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