Oil & Gas Sector Review

11 November 2015

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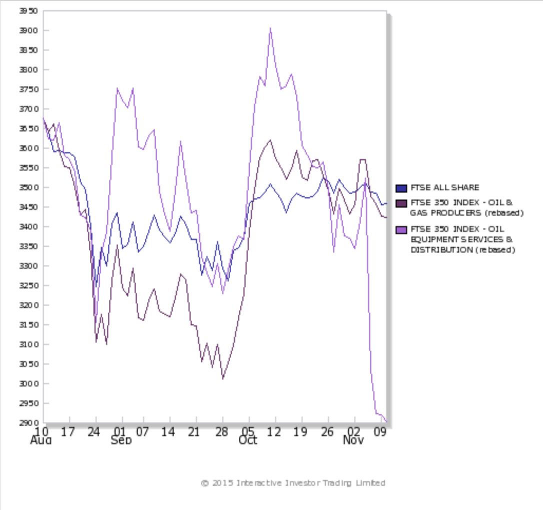


Source: www.iii.co.uk

FTSE 350 Oil & Gas Producers	CY2015	CY2016
PE	17.0	15.1
P/Book	1.1	1.1
EV/Sales	0.8	0.7
EV/EBITDA	5.8	5.2
FTSE 350 Oil Equipment Services & Distribution	**CY2015**	**CY2016**
PE	13.1	10.5
P/Book	1.3	1.3
EV/Sales	0.7	0.6
EV/EBITDA	8.1	7.0
FTSE All Share	**CY2015**	**CY2016**
PE	16.1	14.9
P/Book	1.8	1.8
EV/Sales	1.5	1.4
EV/EBITDA	9.2	8.5

Source: Bloomberg

HYBRIDAN LLP
20 Ironmonger Lane,
London, EC2V 8EP
Website: www.hybridan.com

Tel: 020 3764 2341
Email: research@hybridan.com

Troubled waters…

Fifteen or so years ago the oil price was on its back (around $10 a barrel) and Tech Boom (v.1) was in full swing. I recall trying to sell a BP call warrant, at its intrinsic value. "No Thanks…" said a renowned guru investor - who was probably the equivalent of Neil Woodford before Neil Woodford was Neil Woodford - "…but what have you got Nokia 3 month ATM calls?" So I sold him some of those at 75% implied vol.

In the same fortnight that Apple reported net profits of $11.1bn for the last quarter and King Digital Entertainment (creator of Candy Crush) announced it had been bought for $5.9bn, I thought it might be worth having a little look at the much beleaguered Oil & Gas market.

The Oil & Gas industry had until quite recently become complacent with an oil price above $100. Over the last 15 years the oil price has risen fairly consistently, the costs of producing the oil has risen similarly and the margins have stayed broadly the same. Overall demand for hydrocarbons has grown along with GDP so everyone was making a little bit more money each year and all was well…and it is therefore a bit shocking that all of that has come to a shattering stop.

There are always plenty of 'un-knowns' when trying to assess the oil price, but there are also some 'knowns' too. General & administrative costs, Capex and Opex across the industry, have plenty of capacity to be "re-balanced" or, more crudely, to be cut severely. There are estimated to have been 300,000 oil related redundancies globally in the last year, so personnel costs will dropping off for certain. Likewise service companies will be trimming margins and costs, as will shipping companies and refiners and all the rest.

Technology improvements will also be driving down costs. Fracking techniques have already made quantum improvements to production and it is likely that new techniques could lead to a further step change in oil recovery levels - and therefore production costs - though these will phase in gradually over the next several years.

Pricing and demand is perhaps not as correlated as one would think. Certainly the price has changed very quickly and the demand – though still rising year on year – is not able to react that quickly. People will not start to drive further in their cars or use more plastic because the price is low for a few months, and given the amount of duty on most oil based products the benefits are not of the same quantum as the fall in crude prices. That said if it cost £10 less to fill up your car each week, that £10 will get spent somewhere else in the economy; so it is not all bad news.
But what of Supply? Supply rarely surprises anyone who watches it closely. Bringing in producing oil & gas fields is a long and expensive operation. Once they are in, they pump hydrocarbons pretty much as planned. There is some concern about the potential new supply from both Mexico and Iran either of which could create a blip in supply. On the other side of the equation some of the, more expensive artic and deep sea activities may well drop off. **Continued overleaf….**

However, the 800lb gorilla is OPEC, by which we probably mean Saudi, by which we actually mean the King of Saudi Arabia. Trying to anticipate what his plan is, is perhaps the key to all of this.

"The Stone Age did not end for lack of stone, and the Oil Age will end long before the world runs out of oil", is the phrase most commonly associated with Sheik Yamani; Saudi Arabia's oil minister 30 years' ago. At current rates of production Saudi has 50 years, or maybe 150 years of oil in the ground… Who knows? Who cares? If they can get it out the ground for $2.50 and sell it for $12.5 it is still an amazing business model for as long as it lasts. Perhaps that is an extreme suggestion but it makes the point. Fossil fuels for energy have a limited shelf life (For plastics and other oil derived products maybe longer), but why would Saudi, and other states sitting on vast low cost reserves hold back so others can benefit from high oil prices? Conversely, why would the USA and other nations want to be entirely dependent upon Arabian Peninsula oil?

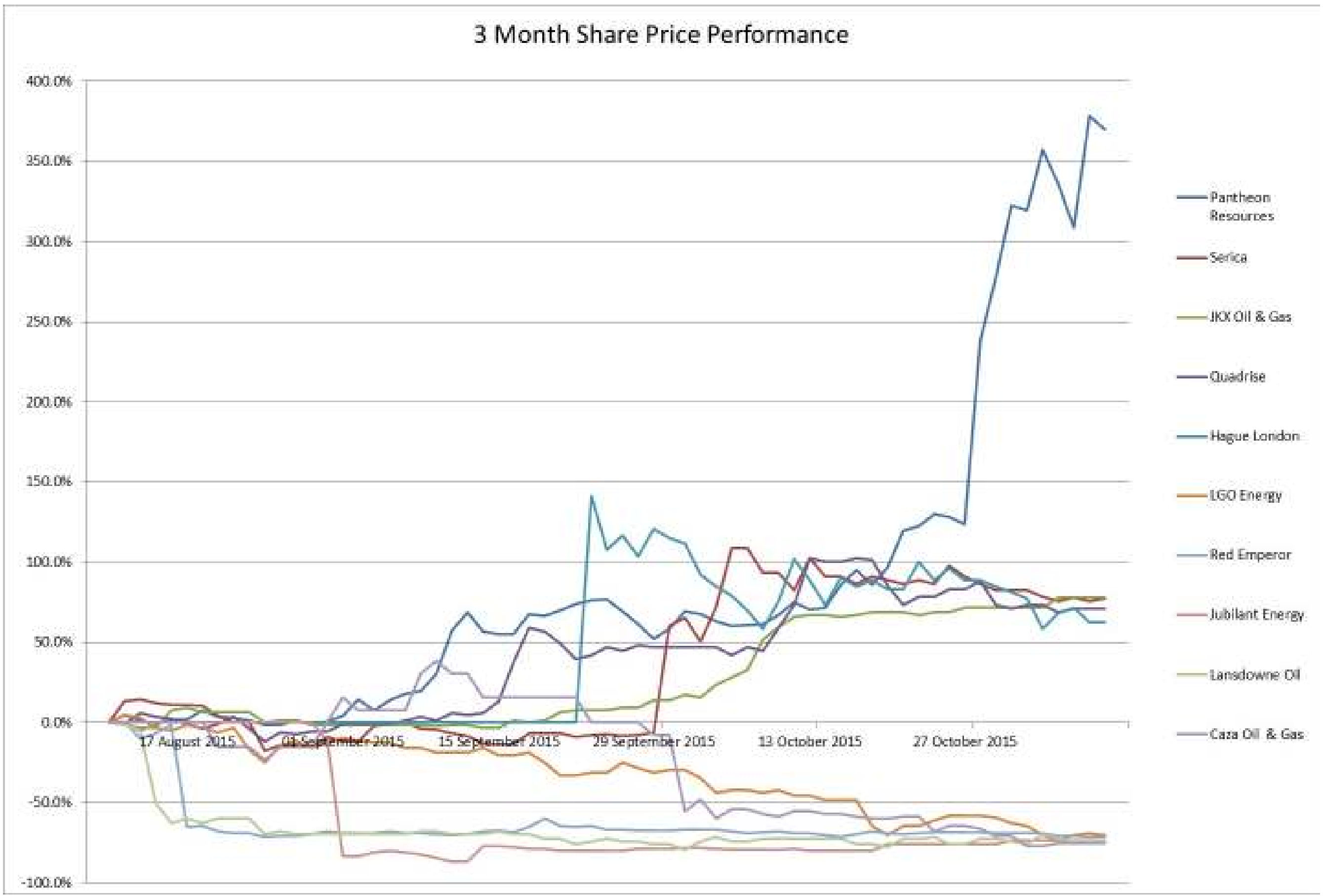
The range of views as to where the price goes in the next 12 months is very wide, with plenty of outlying predictions, and you can take your pick from those, but the general consensus amongst the 'oily' fraternity is for the oil price to rally back towards the $70-80 level by 2019. With general cost cutting and improving extraction technologies this still leaves plenty of margin for explorers and producers and investors to go for in the more straightforward jurisdictions (excluding the artic and deep sea operations for example).

Looking through the individual companies in the UK Oil & Gas sector, there are some really bombed out names which may have some 'punting' potential; in the penny-share style. But picking a winner will involve some luck. However, assuming the market is vaguely efficient, and looking at the top quartile of companies, as measured by performance of share-prices over the last three months, gives us a very rough idea of who the winners might be, and who is on top of their costs. Certainly the "Big Oil" Companies of BP, BG and Royal Dutch Shell - are in that list of survivors, but so also are some of the sub £50m market cap companies, that in consequence may be worth investigation.

Risers and Fallers

As at 9 November 2015	***3 month Share price movement***
Pantheon Resources	326.16%
Serica	87.20%
JKX Oil & Gas	75.40%
Quadrise	65.10%
Hague London	62.30%
LGO Energy	(69.70%)
Red Emperor	(72.52%)
Jubilant Energy	(73.33%)
Lansdowne Oil	(73.77%)
Caza Oil & Gas	(75.38%)

Source: Fidessa



Source Fidessa

Risers

Pantheon Resources (LON:PANR 84p/£165m 3mth +326.16%)

The oil and gas exploration company with a 50 per cent working interest in several projects in Tyler and Polk Counties, onshore East Texas, updated on the successful flow test of the VOBM#1 well on 28 October. The well encountered 62 feet of net pay, at a depth of c.14,200 feet, in the Eagle Ford sandstone, the primary target of the well.

The well flowed natural gas at a stabilised flow rate of 6,145 Mcfpd (thousand cubic feet per day) (with a calorific value of 1,100 BTU (British Thermal Unit) /cubic foot) and 504 bblpd (barrels of oil per day) oil on a 12/64ths choke with a flowing tubing pressure of 7,350 psi (pounds per square inch). Gross production from the VOBM#1 well equates to over 1,500 boepd (barrels of oil equivalent per day). Initial flow rates and other testing data indicate that the well has the potential to exceed the pre drill P50 Prospective Resource (Recoverable) estimate per well of 1.4Mmboe (barrels of equivalent), however it will take a period of sustained production data before a more definitive assessment can be made.

On 6 November there was an update on the VOS~1 well. An oil and gas bearing zone has been encountered at a depth of c.12,600 feet. This zone is separate from and independent of both the primary and secondary well objectives (being the Eagle Ford/Woodbine sandstone and the Austin Chalk respectively) and has flowed both natural gas and oil. As a result of well intervention operations in relation to controlling this zone, which also included flaring of natural gas, Pantheon now anticipates an additional c.14 days of drilling to reach the main targeted horizons.

Serica Energy (LON:SQZ 10p/£26.3m 3mth +87.2%)

Serica Energy is an oil and gas exploration and production company with exploration, development and production assets in the UK and Norway and exploration interests in the Atlantic margins offshore Ireland and West Africa. The Company is in partnership with other companies in its licences offshore UK, Ireland, Morocco and Namibia.

The company on 30 September announced H1 June 2015 results. In the North Sea Erskine field net production attributable to Serica was substantially above base case and averaged over 3,100 boepd since mid-year to 28 September 2015. On 27 October the company announced a deal effectively merging the extension to its Columbus field with the relevant portion of the adjoining block. Serica's contingent resources attributed to the Columbus Field increased by 50 percent to 7.8 mmboe.

JKX Oil & Gas (LON: JKX 28.5p/£49.1m 3mth +75.4%)

The last major news was the H1 June 2015 results in July 2015. Average production was down to 8,611 vs 10,126 boepd. Development drilling was suspended in the Ukraine due to a negative investment climate. However JKX saw the award of an extension to the Elizavetovskoye production licence in the Ukraine to include the West Mashivske prospect. The company turned over $44.4m vs $74.3m and made an operating loss of $7.3m vs a profit of $2.4m. The outlook looked forward to the potential resumption of development drilling in the Ukraine in the second half of 2015, Russian plant capacity modifications to increase capacity to 60 MMcfd by the year end, completion of the Hungarian production permitting and two exploration wells scheduled in Slovakia in Q4 2015. During the quarter Neptune Invest has upped its stake from under 6 per cent to nearly 13 per cent.

Quadrise Fuels International (LON:QFI 17.8p/£143.7m 3mth +65.1%)

Quadrise is an emerging manufacturer and supplier of MSAR® emulsion fuels, a low cost alternative to heavy fuel oil (one of the world's largest fuel markets utilising over 450 million tons per annum) in the global shipping, refining and steam and power generation markets. The company posted FY June 2015 in October. A 4,000 hour seaborne Operational Trial Programme is due to commence in H1 2016 to complete in Q1 2017 ahead of a global roll out. The Group remains debt free, with £8.4m in cash reserves at 30 June 2015, and has cumulative tax losses of £40.7m available for set-off against future profits. Group operating costs were held within budget and funds available are expected to meet the Company's needs for the remaining phases of lead projects through to early continuous revenues.

Hague and London Oil (LON:HNL 10.8p/£2.6m 3mth +62.3%)

The Hydrocarbon exploration company, formerly Wessex Exploration, announced unaudited interim results for the half-year ended 30 June 2015. During the period the strategic focus shifted toward lower-risk opportunities in Southeast Asia after the integration of SC54A, Philippines within the portfolio. New Directors subsequently focused on cost-effectively scaling up the business and the company's efforts during 1H15 culminated in the Duyung transaction, announced on 23 September 2015. That's an 85 per cent stake in the Duyung Production Sharing Contract located in the Natuna Sea, Indonesia, with estimated gas initially in place of 902 Bcf gross (150 mmboe). In the period the company made a loss of £0.8m and ended the period with £0.95m cash.

As part of the transaction, the company has agreed to provide the partnership with US$0.5m of working capital and to acquire long-lead items and/or contract services for the drilling of an appraisal well on the license, Mako South-1X. If the Company proceeds with the transaction then the company would carry the partner for its net 15 per cent working interest share of costs, capped at US$10m.

LGO Energy (LON:LGO 0.5p/£15.1m 3mth -69.7%)

The international oil and gas exploration, development and production company most recently (3 November) updated the market following the earlier loss of a well due to mechanical problems in October. This has caused a funding gap and options are under review and it is assessing a method of how best to access the exceptionally thick pay zone. Recent performance from the Company's Spanish subsidiary, CPS, has been encouraging with September average production of 186 bopd. Additional well cleanout work conducted over the summer months has resulted in a substantial increase in production from a number of wells, notably well Ayo-37.

Red Emperor (LON:RMP 1p/£4m 3mth -72.5%)

The company reminded us in its quarterly report to September that in the Philippines the Hawkeye-1 exploration well was drilled to the planned total depth of 2,920m with the top reservoir intersected at 2,710m. The well proved the existence of hydrocarbons in SC55, however the hydrocarbon size discovered was at the low end of expectations and not likely to be economic to develop. Hawkeye-1 was plugged and abandoned with results from the well to be analysed with respect to other prospects, including Cinco, in the license that potentially share the same charge source. In Georgia, the PSA (Production Sharing Agreement) across Block VIa remains in good standing and the subject of sale negotiations with at least one interested party. Due diligence and negotiations are ongoing, with Red Emperor being advised by the operator, Strait Oil & Gas, of the desire to complete a transaction before the end of the year.

Jubilant Energy (LON:JUB 0.6p/£2.5m 3mth -73.3%)

The emerging oil and gas player in India, holds operating and non-operating stakes in a diversified portfolio of upstream asset predominantly located in India. These assets are at different stages of maturity. The Kharsang Oil Field is the only producing asset. Three other assets, namely, KG-OSN-2001/3 (Deendayal/KG) Block, AA-ONN-2001/3 (Tripura) Block and CB-ONN-2002/3 (Sanand-Miroli) Block are under development / appraisal having a total of 15 discoveries of commercial interest, predominantly gas. Two Blocks AA-ONN-2009/1 and AA-ONN-2009/2 in Manipur and a PSC-I Block in Myanmar are under Exploration. Other Blocks namely Cauvery, Mehsana and Golaghat are under relinquishment.

Facing a cash crunch the company has entered into a related party loan agreement for $1.2m at 14 per cent interest. The company will be delisted from AIM and the company has offered to buy all shares at 0.6p. The shares have traded as high as 11.25p this year.

Lansdowne Oil (LON:LOGP 2p/£3.2m 3mth -73.77%)

The upstream oil and gas company, focused on exploration and appraisal activities in the North Celtic Sea Basin, off the south coast of Ireland reported H1 June 15 Numbers in September. During the period the company secured an additional £2.9m of funding by way of a placing and loan note. Post period a well in which the company had a 20 per cent interest was plugged and abandoned after being deemed sub commercial. A 50 per cent relinquishment of the areas held in SEL 5/07 (Rosscarbery) and aSEL 5/08 (Amergin) was made on 31 July 2015. The main prospects were retained and efforts continue to farm-out for drilling. On 3rd November the company announced a 2 year extension to its exploration license (20 per cent interest) in the block containing the Barryroe oil field.

Caza Oil & Gas (LON:CAZA 0.4p/£0.96m 3mth -75.38%)

Caza Oil & Gas is engaged in the exploration for and the development, production and acquisition of, petroleum and natural gas reserves. Q2 results showed revenue down 13 percent to $2.9m from Q1 and down 53 percent from Q2 2014. This was owing to lower commodity prices during the period and reduced production volumes as a result of the Company's prudent decision to cut back on capital expenditures until operational costs adjust to appropriately reflect the current pricing environment and/or prices rebound allowing for greater return on investment. On a six month view, cash from operations was $6.1m but with an overall outflow of $2.7m leaving a balance of $2.4m.

The company has breached covenants on its $45m outstanding debt with Apollo Investment Management and is exploring refinancing options to retire the facility together with sums owed pursuant to the Convertible Loan Agreement entered into between Caza and YA Global Master SPV Ltd or Yorkville. Caza is in advanced discussions with a third party regarding a potential equity financing of the Company and for now Apollo continues to grant forbearance.

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