INTERIM BULLETIN # 67 – FEBRUARY 17 2011
PORTFOLIO PURCHASE / UPDATE
DEETHREE EXPLORATION – DTX:TSX (see Bulletin 37 in Members Centre for original full report)

I have given an order to my broker to buy 6000 shares on the $4.20 financing announced today by DeeThree Exploration (DTX-TSX). (Public companies are allowed to give discounts to investors on financings, and this is a full $1/share below current prices).

DeeThree is a junior company whose valuation is based on its very large 220,000 acre land parcel in the Alberta Bakken play just north of the Montana border. This is one of the hottest, most watched exploration plays in all of North America right now. It has 750 boe/d production of gas that is not really relevant to its valuation (though moreso now as you will read).

DeeThree is buying 1830 boe/d of production and 2P reserves of 5.4 million barrels for $125 million from Fairborne Energy (FEL-TSX) in a 50 section contiguous land package in west central Alberta - outside the Alberta Bakken. The production is 575 barrels of oil, 165 bopd of condensate (which gets basically the same price as oil) and 6.5 mmcf/d (million cubic feet per day) of gas – that gas equals roughly 1100 boe.

The gas production has a high 65 barrels of Natural Gas Liquids (NGLs) production per million cubic feet of gas produced (65 bbl/mmcf), but DeeThree couldn't tell me how much was condensate and how much was the lower priced ethane, butane and propane. They did say the netback (profit per barrel) on production was $30, and $55 on the oil part.

The juice here for DeeThree is the 32,000 acres of undeveloped land that they believe is highly prospective for the Belly River oil formation. Management is hoping that this will give them an EUR (Estimated Ultimate Recovery) of 130,000 - 175,000 barrels of very light 42 API oil per well with some solution gas in place (which helps make the oil flow even better).

If that ends up true, then the metrics of the transaction will be fairly cheap for DeeThree over time (because it's not cheap right now). They are the operator, own the local infrastructure and have an 88% working interest in the new play.

DeeThree says it is paying $64,480 per flowing barrel for production, after backing out $7 million for the land value. Fairborne says it was $68,300 and didn't back out the land value. The deal was done at a 20%-26% premium to what the assets were being valued in Fairborne (depending on which side of the transaction you want to argue from).

I would suggest this is high for a natural gas weighted deal. However, DeeThree trades at a BIG premium to its NAV when you measure that number on production or reserves (DeeThree has almost zero on both counts). DeeThree trades on the land value of its Alberta Bakken play.

So it can rightfully claim that this transaction is accretive. My bet is that that wiggle room allowed them to pay more than other WCSB producers likely would have.

Assuming the financing is fully subscribed (including the overallotment) DeeThree will have 63.1 million shares out, which would give it a market cap of $300 million at $4.75 per share. Subtract the $37 million cash it would have to get an *enterprise value* of $263 million and then divide by 2580 boe/d production (current ~750 + new 1830) to get a price per flowing barrel of $101,831.

That would be high for a gas weighted producer. But what is the Alberta Bakken land worth? If it was valued at $500/acre (and I would suggest it is easily worth that) over 220,000 acres, that's $110 million worth of enterprise value. Then the production is valued at $153 million and the valuation per flowing barrel is $59,195 – which is reasonable given the high NGL count.

(To be clear, DeeThree will spend 80% of its money on this new land package chasing oil from the Belly River formation, not gas/wet gas, so the oil weighting of the production from this land package will increase quickly if they are successful.)

On those metrics, I think any success in the Alberta Bakken should now have a bigger impact on the stock than it would have prior to this deal. There is a solid floor of value from which the stock can now jump.

DeeThree also estimates it will give them $30 million in new debt capacity, which is significant. They would have $67 million in working capital available to them plus cash flow.

It's a good/great deal for Fairborne. They are 74% weighted gas producer, and likely to stay that way as they have now sold one of their two oil plays. Prior to this transaction, they have $194 million in debt against a line of $325 million and a $100 million convertible debenture (CD) that they can always roll over (the market LOVES these 5%+ CDs right now). They get a premium for their assets, sell 11% of production and reduce debt by 38%.

However their company-wide netback is only $24, and their finding costs are $25, which is a bit high for a gas company (gas is cheaper to get out of the ground than oil). So they are on a cash flow treadmill. If Canadian natural gas prices fall a lot this spring/summer, (50/50-very cold winter in Ontario has helped storage get depleted a lot) there is **no way** they would get this price then. So they are being smart with their timing. Jan/Feb is usually top of the seasonal natural gas market.

My question to DeeThree CEO Martin Cheyne was – you have a big land package in what looks like to be the sweet spot of the Alberta Bakken, one of the hottest plays in North America, so why are you doing this? Was this a vote of non-confidence in this play?

I asked because Crescent Point's first well in its Alberta Bakken lands was **not** a good one. In the first two months it went from 30 (thirty) bopd to 9 (nine). Research I read indicated that Crescent Point did not want to comment on production levels for any of its wells but did indicate in January that it has three wells on production in the Alberta Bakken and plans to drill ~12 wells in 2011 in the play.

Murphy has licensed two horizontal wells and Shell has licensed four wells near Crescent Point's recent activity.

Cheyne assured me that their first well in the Alberta Bakken is now complete, and will get fracked in April over 15 stages (which means a 30 day test won't be made public until May or June **:0(**). They are now moving the rig to do the second well, and want to do 7 wells this year and may even bring in a second well if results warrant doing so.

(The reality is that investors still need to treat this as an exploration play, but given Rosetta's NFX-NYSE) continued drilling on the Montana side of this play – they have both drilled several horizontals – I will be VERY surprised if the Alberta Bakken doesn't become a productive play.)

In conclusion, this deal could be construed as a great win-win. Cheyne and his DeeThree team will now have a critical mass (at 2580 boe/d and net cash) to the point where most of the Street will start covering them. They have backfilled the value vacuum that the Alberta Bakken land boom created for the stock.

Subscribers can read how excited I am here. This company has a relatively low number of shares out giving it lots of leverage to a big land position in one of the most watched plays in North America right now. It has the cash and the cashflow to grow without significant further dilution, which takes a cap off the stock (if the market knows you have to raise money they don't buy the stock in the market, they wait for the financing).

But it's just not in my nature to be wildly bullish so I would add that this team was not overly impressive in building this company before the Alberta Bakken play fell into their lap (like every other junior in the play they bought their land as a shallow gas play). To be fair, they came public in 2008 just before the crash. So this relatively low risk Belly River play is a new lease on life *where DeeThree management can show the Street they know how to operate a resource play. If they can do that, the market will give them a higher valuation on all their production.*

The next likely catalysts for the stock will be drill results in the Alberta Bakken from someone else. A rising or falling tide of the Alberta Bakken will determine where this stock goes through the next 4 months - before DeeThree has results from either property that will impact the stock.

I will let you know how much stock I get. See if your stockbroker works for a firm that is part of the financing syndicate. The stock will come free trading whenever they issue a prospectus, which usually takes 2-3 months. This will give the stock some needed liquidity, i.e. it will trade more shares daily (illiquid stocks get punished in their valuation).

Look for a brief portfolio update this weekend (briefer than the last two), including Second Wave Petroleum (SCS-TSXv), an old OGIB stock. The full report on SCS is Bulletin 21 dated May 10 2010 and the best update after that is Interim Bulletin 46, dated October 28 2010.

Lastly, I love subscriber feedback and answering questions from subscribers - you sometimes pick up on details I have missed! So keep it coming, but please remember I cannot give any financial advice so questions such as "should I still buy this stock here", I just can't answer. That depends on YOUR risk tolerance.

Thank you for your support and we'll chat again Saturday or Sunday.