

## **INTERIM BULLETIN # 69 – MARCH 10 2011**

### **MARKET MELTDOWN MANIA**

### **Q4 FINANCIALS FROM GASFRAC, PEYTO**

### **UPDATE ON COASTAL ENERGY**

Let's start with the markets:

Today's market drop was likely a sea change in market sentiment for awhile, particularly for commodity stocks. And that means for the junior companies, which is where I do my trading, the change in sentiment could be even more pronounced.

Since September 2010, investors have enjoyed one of the most stable and steep rises in oil stocks, thanks in large part to US Fed Chief Ben Bernanke and his second round of quantitative easing - QE2. A rising tide lifted all boats, and quite possibly made many junior energy investors forget they are playing in the most volatile of all markets – the junior markets get hit first, they get hit hardest, and are usually the last sector to recover from a shake (or quake) in confidence.

I forgot. What was I doing not selling a bit of my Bengal Energy when it doubled in a month for me? The steeper the stock chart usually the longer the consolidation period. I own enough GasFrac I could have easily sold 10%-20% on this last run up and let some steam out of the portfolio.

I like to sell regularly. I like having cash. It makes me feel secure – and because I've been in the markets long enough to know that "stuff happens" – out of the blue – and then you're glad you sold. When you are selling 10%-20% of your position at 2.5x what you paid for it, there is no downside to that decision. I had been selling steadily in bits and pieces, but not much lately.

So, I am not going to talk about what may or may happen in the overall markets because there are a lot of guys out there a lot smarter than me on that.

But I can tell you a bit about how I see the junior oil stocks trading from here. Obviously, with the Saudi Day of Rage tomorrow and the ongoing Libyan situation, the crystal ball is very murky.

I see the global oil price holding its own here, maybe going a little bit higher unless there is some significant social disruption in Saudi Arabia. If that happens, then all bets are off and oil is on its way to \$150 quickly and the big boards – London Tokyo New York – will have BIG downdrafts.

However, if oil stays close to \$110 a barrel, I think the junior oil stocks have a 5-20 day swoon, steep at first then levelling off before basing and arising anew. The market's self correcting mechanism (collective sentiment) now works MUCH faster than it ever has, thanks to the instant global communications network we enjoy. So that makes me think the market will get its pain out of the way more sharply and quickly than in previous years.

Having said that there is probably still some debt in the markets that will now need to get repatriated back to its original owner, and that takes some time.

Assuming the oil price stays fairly constant here, I still think the junior oil trade has probably changed now. Certainly the more junior companies – the really embryonic ones – are going to have a tougher time attracting and keeping investor interest. Look at my own OGIB portfolio. Without hard news with fundamental value – production or significant reserve growth – companies like Wind River, Border Petroleum, the Alberta Bakken players (Primary Bowood and DeeThree) could face an uphill struggle. Anything in the speculative part of the OGIB portfolio will now need to produce solid positive results to increase in price.

Institutions that were previously willing to buy these stocks will likely now have a smaller appetite for the really risky plays and add to more “senior” junior positions like Ithaca and Sterling. That will certainly be my idea – if I buy more stock in an existing OGIB portfolio company it will be the more senior companies.

Another item to watch now that sentiment has changed is recent financings. Several OGIB stocks – Primary and DeeThree come to mind – just issued large free trading financings, and if those stocks fall below those financing prices, (72 cents and \$4.20 respectively), that could create a new resistance level for those stocks.

As much as I love the Alberta Bakken play, I may sell those stocks if they slip under their financing prices for more than a couple days. I am hesitant to sell some of these stories in the next couple weeks because I think the junior oil trade will be one of the first junior sectors to bounce back – but only on fundamentally driven news. I think the previous speculative premium many of these companies enjoyed will now be erased. I'm not convinced that area plays like the Alberta Bakken will now give the juniors a lift if somebody like Crescent Point (CPG-TSX) in Canada or Rosetta (ROSE-NASD) in the US announces positive drill results. It may, but it may not. All I'm saying here is I will be watching the charts.

Another item is the 4 month hold financings, like the ones I participated in Border Petroleum and Wind River. Should the junior oil market get and stay weak (like it was summer 2010) then I must (and will) assume that the institutions that bought those financings will be looking to sell their stock the moment it comes free trading (it's usually hard to short these illiquid stocks to

cover your financing). This means that the stock price will likely be close to the financing price at the end of the four month hold period.

Illiquid stocks – ones that don't trade very much – could be especially hard hit now. And I have a few of those!! If institutions own the majority of the free trading float in a junior stock – like they do now with Torquay or Border or DeeThree – they could be SELLERS into GOOD NEWS just to gain liquidity; get to cash. Again, this will likely only happen if the junior oil market gets and stays depressed. For those of you who have not been through a TRUE bear market, that can be tough to believe, but trust me – good news is just a liquidity event and it will take 2 or 3 bits of good news for those institutional sellers to exit the stock, allowing it to rise again. (The longer the base generally the bigger the pop up.)

I don't have any hard statistics, but I can say I have seen A LOT of money raised in the junior sector over the last year. Everyone is chasing the new shale plays in North America; the resource plays that are geologically consistent over large acreages and can support hundreds of future drilling locations – baking 2-5 years of low risk growth into the cake. Well, those plays cost \$50 million TO START, and a lot of companies have jumped into the fray. So they have issued tens of millions of shares to these (very willing) institutions to finance all that.

What this illustrates is that there is a lot of stock in the market now that takes a lot of liquidity to digest. Big chunks of that stock now might need to be sold on either bad news, no news **or even good news**. It will take a lot of buying to keep a stock up and unless there is really strong fundamental news by the company, that may not happen.

### **What happens to junior oil stocks if the oil price goes way up?**

It's quite possible that the higher the oil price goes now, the lower the junior oil stocks will trade, and here's why:

1. This will create a flight to quality among investors.
2. Oil and the market now have an inverse relationship (which is the market's way of saying the oil price really can't go any higher). If the oil price goes higher, the overall markets will go lower and scare investors out. The institutions/mutual funds that are now the gorillas in the junior resource market will get redemptions from these investors for their funds, and they will have to sell stock to create cash to pay out these mutual fund holders. They will sell the junior stocks first. During these times they don't care about the company, its story, its potential, or how the institutional broker that sold them the stock thinks it's still a great buy. *They are spared the luxury/curse of having to **think** about their investments.*

3. Exxon and Chevron etc and all the other senior global producers will likely trade in tandem with oil and benefit from an increased oil price – as will cash positions.

### **What about services stocks?**

In mini-meltdowns like we're having now, all the stocks get sold. But all things being equal, I see this new confusion actually HELPING service stocks – they will be increasingly seen as the NO-BRAINER section that I view them as. And I've got my eye on a couple right now.

### **CONCLUSION**

This likely reads quite negative, but my best guess is that we have some very near-term weakness and near term (2-4 weeks) mild weakness before the junior oil stocks resume their uptrend – though not on the same incline we've seen. Big land plays may not attract the attention they have – it may take production.

Geopolitically, it's going to be a very interesting two weeks, and no one knows what is going to happen. But for every small increase in Saudi political/social tension, oil will go higher and the market will go lower – likely taking the juniors with it.

So this incident has the potential to change the landscape for the junior oils, which means I change and I have no sacred cows. These companies now have to show me they have the goods, and the stocks need to show me they have the market support. Any delays or misses and I will be much quicker on the sell trigger than before.

And please remember that my service is a guide, not a bible and you may have different feelings and attitudes about the market.

### **GASFRAC – GFS-TSX *original write up Aug 25 2010***

Again, this is my favourite company in the portfolio. And they delivered Q4 and annual numbers better than I expected. The \$41 million revenue in Q4 was \$10 million more than I was expecting (no wonder the stock rocked last week) and at first glance, everything seems great – margins are fairly constant which is great as usually growth costs money. Yes you should get economies of scale and greater profits, but first – growth costs money. The number of jobs is up and the price per job is up, (due to bigger equipment being used, which is what the IPO was for – they should see a similar bump in Q4 11 from the bigger equipment they're buying that was paid for from the November 2010 financing).

## Other interesting points

1. The company has \$119 million in working capital and 60.6 million shares out – almost \$2/share.
2. Three customers account for 63% of revenue, but over 40 customers overall.
3. They now have 2 rigs working in Texas after bringing rigs back into Canada from the US in 2010
4. The LPG Fracturing Process patents for the U.S., Canada and International markets remain in examination.
5. Q1 2011 will be lower due to the 19 day self imposed work stoppage due to the first accident

Overall I would expect the market to see this as positive. I will be listening to the conference call tomorrow and reading the analyst reports on Monday to get a better sense of how the market is viewing this release.

## COASTAL ENERGY *CEN-TSXv – original write up is Issue #2 August 2009*

Only 16% of TSX Venture board stocks were up today, and Coastal Energy was one of them. This Houston based company has a large offshore acreage in the Gulf of Thailand and in early 2010 grew production from 2000 – 10,000 bopd due to two big wells at their Songkhla field.

Since then production has slowly crept up but recently stalled at 12,500 bopd.

They announced a new discovery at Bua Ban North, in two zones. (That would be the yellow blobs above Bua Ban-2) They also announced they had successfully fracked a well at Bua Ban that previously wasn't productive – it is now producing 270 bopd.

However, overall production at Bua Ban is declining – it was 3000 bopd from four wells, and it is now 2000 bopd, so I was a bit surprised to see the stock perform so well when really, right now, the company is on a production treadmill, with new discoveries replacing declines.

But the fact that the new frack works, and can be now used in other wells, adds another weapon to the Coastal arsenal and Bua Ban



North is now a producing field, both of which increases the future (and likely) upside in production.

The geology is confusing at their main Songkhla field, as there are many faults which make reservoir calculations (i.e. how much recoverable oil there is in each compartment that is boxed in by the faults) difficult.

The newly tied in Songkhla A-12 well is producing 1600 bopd. The new sidetrack well Songkhla A-07 tested at 800 bopd.

Overall production at Songkhla is 8500 bopd – less than what it was this time last year.

So while I do see a new discovery, the company has seen some big declines in production. Macquarie upped their target on the stock to \$10, and Canaccord kept theirs at \$9.25. I'll be speaking with management to get a better understanding of the potential here, but at first blush I'm content to stick with the 10,000 share position I have now – neither selling nor buying.

Their Benjarong frack on the A-01 well did produce some, but not enough oil to be economic.

## PEYTO PEY-TSX

This is the lowest cost fastest growing intermediate gas producer in Canada. I therefore use it as my gas ETF, much like I might use Eldorado Gold for my personal gold ETF – Eldorado is usually the lowest cost intermediate gold producer. Whatever sector you are in, my experience is that company has the best beta to its commodity price of any producer – big or small – in the entire sector.

Peyto issued its unaudited Q4 financials, showing production growth per share of 52% year over year. That would be several standard deviations up from the average western Canadian gas producer.

Even at current gas prices they have a recycle ratio of 1.8x – which means that for every dollar they put into the ground to find gas, they are getting \$1.80 back from selling it. So they are recycling their money 1.8x. The recycle ratio is profit per barrel divided by cost per barrel

Peyto was slow to pick up the horizontal drilling, but now that they have they are increasing production quickly, in their usual cost-effective manner.

Each of their three plays in the Deep Basin in Alberta – a liquid rich gassy area that hugs the central Rocky Mountains along Alberta's western border with British Columbia – is meeting expectations, except that the Cardium gas wells they are drilling are coming up with 90 barrels

of Natural Gas Liquids (NGL) – most of it condensate, the most valuable NGL – vs. the expected 45 barrels per million cubic feet of gas. That really helps with cash flow.

Production was 28,200 boe/d of gas at the end of Q4 and is 32,500 now.

If and when I get any sense Canadian natural gas prices will turn up, I will likely double my position here first then go looking at juniors.

**NOTE – I AM ON SPRING BREAK VACATION** next week skiing with my 14 year old prince who is determined to show youth beats experience. But I will be checking the markets daily – just not minute by minute as usual.