

**BULLETIN #63--WEEKLY WRAP – JUNE 19 2011  
UPDATE – DEETHREE EXPLORATIONS (DTX-TSX)  
WIND RIVER ENERGY (WVR-TSXV)  
GENERAL MARKET COMMENTS (OH, THE FEAR..)**

All junior stocks are hurting right now, but DeeThree didn't just drift lower this week, it got crushed. Whenever this happens in the middle of a drill campaign I get nervous – does someone know something? I always assume I'm the last guy to know anything, and that the chart never lies (at least on downside moves).

A brief chat with management calmed my fears – a bit. The first well that had an IP rate of 291 boe/d will be put online sometime in the next two weeks, as will the second well that hit water. The third will get fracked in about two weeks as well. So I'm led to believe that it's not really possible for anyone to get a sense just yet of how each of those first two wells are doing.

Realistically what I expect happened is that one of the funds who bought the \$4.20 financing was caught offside on another stock and desperately needed liquidity. Or they just lost faith in this play and thought the premium valuation on this stock would keep a lid on it and didn't want to wait for the market pain of the next month to play out (more on that in General Market Comments).

Each June the bigger Canadian energy producers hold a conference in Calgary called CAPP – Canadian Association of Petroleum Producers. All the sell side (that= brokerage firms) analysts and investment bankers are there schmoozing with management, and a lot of buy side (pension funds, managed money fund managers) people are there too.

One of the sell side firms there, Macquarie Capital, issued this brief research note on the Alberta Bakken play from a conversation with Murphy Oil (MUR-NYSE) that was there. Macquarie's angle was to see how this might relate to DeeThree, as they cover DeeThree and did a big chunk of the \$4.20 financing. I have stuck my own notes in between in italics:

"Alberta Bakken:Yesterday at CAPP we cornered the representatives from Murphy (MUR US) in the breakout session to try and get better insight into what they are doing in the emerging Alberta Bakken play in southern Alberta. We came away with a number of insights from their first couple wells into the play.

First, the company confirmed that the first two wells were drilled into the Exshaw formation, and not the Banff or Big Valley. This is the equivalent of the main producing formation in the North Dakota Bakken.Note that the Exshaw is the same formation that DeeThree (DTX CN) targeted for their first Hz well into the play (initial IP of 250b/d).

Second,The company cored the Banff, Big Valley, and Exshaw formations and did not find any material levels of water. Interestingly they also cored the Second White Specs formation. Primary Petroleum has also strongly suggested they expect to see some successful uphole production (like the Second White Specs) from the Alberta Bakken.

Third, the company confirmed that their early view of well economics in the play looks something like 225-250 b/d IP and 225-250 mboe EUR. My talks with both oil & gas and finance people associated with this play is that Murphy did much better than this. Which, assuming a D+C cost of \$4.0mm, drives single well economics of - NPV10 BT ~\$5.2m, AT ~\$3.1m, IRR BT 61%, AT 39%. This is much better than the Dundee report of a couple weeks ago that only had NPV10 of \$1.6 million. We have included the choose-your-own adventure well economics table from our last DTX CN report below: "BT=Before Tax, AT=After Tax

NPV=Net Present Value, and you can roughly think of this number as the amount of money the producer will have left over, after all costs in getting the well to produce at that level. Very roughly you could call it the profit.

**Fig 1 NPV / IRR well sensitivity – AB Bakken horizontal oil well**

All-in Capital Cost	IRR (BT)	IRR (AT)	NPV10 (BT)	NPV10 (AT)
C\$6m	29%	20%	\$3,195	\$1,650
C\$5m	42%	27%	\$4,187	\$2,396
C\$4m	65%	40%	\$5,179	\$3,142
C\$3m	107%	64%	\$6,170	\$3,889
C\$2m	201%	120%	\$7,162	\$4,635

30-day IP Rate	IRR (BT)	IRR (AT)	NPV10 (BT)	NPV10 (AT)
300bbl/d / 225mbbl	70%	43%	\$5,338	\$3,249
250bbl/d / 225mbbl	66%	41%	\$5,261	\$3,197
200bbl/d / 225mbbl	61%	39%	\$5,229	\$3,176
150bbl/d / 225mbbl	55%	37%	\$5,102	\$3,091
100bbl/d / 225mbbl	49%	33%	\$4,890	\$2,949

30-day IP Rate	IRR (BT)	IRR (AT)	NPV10 (BT)	NPV10 (AT)
300bbl/d / 269mbbl	85%	51%	\$6,522	\$4,043
250bbl/d / 221mbbl	65%	40%	\$5,179	\$3,142
200bbl/d / 174mbbl	45%	30%	\$3,702	\$2,153
150bbl/d / 126mbbl	26%	18%	\$1,838	\$903
100bbl/d / 79mbbl	9%	6%	-\$101	-\$402

Assumes US\$90/bbl WTI, US\$6.00/mmbtu NYMEX, US\$0.95/C\$  
Sensitivity on Capital Cost assumes IP30 of 250bbl/d and EUR 225mbbl  
Sensitivity on 30-day IP assumes All-in Cost of \$4m and EUR 225mbbl

Source: Macquarie Research, May 2011

So this is positive news, but not likely to help the stock until wells 2 & 3 are out.

Whenever a stock I own takes a dive like this I have another look at my math and justify to myself what the stock is worth...and then I was writing this out for myself, I realized, wow, this is what sell side analysts do every day! So I decided to share this with you.

This is very rough math. But for me the process was more interesting than the outcome. This is the type of mental hoops the analysts at brokerage firms put themselves through to come

up with positive comments on a stock so you - the retail investor – will continue to buy the stock and provide liquidity for the institutions that bought the financing that gave them, the brokerage firms, all their fees and commissions.

Of course, the only REAL thing here is that if DeeThree's Alberta Bakken wells keep hitting 200+ bopd IP rates, the stock is going higher,(once we get our market back) and if they don't, the stock is going lower. Because DeeThree doesn't need money (\$20 million cash and \$20 million untapped debt that could go to \$40 million) - it's that simple.)

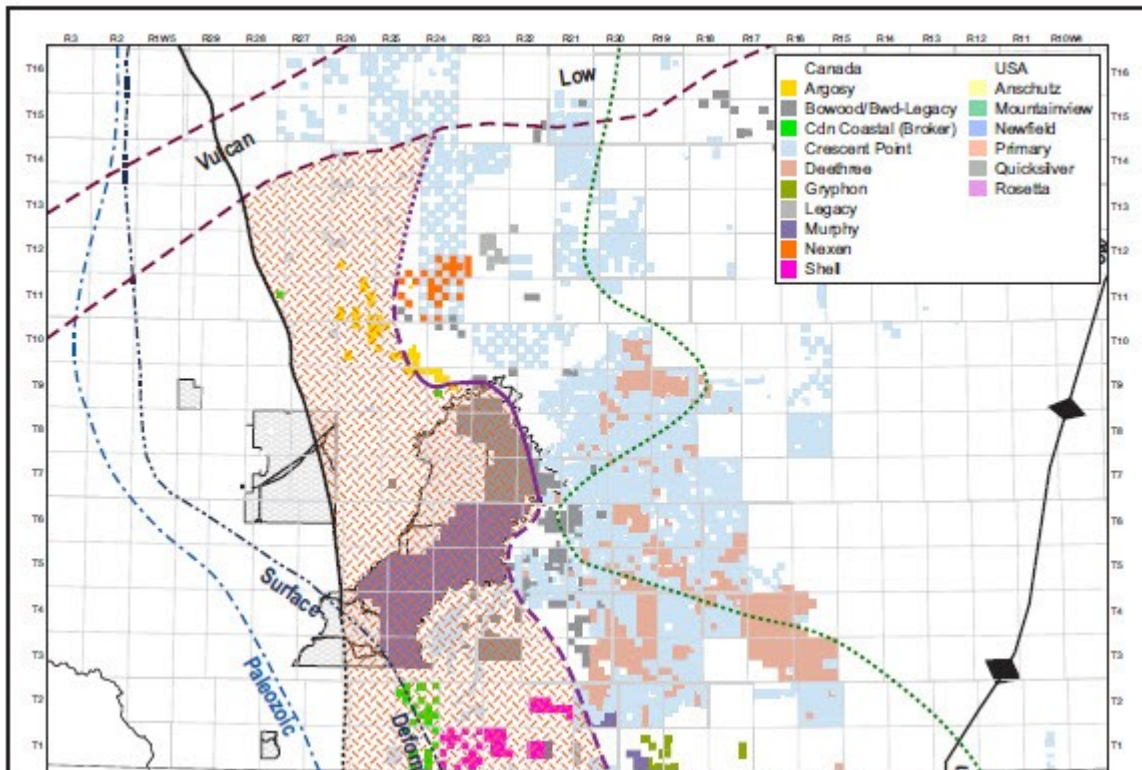
So, my best guess at this early stage on Macquarie's NPV chart above is the middle line in the middle chart that gives an After Tax NPV10 of \$3.176 million. At roughly 270 net sections in the play, and at 4 wells per section, a very rough unrisks NAV (which means that every well will hit and the average will be this level of production etc. ) is  $4 \times 270 \times \$3.176 \text{ million} = \$3.43 \text{ billion} / 64.6 \text{ million shares out} = \$53 \text{ a share.}$

Every well WON'T hit that and the stock will never go anywhere near that level. But that unrisks potential valuation does explain the premium valuation the stock has been getting for the last 8 months. (And of course, as investors in junior stocks this unrisks NAV that is a multiple of current stock price is what we want to invest in – huge upside potential if it works).

Back to reality. A 2250 boe/d producer that's 70% gas is likely worth about \$40,000 per flowing barrel, which gives a value of  $2250 \times \$40,000 / 64,600,000 \text{ shares} = \$1.40 + \text{cash.}$

That's a big difference from \$53! And that's why this stock is a high risk high reward play. But originally, the core from historical holes, which looked just like those from the original Bakken, and now the success of several wells, has reduced the risk dramatically.

Looking forward - my impression is that most operators are drilling as far southwest as their land position will allow. See the map of landholdings below, overlaid by where Canadian brokerage firm BMO Nesbitt estimates the overpressured part of the formation (shaded, on the western half) to be. The bottom of the map is the Montana (US) border.



The western half of the Alberta Bakken is overpressured, which means the oil should squirt out of the ground easier if it has all the pressure inside the formation – that means higher production rates. DeeThree's first well was there, and Argosy's well was on the western boundary of their lands just inside the overpressured part. Even the recent 25 section joint venture with an anonymous JV partner is in the southwest corner of DeeThree's land position.

DeeThree CEO Martin Cheyne tells me that they still have roughly net 50 sections in the southwest and central parts of their land position, after the joint venture.

\$1500/acre is roughly \$1 million per section (640 acres=1 section, or \$960,000). Land has sold for \$1300 an acre, and now that DeeThree hit in the SW corner of their block, \$1500/acre is a reasonable price to consider.

If these 50 sections each have 4 wells that have \$3.176 million AT NPV10s, that's \$12.7 million per section. There's no problem paying \$1 million per section if you'll get \$11.7 million back! But all this math has yet to be geologically proven.

So I think there's a good chance those net 50 sections are worth close to \$50 million. If I put the rest of their 200+ sections at a nominal \$10 million value, that's \$60 million in land value. (That \$10 million would go up (A LOT) if this second well in the eastern part that hit water is economic.) If the company has an enterprise value (market cap - \$20 million cash) of \$157 million, that leaves \$97 million value for production – which is \$97 M / 2250 boe/d production – that equals \$43,111 per flowing barrel. This is roughly what I see as fair value in both land and production. But make no mistake, all this mental math means nothing if they don't hit on any more wells.

Two weeks ago DeeThree had a GREAT looking chart—upticks in price, momentum, all the

internals looked good. Now, unfortunately, there is nothing positive about this stock chart. A lot of technical damage has been done and in the absence of news for a month I could see further downside in this market.



## WIND RIVER ENERGY – WVR-TSX

This new asset near Phat City Montana intrigues me. First off, it's out of the blue as I bought the stock for the Niobrara play in New Mexico. Second, this oil play cost them just over \$1 million for a 50% interest in 46,543 acres (roughly 72 gross, 36 net sections) in an area where previous wells produced over 1 million barrels of oil.

Management didn't want to talk about the asset until the new powerpoint is up sometime this week. But I would suggest wells that have EURs (Estimated Ultimate Recovery) of 1 million boe are conventional and come from highly porous formations; they don't need fracking. I've never heard of a tight/shale play with wells of 1 million boe EUR. No fracking means relatively low cost well – probably \$2 – \$3 million for that 7000 ft depth. The pro-forma

Internal Rate of Return (IRR) and recycle ratio on these wells is likely VERY high. That depth will have light oil.

The point here is that these very small juniors like Wind River and Border Petroleum that are tackling tight oil resource plays have huge capital requirements - \$5-\$6 million a well. Paybacks are usually 2 years. So if Wind River can have a big recycle ratio oil play that has some legs (26 net sections gives it some decent running room, depending on the size of the play), that goes a long way to creating the cash to fund the larger Niobrara wells and reducing dilution.

## GENERAL MARKET COMMENTS

I buy stocks that will move up on successful drill results – specific catalysts. But the reality is stocks go up and down with the market. And right now what I'm reading in the junior oil and gas market is that until oil gets under \$90 and stays there for a short while, the market is not willing to buy the juniors in such a wave that a rising tide will lift all boats like it did from September 2010 to March 2011.

Seeing a few more juniors get rewarded for good news will be a good intermediate sign the bull market in junior oils is returning.

So there is two very counter-intuitive factors out in the market right now – one is that junior oil stocks as an overall group aren't going higher until oil goes lower. The second is related – the market isn't buying junior oil stocks (besides the usual summer doldrums) because the market has too much faith in the oil price, not because it doesn't have enough. The market believes that if oil does go to \$150 a barrel demand destruction will force us all into another global recession – and if recession is coming, sell the riskier juniors first.

That actually brings a third counter-intuitive thought into the mix – once the market is convinced the oil price will stay low enough to not cause recession, it will buy the juniors as even at \$85/bbl these companies make GREAT money.

Finally, I read A LOT of research – macro stuff, oil and gas sector and stock specific. I try to stick to my knitting in the junior oil and gas space and not spend too much time thinking about the big picture – I just want to be aware of it to the point where it affects my investment decisions.

The 2008 financial crisis showed that the world's financial structures - the central banks, large hedge funds, the IMF, are much more interconnected now than ever before and unfortunately one group's mistakes (usually but not always, misguided greed), or wrong bets, can affect millions of unrelated people.

And so I have been watching the drama surrounding the finances of the PIIGS (Portugal, Ireland, Iceland, Greece and Spain) with interest. I came across a piece from Macquarie Capital on June 16 that resonated with my thinking – here it is.

It says they believe the world's economy is getting better, but low volume in trading of stocks, and low fear levels in the market are not yet consistent with the bottom of market corrections – in fact, we may soon see a downward spike, a gap down, in the markets that would signify a

market bottom (but after that it's all going to be OK):

"As a firm believer of market cycles and financial history repeating itself (or at the very least rhyming somewhat), this summer is a tad ridiculous.

Rewind to May / June of last year and at first blush, events are transpiring much in the same fashion. The Greek debt problems were causing investors to sell the euro, concerns over European banks mounted and overall economic data was softening. That is very similar to the events weighing on the markets today.

The S&P/TSX Composite has brushed against the official correction zone of being down 10% from the recent high.... U.S. markets aren't doing much better with the S&P 500 having declined by 8%. This has both equity markets in oversold territory. The weakness has investors understandably skittish regarding the prospects for the summer and beyond.

Europe – It isn't new news that Greece is in dire financial trouble and even with continued bailouts from the European Union and IMF, the country's path remains very uncertain. Currently, the battle is really between Germany's view that bond holders should share in the costs to restructure Greece (aka extend duration of existing bonds which is in effect a debt default) and France's view that a default must be avoided. A default would certainly weigh on the balance sheet of many European banks that own significant amounts of Greek debt. This has been impacting not just European bank shares but really banks around the globe.

Will Greece default? Maybe. Will they leave the single currency union? Maybe. The political will of nations on much firmer financial footing to fund continued bailouts is clearly waning. There is also a substantial amount of jockeying at play here in a high stakes experiment in game theory as the rhetoric mounts. Are we overly concerned? No.

The world was well aware the European sovereign debt risks hadn't gone away, but the bailout funds from the union and IMF certainly put a big bandaid on the problem. Now the bandaid has fallen off and nobody likes what they see underneath. But once the rhetoric dies down, we would expect them to put a bigger or new bandaid on the problem.

The core of Europe remains to be in relatively good shape from an economic and financial perspective. And if there is anything the global financial crisis taught the central bankers of the world it was, avoid systemic risk. We don't believe European debt issues will derail the market recovery and this likely won't be the last time this issue roils markets. In the meantime, the turmoil is certainly contributing to the "risk off" trade impacting everything from equities to commodities.

Economic Air Pocket – Over the past month we have continually written, and presented in a number of cities, about the economic air pocket evident in the data. Using Citigroup's Economic Surprise Index, we have noticed the trend in U.S. data has been steadily deteriorating over the past couple of months.

But this appears to have stopped and even improved a little. Also of note, Canada and the Eurozone continue to remain relatively stable. And Chinese data now appears to be improving. It will be crucial for the overall market that we begin to see an improvement in the economic data. The question is when.

While not solely responsible, we do believe the data is being skewed by a number of temporary factors. Energy prices had been rising for much of the past 8 months but recently prices are now below levels from last quarter. This should stop absorbing disposable income and may actually begin to free up cash for retail spending. Oil prices are 3% below last quarter in part thanks to the \$15/barrel pullback during the past few weeks.

Plus the disruption stemming from the earthquake in Japan is currently impacting both manufacturing and employment data, around the world but more so in the U.S. Given our just in time logistics reliant manufacturing approach, disruptions can really impact operations. But as Japan's industrial production has recovered, we would expect the same in other regions.

We continue to believe that these temporary factors will dissipate as the data comes out over the summer months.

### **Corrections, They Are Rather Common**

#### Years With a 10% Correction

1981, 1982, 1984, 1987, 1988,  
1990, 1991, 1992, 1994, 1995,  
1997, 1998, 1999, 2000, 2001,  
2002, 2006, 2007, 2008, 2009,  
2010, 2011?

#### Years Without a 10% Correction

1983, 1985, 1986, 1989, 1993,  
1996, 2003, 2004, 2005

From 1981 to present

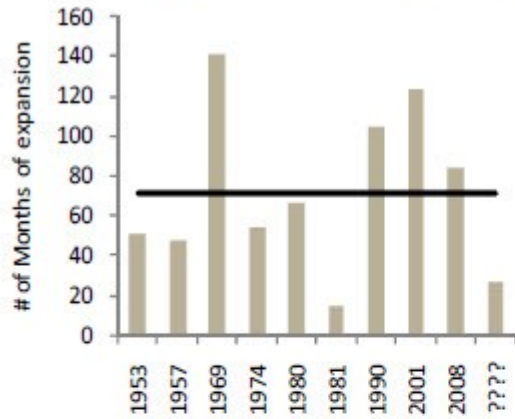
### **Big Picture**

Few would disagree the summer is lining up to be a volatile one for the markets and given the fact that we had not experienced a correction since last summer, some may believe we are due. But let's not forget the big picture. Economic expansions typically run for about 75 months on average and if you exclude the double dip we experienced in the early 1980s due to some ill timed monetary policy plus the need to kill inflation, the average would be longer.

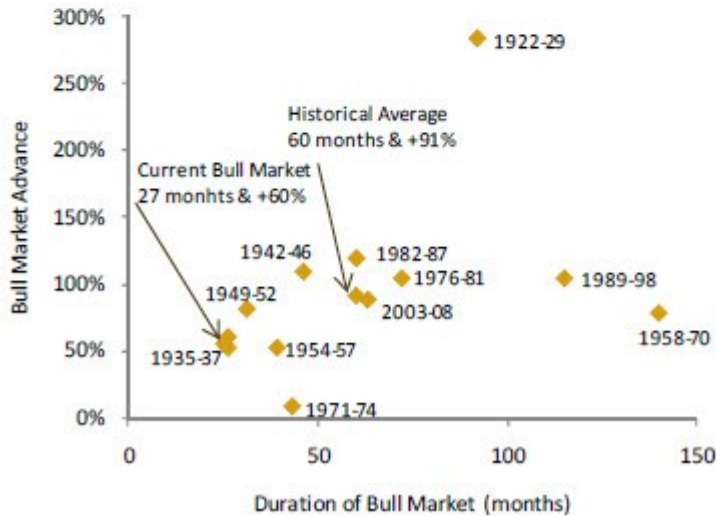
Currently we are still less than 30 months into this economic cycle which is encouraging. Add to this, the economy hasn't really added much capacity or labour as of yet, so it would be very surprising to see this cycle end anytime soon.

Then there is the market cycle. We went back to 1920 on the TSX and looked for actual bear markets, a decline of 20% or more. We also measured the subsequent bull market, once the TSX had advanced 20% off the bottom. What we found is the average bull market has been 60 months, or 5-years, and the TSX rose an average of 91% (or 111% off the low). The current bull market is 27 months old and has risen 60%. And, based on all the bull markets during this period, if this one ended this summer, it would be one of the shortest on record. We don't think that is going to happen.

## Economic Expansion Still in Early Innings



## ...as is the Market Advance



## Buying Some Now & Some Later

In our view, the markets do appear oversold by most measures at this point. Market Breadth for the TSX is down below 20%, meaning less than 20% of the index constituents are trading above their 50-day moving averages. This is roughly the level that market breadth bottomed during last summer's market correction. In the U.S. market, only 17% of the S&P 500 constituents are trading above their 50-day moving averages. At the sector level, the more cyclical sectors and financials appear to have the weakest market breadth.

Relative strength of the market is pointing to a good entry point as is investor sentiment. Plus, if you look at the trading ranges of most sectors and indices going back a couple years, most are at the bottom end of their ranges

So why are we only buying some?

During the market weakness of the past six-weeks there have been a couple of nagging missing pieces. The first was the VIX which measures the implied volatility in the equity index options market in the U.S. If the market were anywhere near a capitulation event, this would

be much higher and so far it has remained stubbornly low. Only during the past few days has it started to rise. The other aspect that is of some concern is the volumes during the market retreat. Look at the volumes last summer and that was clearly motivated selling/buying.

Currently, volumes have remained rather low which may mean there is a sudden down gap ahead of us. And while some may choose to wait, we have also become cognisant that these don't always arise. And the market could begin to recover on better data and resume the recovery path. Earnings season begins in less than a month and this does typically give strong evidence of the underlying economic recovery.

There still may be more weakness ahead of us as the European and economic news weighs on the markets. But given the degree of the pullback, we have started adding to the portfolio we run at Macquarie Private Wealth.

#### WHAT I LIKE RIGHT NOW

Both Wind River and Border Petroleum should have new powerpoints this week that will give investors a better idea of their assets. With drilling success, both these stocks will be strong in the fall of 2011 – Border potentially sooner.

Wavefront (WEE-TSXv) is getting an audience again, as seen by the volume and price burst when they announce news. Again, as the stock trades down here under \$1, it doesn't want to go under 90 cents. I am a buyer on any given day here to add to my position.

Golar (GLNG-NASD), Secure Energy (SES-TSXv) and Coastal Energy (CEN-TSXv) continue to have excellent stock charts.

The chart on TAG Oil (TAO-TSXv), however, is weakening – not completely negative yet but the price has cut through all its moving averages in the last two days, Relative Strength has gone negative and MACD is about to go below zero. They should have one more good piece of news coming – the initial flow rate on the Sidewinder 4 which has 47 feet of pay. However, after that there may be no more news until these wells get brought onstream in late August (I know they have been doing some work in the east coast shales but I expect no news this summer on that). That's two months from now in what will likely be a very choppy market.

This upcoming press release on the final Taranaki well could be a trading opportunity.

REMINDER – I AM AWAY FOR A MONTH– from July 6 – Aug 2 on holidays. I will be keeping a distant eye on markets and OGIB stocks, but unless there are any drastic moves my communication flow will be minimal. (You all deserve a break too ;-)). Please email any comments or concerns to [customerservice@oilandgas-investments.com](mailto:customerservice@oilandgas-investments.com) and my team will forward it on to my blackberry.