

## BULLETIN # 44 – FEBRUARY 6 2011

### WEEKLY WRAP – GASFRAC (GFS-TSXv) AND DONNYBROOK (DEI-TSXv)

#### **GASFRAC (GFS—TSXV)** (original write up August 2010)

This was the first week for the stock after the company announced it had re-started operations, following an industrial accident last month. The stock's performance told me it was business as usual and the market was not going to put it in the penalty box for the accident.

BMO Nesbitt Burns removed its \$8/share underperform target and replaced it with a \$14 target and an outperform rating.

Regional brokerage firm Haywood Securities initiated coverage on GFS, re-iterating most of the things I already knew about the company, including

1. the NY State Dept of Environmental Conservation has recognized GasFrac's operations as "green" alternative to traditional water fracking.
2. named Husky and Pennwest as clients, and said that multiple repeat orders from these clients was giving GasFrac a big backlog – to the point where one unnamed client has asked for their entire fleet capacity for the next 12 months and longer.
3. almost all the \$65 million raised in the IPO has been spent on increasing the fleet, so they now have 105,000 horsepower (HP) vs the 50,000 HP they had when they went public in August 2010 – so they can now do bigger fracs and more fracs and be more efficient, (what that really means on the ground is that they can move equipment around faster and set up times at a job)
4. by year end 2011 they will have 152,000 HP
5. GFS costs \$220,000 for a frack job vs \$180,000 for traditional fracks, but clients can get \$500,000 in value
6. It is an ideal takeover candidate by an energy services giant like Schlumberger or Halliburton

Haywood put a \$15 target on the stock, based on a 6.1x EBITDA (roughly equivalent to cash flow) multiple.

A couple things I didn't know that I will be asking management about include a new Mobile Propane Recovery System, and a Field Management Program that sounds like it could involve outside parties doing frack jobs, but I have to call Reid MacDonald and ask him.

The other very interesting point (IMHO) that Haywood brought up was that GasFrac is expecting to hear back on several patent applications in the coming 2-3 months, which could be a catalyst for the stock.

I've said before that I don't consider the patent issue a big deal either way – when Halliburton or Schlumberger decide to try their hand at propane fracking, they'll just tell GasFrac to go sue them (or go frack themselves ;0)). And if anything, this recent accident will tell the market that they NEED to hire GasFrac who has all the experience in this realm in case something goes wrong.

So I'm not convinced the patent approval/denial would mean much for the stock.

## DONNYBROOK ENERGY (DEI—TSXV)

Donnybrook and Cequence issued news this week on their first horizontal Montney well in the Simonette area, which is in the southeast end of the Montney. It was a very good well, with flow rates of 6.4 million cubic feet per day of gas and 100 barrels per day of condensate – the most valuable NGL, or Natural Gas Liquid.

So how many boe is that – or barrels of oil equivalent?

To get the boe number, divide 1,000,000 cubic feet of gas per day by 6000 – that gives you 166.67 boe. So 6.4 million / 6000 = 1066.67 boe. Then add 100 boe of condensate and you get 1166.67 boe. The average western Canadian well produces 50-80 boe.

First, there is a saying in the oilpatch that goes “All boe's are not created equal.” And that's right. Pure dry gas is the lowest value (has the lowest profit margin per boe or *netback*), and condensate or oil would be the highest – and with the gas:oil ratio so high, there is a huge difference in value between a 100% gas boe and a 100% oil boe. The netback on gas right now might be \$10-\$18 per boe, whereas I have seen some oil plays have \$58 netbacks.

Investors can see how the market prices in that difference in the stock when you value it “per flowing barrel or boe” – a metric I use often. To do this you divide the enterprise value (market cap + debt, or – cash) by the production in barrels of oil per day. Oil production – particularly from large low risk “resource plays” can regularly be \$120,000 to \$150,000 per flowing boe, vs. \$30,000 for some gas plays.

Cequence actually released this well as part of a bigger release that included several wells. Research on Cequence focused mostly on Cequence's other wells, but reaction was very positive. (Nobody covers Donnybrook as DEI management wants to make shareholders rich

and not investment bankers, i.e. they raise their own money.) Cequence's stock has jumped 30% in the last two weeks, and most analysts upped their targets on CQE from \$3 - \$3.50.

Analysts estimated CQE would put 3 wells per section on their Montney Simonette lands, where the Donnybrook well was. (DEI management has said 4 wells/section, and next door at Resthaven Celtic is using 4 wells per section.) With DEI having 20 net sections in that area, that is, conservatively, 60 wells.

One brokerage firm guesstimated that each well would have an EUR (Estimated Ultimate Recovery) of 3.3 Bcfe, with 30 barrels of condensate per million cubic feet of gas (expressed as 30 bbl/mmcft) and cost \$5.5 million all-in, but gave no IRR or NPV number. Other analysts guesstimated an EUR over 4 bcfe per well, so when I use 3.3 Bcfe, and only 3 wells per section in my valuation math below I'm being very conservative.

Another firm gave the well (follow my math here) an

- after tax NPV of \$3.7 million based on their commodity price forecast – SO....
- multiply that by 60 wells (80 @ 4 wells/s) to get \$222 million (\$296 million on 80 wells).
- divide by 182 million shares out fully diluted (and all options and warrants ARE in the money so I will use the fully diluted number),
- to get a rough (and conservative) value of **\$1.22 per share JUST for their net 20 sections at Simonette (\$1.62 on 4 wells/section)**

And we have yet to find out what their 70% Resthaven well will produce – that will just be gravy on the top. The original Celtic (CLT-TSX) discovery well had TWICE the IP rate what this Simonette well has. Assuming the 5 gross sections (3.5 net to DEI) that DEI has there are productive and could hold 3 wells per section, then DEI has 10 net wells which will be between 3-6 miles away from this discovery well.

And DEI has six net sections in nearby Montney areas Bigstone and Gold Creek that have not been tested.

A couple subscribers emailed in asking why the stock didn't go up on this news. It's important to remember that a stock and the underlying company are two different things that are, for the most part, related.

But one is fundamental, (the business) and the other is just mental (the stock).

The stock usually acts as a clairvoyant mind-reader, pricing in what investors *believe* the company should be doing 6 months from now.

But this stock has a lot of warrants overhanging it from previous financings, and these warrants have an increase in their strike price this month – giving investors huge incentive to exercise them quickly. Some investors just sell them, and some like me (in this case ;0)), exercise and hold them.

*(Lynden Energy shareholders take note – this is what will happen to LVL – any good news that creates big liquidity will likely see a big avalanche of warrant exercises for the first while).*

The stock was running ahead of the company on anticipation of this good news being announced. So now there is a fundamental value underlying the stock, whereas prior to this discovery the only tangible value was cash on hand. The stock traded 24 million shares this month, 2-4x normal as the price continued to rise, so that's a very good sign.

Their new powerpoint is posted to their site:

<http://cms.spincaster.com/siteFiles/27/files/DEI26Jan2011.pdf>

## **OTHER PORTFOLIO UPDATES**

**STERLING RESOURCES – SLG – TSX** (original write up Issue 11, Dec 29 2009)

The market continues to bid the stock up in anticipation of positive results from Cladhan well that is spudding late February. My only concern is that expectations are now very high for this well.

**BENGAL ENERGY – BNG-TSX // COASTAL ENERGY – CEN – TSXV // EQUAL ENERGY – EQU-TSXV**

All three stocks are moving up on no news – especially Bengal. I interviewed Bengal CEO Chayan Chakrabarty last week and will be preparing my write up this week. They have one offshore well coming up in which they have a 10% interest, and other producers in the area have had 4000 bopd wells. I'm not convinced that market speculation on this well is moving the stock price up. The company needs to find joint venture partners for its Indian assets.

LASTLY – I am completing my report on **GOLAR LNG – GLNG-NASD** – and I consider this stock a top pick to make me money for many years, just like GasFrac. It pays a 6% dividend at Friday's close, or \$1/share now.

Day rates in the LNG (Liquid Natural Gas, which is compressed to 1/600<sup>th</sup> of its normal volume when liquified) shipping business have made a big jump recently as basically every ship in the world is now busy. They have a technical edge in that they are the world leader in building and operating FSRUs – Floating Storage and Regasification Units. These FSRUs are ONE FIFTH THE

COST of an LNG import terminal, and put the gas back into its usable state offshore, just over the horizon, so there is no NIMBY syndrome – Not In My BackYard.

So just like GasFrac, it creates an economic and environmental win-win, and they are the world leader in this rapidly developing new market. Management owns 46% of the stock and has an INCREDIBLE track record in increasing dividends in their other shipping companies.

I will explain in my report how and why I see the company tripling its dividend to \$3/share in the next 3 years, and the market feeling so secure about the cash flow behind it that it will give the stock a 4% yield – making for a potential stock value of \$75/share. The stock closed Friday at \$17.85 and I will have my report ready by Wednesday.