

Bulletin # 50: Donnybrook (DEI)

THE NEXT JUNIOR GAS BUYOUT IN CANADA?

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Natural gas stocks have been some of the best performers in the Canadian energy patch in 2011, despite low natural gas prices.

These high flying stocks – like Artek (RTK-TSX) and Celtic Explorations (CLT-TSX) and Cequence Energy (CQE-TSX) have one thing in common – they are finding gas in the Montney gas play that straddles the B.C. – Alberta border in western Canada. Several companies in this play have been bought out – Storm Explorations was bought last year by ARC Energy, and Monterey Explorations was taken out by Pengrowth Energy Trust *for an 80% premium.*

I see another junior that is setting itself up to be the next Montney buyout – **Donnybrook Energy (DEI-TSX)**. I alerted my subscribers to Donnybrook at \$0.23 cents last October, just after new management joined. I knew of Murray Scalf (Vice President) and Malcolm Todd (CEO) as Scalf had just sold his private company in Alberta's Cardium oil play to Wild Stream Exploration (WSX-TSX) – one of my favourite stocks at the time - for \$10 million.

Last year they quietly assembled interests in 55 square miles – about 40 net square miles, or “sections” as the industry calls them -- and have already hit big on their first well. The market is now expecting results of their second well in April. That well is only three miles from one of the biggest wells in western Canada last year, and was drilled by Celtic. It was the sparkplug that ignited Donnybrook's land values and a host of other Montney stocks. And Celtic is participating 30% in this second Donnybrook well.

In the next few pages I'll explain why the Montney is such a hot area, and is getting so much attention from investors – despite being a gas play in a time of low gas prices. And I'll show you why I think Donnybrook is one of the best positioned companies in the Montney to get bought out – and I'll share the ballpark price I'm hoping to get for my Donnybrook stock.

I back up every stock pick I make for my subscribers with my own money. They know how much I've bought at what price. The portfolio that subscribers see is my real dollars.

Lastly, I will explain how the recent Japanese earthquake and tsunami is having a positive benefit for Montney gas stocks.

Even after securing a big land position, hitting on a big well and getting two experienced partners to earn-in on their lands, I am on the only person/company following Donnybrook. Even as a triple for my subscribers, it remains undiscovered by The Street.

QUICK FACTS

Trading Symbols:	DEI-TSXv
Share Price	\$0.63
Current Production:	250 boe/d (50 bopd liquids and 200 boe/d gas)
Shares Outstanding:	170,772,066
Fully Diluted:	188,977,322
Market Cap:	\$119 million
Net CASH:	\$10 million
Enterprise Value:	\$109 million

HOW DONNYBROOK ACQUIRED ITS BIG LAND POSITION SO CHEAP

Many investors don't realize the revolution that has forever changed the global energy industry: we can now get oil and gas out of ROCK – specifically shale. That only started in the late 1990s in Texas, but has spread across North America in the last 13 years, and is now going global.

Dozens and dozens of new oil and gas discoveries are being made, creating hundreds of billions of dollars in market capitalization, and enriching investors in plays like the Bakken in North Dakota and Saskatchewan.

Companies can now make a well bore go horizontal for over a mile – through very tight sand or rock -- that they never could before. Then they blow water and sand down at ultra-high pressure, fracturing the rock and letting the oil & gas it holds flow out to the well. This is called “fracking”.

A horizontal well with fracking costs twice as much as a vertical well, but gets 4-7x as much oil and gas – so it's very profitable.

It's so profitable that the North American producers drilled like mad and discovered so much new natural gas supply, the price of gas on this continent has collapsed. Natural gas stocks collapsed along with it.

The good news was, land values for gas plays in Alberta also fell dramatically. And the provincial government had just increased royalty rates, inflicting more pain on producers. Capital fled the province to British Columbia and Saskatchewan.

It was the bottom of the market, and that's when Scalf, Todd and Donnybrook started buying Montney land – on the Alberta side.

WHY IS THE MONTNEY GAS PLAY SO SPECIAL – AND PROFITABLE?



As I said, Montney gas producers have been some of the best performing energy stocks in Canada over the last five months.

Six factors are helping improve stock prices for Montney gas producers:

1. The amount of gas being found per well is increasing – because they are discovering gas in different formations at different depths in the same drill hole (and a new, even lower formation being chased now is fetching the highest land values ever seen in Alberta!)
2. The Montney is producing many kinds of gas – not just methane, which heats your home, but also *propane* (for BBQs), *butane* (for BIC lighters ;0) and *condensate*, which is used to dilute the heavy oil from the oilsands so it will flow in a pipeline. *These other gases, called Natural Gas Liquid, or NGLs, are **2-15 x more profitable** than methane gas.*
3. Improving technology – fracking - continues to open up old formations that before, no one thought would work – even now, five years after the play became big
4. Fracking works better in the Montney because it is geologically more a tight sand formation, not an actual shale as much
5. The producers are expanding the size of the play – lately to the south and east – which is increasing the size and speculative appeal of the Montney play where Donnybrook is
6. Recent corporate transactions have pegged the value of Montney land at \$5.7 million per section

7. The price of these NGLs is now increasing even more in the wake of the Japanese earthquake and tsunami, as Japan is the second largest user of LNG in the world.

These factors point to Donnybrook getting bought out for 50%-100% higher than its current stock price. Here are Donnybrook's two main properties:

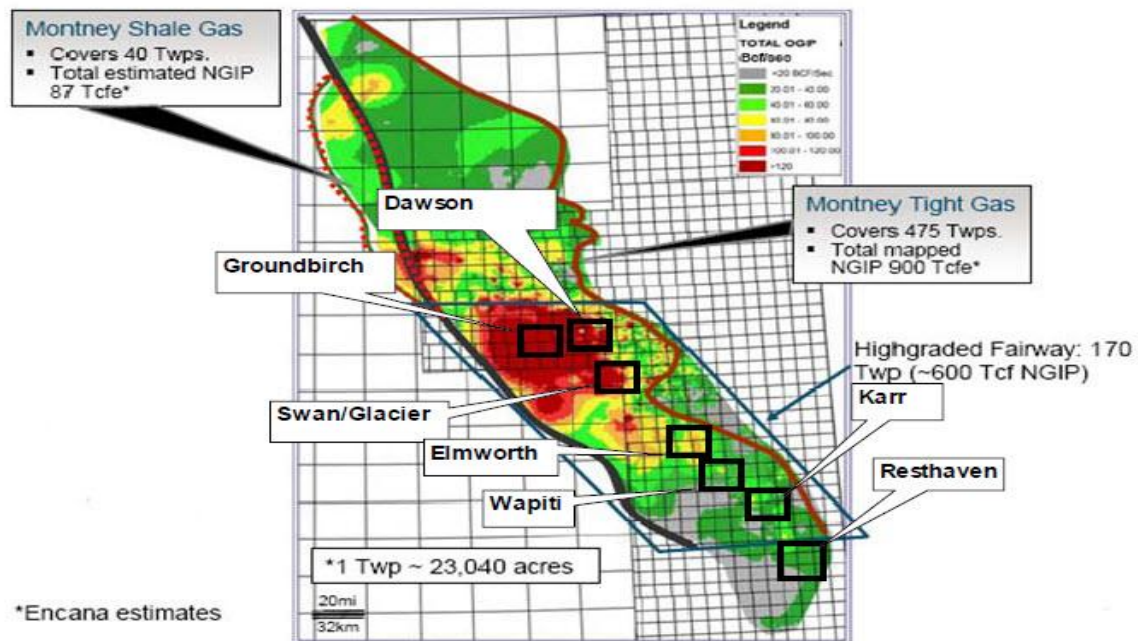
RESTHAVEN – 70% Working Interest, Celtic Exploration 30%

This is the smaller Donnybrook property, but this area is what sparked so much market interest in its stock.

As background, the average well in western Canada produces 50-80 barrels of oil a day – the equivalent amount in natural gas production would be 300,000-500,000 cubic feet of gas per day.

In November 2010, Celtic Explorations – one of the most highly respected intermediate producers in Canada – hit a huge gas well near Donnybrook's land that Initially Produced ("IP" rates) 10.2 million cubic feet of gas per day in a new area on the southeast corner of the Montney that they called Resthaven. That was the spark that ignited all the junior players there, including Donnybrook.

Fig 1 Montney fairway – OGIP



Source: Encana, Macquarie Research, November 2010

Celtic's new Resthaven area at the southeast end of the play was 428 square miles, or sections, and is now considered Montney lands. Donnybrook was able to acquire five sections in the middle of this play, and Celtic is now drilling this land to earn an interest in it. This first Resthaven well is only three miles from Celtic's original discovery well, and nobody knows this area of the Montney better than Celtic.

Now, here is a very important point, which was #2 on Why the Montney Is So Special: that Celtic discovery well ALSO produced 50 barrels of NGLs per million cubic feet of gas a day in addition to the 10.2 million cubic feet of dry gas. And most of it is the NGL with the highest value – condensate. That works out to 500 barrels of very profitable NGLs a day. (The industry expresses this ratio as 50 bbl/mmcfd)

NGLs are the SAVIOUR of many junior gas producers. They just can't make any money on the low cost of dry gas, or methane, at \$4 per thousand cubic feet (\$4/mcf).

But NGLs are usually priced as a percentage of crude oil – and condensate, which is super light oil, sometimes trades for MORE than oil. So the higher the oil price goes, the higher NGL pricing goes. And oil has been going up lately! NGLs can dramatically increase the profitability of natural gas producers, especially at the high production rates that companies are getting in the Montney.

Also, there are at least four producing gas zones in the Montney – the Upper, Middle and Lower Montney, and the Doig.

(And now the industry is just starting to drill the lowest formation, but one of the most exciting – the Duvernay shale.

Big energy companies have paid hundreds of millions of dollars in the last year to buy Alberta land that is thought to be targeting the Duvernay. In fact, a March 2011 sale of oil and gas rights saw the highest amount ever paid in Alberta, and most pundits believe it is someone chasing the NGL rich Duvernay – because it may also have OIL.

Donnybrook owns the Duvernay rights on all its properties.)

It's a lot cheaper to drill all these formations from one drill pad – drill several horizontal wells off one vertical well from the same drill pad than having to move a drill around well to well. So that also makes the Montney less expensive and more profitable.

Donnybrook management was able to secure five sections of land in the middle of this play from a major oil company, and immediately joint ventured 30% of one section, and 51% of the other four sections, to Celtic. That gives Donnybrook 2.7 net sections at Resthaven. Each

section should be able to support four wells, making for 11 net wells at Resthaven to Donnybrook.

Of course, there is no guarantee that any of these wells will hit close to the flow rate and NGL content that Celtic's discovery well did – but the Montney has shown it's relatively consistent, with other producers hitting similar well rates – some higher, some lower – over a large area of the play.

Flow rates from Donnybrook's first well at Resthaven should be released sometime in early to mid April. If it is as successful as Celtic's first well, the estimated value of this play alone to Donnybrook justifies the current trading price of 63 cents, and I will explain my math in the VALUATION section.

To put this in context, one Canadian brokerage firm, GMP Securities suggested the Resthaven play could be worth \$39 a share to Celtic. There were several brokerage firm reports out on this play, and Canaccord Capital said in their research on this play that this is TWICE what the next best area of the Montney, Kaybob, gets.

Celtic's stock jumped 30% the day it announced its first well in November 2010 and has since almost doubled. I expect positive news on this first Donnybrook well could have a similar effect on their stock (but no guarantees – this is the stock market!)

Obviously, Donnybrook's Murray Scalf and Malcolm Todd saw the same type of potential, as they quietly accumulated about 38 gross (22 net) sections in the area, mostly just east of Celtic. *The values for Donnybrook's land went up dramatically after that Celtic discovery well at Resthaven was announced. How much? One analyst estimated that Petro-China just paid **\$5.7 million per undeveloped Montney section** to Encana – in a different area of the Montney - and Resthaven is now thought to be **THE BEST** area in the Montney.*

Donnybrook is not on any analyst radar screens, because it is relatively new and so small. So when analysts look to see what else is there, they say - Hey, two townships east, Cequence (CQE-TSXv) is drilling. That could be interesting. Well, Cequence is earning into the sections that Donnybrook was so quietly staking for most of this year.

SIMONETTE – MONTNEY

Donnybrook also quietly bought more than 30 sections in the Simonette area of the Montney, also in the southeast corner of the play. Their first well was only 7 miles from Celtic's Resthaven well. Simonette is due east of Resthaven (and don't ask me how the companies come up with these names).

Donnybrook now owns 33 gross (19.5 net) sections at Simonette. Much of their land is joint ventured 50-50 with Cequence Energy (CQE-TSX). Because Simonette is so close to Resthaven, their stock has also been on fire since the day Celtic announced their discovery well last November – Cequence’s stock has more than doubled from \$1.65 that day. This play completely revitalized that CQE stock.



Donnybrook and Cequence have announced the results of their first horizontal Montney well in the Simonette area. It was a very good well, with flow rates of 6.4 million cubic feet per day of gas and 15 bbl/mmcf/d of condensate – the most valuable NGL, or Natural Gas Liquid.

Cequence then announced that well produced 3.1 mmcf/d, or 670 barrels of oil equivalent for the first month – which validates Donnybrook’s land holdings. They also announced the NGL content increased to over 50 bbl/mmcf/d – making the well – and by extension Donnybrook’s land package - much more profitable.

Drilling is underway on a second well and results should be out in April 2011. A detailed drill program for the Simonette area has not yet been announced.

Companies are regularly paying 20x more for Montney lands around Donnybrook now – well over \$1 million per section - than what DEI itself paid a year ago.

FINANCES

Donnybrook has \$10 million cash, after completing a March 2011, \$5 million raise with GMP Securities at 75 cents. As Celtic and Cequence are earning into Donnybrook lands, they are

paying a small premium on drilling costs. A well in Resthaven costs more than \$6 million (DEI will have to pay over \$4 million of that), and a well in Simonette costs more than \$5 million (DEI share=50%).

Donnybrook will use the money to drill two more Montney wells at Simonette, one Montney well at their Bigstone property east again of Simonette, and leave enough working capital to continue their land acquisition strategy through the fall of 2011 (which, as you have read, has worked very well so far..).

To execute an **aggressive** drill program, the company may have to raise more equity at some point before production funds the drilling. With drilling success they may be able to announce official reserves and access debt.

VALUATION

There are several methods to analyze the potential value of Donnybrook; I'll outline two of them.

One is very simple. You know what your house is worth if your next door neighbour's house that looks like yours just sold for \$1 million; the market is telling you what it's worth. As I mentioned earlier, Petro-China joint ventured a huge Montney land package from Encana (ECA-NYSE, ECA-TSX) in February. One Calgary based analyst estimated that Petro-China paid \$5.7 million per section of undeveloped Montney land.

Donnybrook has 22 net sections in what several analysts are calling THE BEST area in the Montney. $22 \times \$5.7 \text{ million} = \125 million , or roughly the current market cap of the company. And of course, Donnybrook already has production, so their valuation would be a little higher. This is a VERY rough estimate. But as just a land play, it gives me some comfort in what my downside is from these price levels.

The other method I use to value this play is through the Net Present Values (NPV) of the wells. The NPV of a well is the amount of money a company can expect to get back from the well AFTER costs. Analysts will multiply the average NPV of a well in a play by the number of wells and come up with a potential valuation for an oil and gas company.

Canadian brokerage firm Canaccord Capital estimated Celtic's Resthaven wells would each have a statistical NPV average of \$10 million. Donnybrook has 11 potential (net) well locations, so translating that Celtic value to Donnybrook (Celtic's discovery well and Donnybrook's first well

are only three miles apart) that Donnybrook's Resthaven interest could be worth \$110 million, or the current 63 cents a share to Donnybrook, based on the 189 million shares fully diluted.

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.

So in using 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 189 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 I think conservative) value of **\$1.17 per share JUST for their net 20 sections at Simonette (\$1.56 on 4 wells/section and is more realistic)**

If I add 63 cents a share theoretical NPV for Resthaven to \$1.17 theoretical NPV for Simonette, I get \$1.80 – almost triple Donnybrook's current share price. Four wells per section at Simonette would create an NPV of \$2.19.

It's important for readers to understand that Donnybrook will **NOT** get bought out for that value – that would take all the accretive value out of the play for the buyer. (Though, Donnybrook has six other net sections in the Montney and gas prices and especially NGL prices have jumped up since the Japanese earthquake...)

The point here is that there is a lot of room between the current share price and \$1.80 or \$2.19 **potential** NPV to get a buyout price that would give me a potentially strong profit from the current price.

That's the investment story here; that gap between the current trading price of 63 cents and \$2.19 is big enough for a company to buy out Donnybrook at a price that makes DEI shareholders happy and is still accretive enough to make the buyer's shareholders happy.

STOCK CHART



Directors and Officers own about 28% of the issued stock. They have lots of incentive.

CONCLUSION

Donnybrook must still be considered a speculative stock. But they have hit at Simonette already, and are waiting on results from their first Resthaven well with Celtic. This should be a MAJOR catalyst for the stock - either up or down - once results are announced.

The risks here are obvious. Resthaven might not be as prolific as Celtic's discovery well would indicate. Canadian gas prices could soften dramatically in spring, though a very cold winter used up a record amount of gas in storage this year. Donnybrook may issue more equity.

But the Montney is THE place to be for natural gas juniors in Canada. The new management at Donnybrook management bought a huge chunk of the 12 cent financing in 2010 and have participated in every financing, including the most recent at 75 cents. They have created the possibility of monetizing all their hard – and highly successful – work in just over a year. This is “old school” – buy your position and work hard.

They expertly – and cheaply - acquired a large land package in a new Montney area that went mainstream after Celtic announced their discovery well at Resthaven. Smart smart smart. *And they have another eight net sections of other Montney ground I haven't even spoken to.*

Management WANTS to sell the company. Most management teams of gas companies don't want to sell because they will be out of a job. The market will not fund new junior gas stories right now. And the competition for oil plays is incredibly tough. As long as investment bankers can sell hope and raise equity to keep other gas junior company's running – even though most aren't making positive cash flow - most teams don't want to sell.

This team wants to lose their jobs. I love that. It could be Cequence or Celtic or another mid-size gas producer who want some of the best Montney ground to date. Donnybrook has a large undeveloped land package, is trading at a big discount to its Potential Asset Value (\$1.91) and *could be a very accretive acquisition for another company – even at twice its current share price, which is the target I have for my position. That's why I think Donnybrook will be the next junior buyout in Canada.*

I own 150,000 shares at 15 cents and 50,000 shares at 23 cents.

EPILOGUE: natural gas and NGL prices have jumped since the Japanese earthquake in early March 2011. The reason is that outside of North America, global gas prices are strong at \$8/mcf and the market is TIGHT. Every single ship in the world that can be transporting LNG – Liquid Natural Gas – is busy. Every single one.

And the market now sees that LNG will make up much of the lost power of that nuclear fuel used to supply Japan – before the reactors there started having problems after the earthquake.

Senior gas stocks like Encana and EOG (EOG-NYSE) have jumped sharply since the Japanese earthquake – they're already pricing in higher gas prices. That can only be good news for the juniors.