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WEEKLY WRAP – TORQUAY, GOLAR, SECOND WAVE

MARKET COMMENTS

The last three weeks have been some of the most difficult I've seen for junior oil stocks in awhile – a sign of how spoiled I have been with a good market since September. It's hard to remember that for the four months before Fed Chairman Bernanke issued QE2 and set all commodity stocks on fire, junior oil stocks didn't trade that well and international juniors in particular couldn't find a bid.

These troughs of investor interest happen regularly in the junior oil sector, and subscribers need to understand that stocks of some of the early stage companies in the portfolio will go very quiet for weeks at a time, with little liquidity. It is prudent for me to put less money in the more junior companies and more in the larger ones with more institutional sponsorship. A good rule of thumb is that the cheaper the stock, the longer time frame you should have for it – which means 2 or 3 down cycles, which we all say are necessary but don't like them when they arrive.

One thought came to me this week and that is that the juniors are in a bit of a lose-lose situation right now. If the oil price goes lower, junior stocks (and all oil stocks) will go down. If oil goes any higher, the market goes lower and risky junior oil stocks get punted first and hardest.

So that's the cautionary tale. On the bullish side, global interest rates remain low, US industrial activity is increasing, and there are no hiccups in the Asian urbanification (my spell checker tells me that's not a word), another stupid war has been started by politicians, this one in an oil producing country – so there are many reasons to be bullish on oil.

On to this week's stock updates....

Torquay Oil Corp. TOC.A-TSXv

On Friday Torquay announced an operational update, but I have yet to speak with management. I hope to have a conversation with COO Terry McCallum on Monday or Tuesday to clarify a few things.

One of them is the comment that the first well at Lake Alma produced 80 bopd and 85 million cubic feet of gas per day in December. 85 million cubic feet of gas per day would be the largest gas well in Canadian history by a country mile and would equate 14,000 barrels of oil equivalent. So that was a typo.

It's clear there are still challenges in finding the best way to complete a well (read: frack) in the Bakken formation at Alma Lake. The company said its sixth well at Lake Alma was uneconomic, and that was likely the one where they were trying a much larger frack job.

So the big one I was waiting on to hit – didn't.

It is likely there are still just two of the six wells drilled at Lake Alma producing oil. This update said the one of the wells has been producing an average 45 bopd for the last 30 days out of just a couple stages of fracking. Overall production at Torquay was at 510 bopd, down from 560 in January – and that 510 almost certainly includes 50 bopd that was purchased and closed recently (the fact it was closed makes me think they've included it in this 510 number) – or organic production has gone down about 100 bopd in the last 6 weeks. This will be due to wells they missed and regular Bakken-style declines on existing wells.

Management did not give any long range work plan in the release, other than to say two more wells are licensed, and one will target the Ratcliffe zone and one will target the Bakken. But I expect them to now start chasing more the Ratcliffe zone wells that I spoke to in Issue #47 on February 27. The Ratcliffe zone potentially hosts a lot of wells on Lake Alma, and they are now ready to do 3D seismic on the western 230 km² of Alma Lake, which will help them understand the potential of the property much better.

The Ratcliffe horizontal wells are a lot cheaper, as they don't have to be fracked, (often half the cost on a well these days, and also means Torquay doesn't have to wait in line for scarce frack crews), and neighbouring NAL (NAE-TSX) is hitting 70-200 bopd on their Ratcliffe wells, according to a research report by Jennings Capital. That's as good as a lot of Bakken wells, and makes Lake Alma a multi-zone play.

This Ratcliffe strategy would make sense, as they try to figure out how best to produce from the Bakken formation, which has been giving them trouble.

Management did say in the release that "It is implementing its third-generation fracture program at Lake Alma to further improve long-term deliverability of the Bakken discovery" but I confess I'm not sure what that means, other than they'll keep trying.

I hope to confirm all this with management in a call later this week.

If they didn't have this Ratcliffe play I would probably sell the stock now. But I am a holder, though I'm moving Torquay to a "3" from a "2" for now in both short term and long term gain potential. As soon as they have two or three successes in either the Bakken or Ratcliffe, I will make it a 2 again. I don't expect that to happen for 3-4 months (by the time they drill, complete, test for 30 days and get news out....).

Meanwhile, management has been doing the prudent thing and spreading risk by buying more properties. They bought and closed on 50 bopd net production over three properties in SE Saskatchewan, which total 3480 acres of just over 5 sections (640 acres=1 section), with eight undeveloped drilling locations. The target formations are the Alida and Midale formations.

Other producers in these formations (Sure Energy, Teralta) in this area have reported 100-150 bopd IP rates here. I did not find any information on what kind of EURs (Estimated Ultimate Recovery) wells in these formations have, or the NPV of wells here.

The Alida is one of the formations that management have been targeting at their Viewfield property, and are clearly having enough success there that they willing to buy properties across SE Saskatchewan where they can target these formations. You can fit A LOT of wells on these acreages – 10 per section sometimes!

They have also acquired 6 contiguous sections just SE of their main Viewfield property near Willmar Saskatchewan, also targeting Alida. They think enough of this property they flew the whole thing with 3D seismic, and have drilled a first vertical well, and are "evaluating" it. Now that they've mentioned it in a press release, they should report whether it hits or not.

Despite all this land buying, management says they still have net cash and have not dipped into their newly expanded line of credit.

The 1.25 sections at Viewfield continue to provide most of the production for the company. They now have 12 locations here, but haven't said how many are producing and how many are undeveloped. Four wells will be drilled after spring break up (in western Canada the provinces ban road travel by heavy rigs while the ground thaws – this can be a 3-6 week exercise and as a result Q2 is usually the slowest growth quarter for producers and slowest revenue quarter for the service industry).

In conclusion – there is still some work to be done at Lake Alma, though the stock did not dip on Friday. But there is very little interest in the stock – one main buyer, and there is clearly a size seller at \$2. Until management can show the market larger, more imminent upside, the stock is likely stuck in a trading range. And unfortunately, our subscriber community is the only real retail distribution on the stock. I hate being the only retail guy at the party.

With 50.6 million shares out fully diluted and let's say zero net cash/debt, the enterprise value here is $\$1.88 \times 50,600,000 = \95.1 million/510 bopd = \$186,525 per flowing barrel – quite expensive for a junior Bakken producer. I would suggest \$115,000 per flowing barrel is more likely until the market has confidence to price in a “resource play” – which is more like \$1.15 share valuation. (This is what Renegade Petroleum RPL-TSX trades at and I consider it a good comparable) I DO NOT expect the stock to trade down to this level, but the stock could take a hit over the coming couple weeks as I don't expect any new production news.

BUT I AM NOT A SELLER. I'm willing to be patient here. I don't like being patient – I wish they all traded like Bengal Energy and Petrofrontier after I bought them, but here I am willing to be patient. Nothing has been dis-proven, it's just taking longer to figure out. The potentially significant upside is still there in both the Bakken and Ratcliffe formations.

GOLAR LNG (GLNG-NASD)

The global LNG market has gone mainstream since the Japanese earthquake; the Big Money in the market now knows all about this previously niche market and has embraced it. Liquidity (trading volumes) and share prices of LNG stocks and even senior gas producers are up, and Golar has benefitted greatly.

This week the company announced some brilliant financial engineering to take advantage of this new-found market interest: it is creating a new public company that is focused on the FSRU market – Floating Storage and Regasification Units.

As a quick background, Liquid Natural Gas gets compressed 600:1 in volume from regular gas you use to heat your home. This makes it very easy to ship around the world. But then it needs a \$2 billion Re-gasification plant to get it back to regular gas to go into the local power grid. Golar can convert an old LNG tanker to a floating FSRU for about \$250,000 – an obvious savings.

FSRUs make about twice the net cash flow of what an LNG tanker gets – which right now is the difference between \$50,000 a day vs. \$100,000 a day – though that ratio could go lower as shipping day rates are now expected to go from \$70,000 a day to over \$100,000 a day.

So this new pubco will be called Golar LNG Partners (GMLP), and they are raising roughly \$250 million by issuing 12 million shares at \$20-\$22 per share. This will represent 30% of GMLP, and Golar will own the other 70%. This strategy is similar to how they own a controlling, consolidated interest in Golar Energy, which trades under the symbol GOLE on the Norway, or Oslo, exchange.

The assets in this new GMLP will be the two FSRUs that Golar now has with Petrobras, the Brazilian national oil company (the FSRU ship names are Golar Spirit and Golar Frost), and two LNG carriers that are currently under long contracts (8 and 13 years respectively) but are locked in at old-market rates. Management and other sources indicate that the cash flow from the tankers will cover expenses and FSRU revenue should be distributable profits.

Remember, Chairman John Fredricksen is all about dividends and he owns 46% of Golar. Golar is a yield play in what is now a hot market sector, and both the growth and the yield are what will drive this stock.

The new issue, GMLP will pay an initial 7% yield (\$1.40/share) from the two tankers and two FSRUs. There is a good chance the market will bid up the stock from the IPO of \$20 to make that a 5% yield. (I say that just because the market is crazy for yield right now with even small junior producers in Canada having to pay under 10% for their convertible debt.) That would take the stock to \$28, and value Golar's equity in GMLP accordingly – that is likely why I saw Golar have a good pop this week as the market got a sense of how strong GMLP will trade.

Being the smart cookies they are, management will vend in the other two FSRUs in from GLNG to the new GMLP in each of the next two years, doubling the dividend over this time frame plus being able to show increasing dividends each year – the Big Money likes that; makes them feel comfortable.

The IPO proceeds – let's say it ends up being \$250 million – will be used to buy 4-6 new LNG tankers. As I explained in my original Golar write up, EVERY single LNG tanker that is seaworthy is now active – there is ZERO spare capacity in this industry around the world right now. My understanding is that Golar will use a down payment of about \$20 million for each ship, and the rest will be funded with debt.

The debt is what makes this industry SO profitable. Money is cheap right now, and current day rates for these ships should mean that each ship should be able to generate about \$25 million each in cash flow for the company, starting sometime in 2013 when they are built. But being as there are few LNG tankers being built now, they will still be one of the first few new ships into service.

So four ships create an extra \$100 million in annual cash flow. Golar was paying \$1/share when I bought it at \$15.43, or a 6.4% dividend. I have said I expect that to go to 4% - a difference of 2.4% yield. Well that creates an extra market capitalization of almost \$1 billion (Valuing the \$100 million cash flow at 6.4% would mean a market cap of 1.56 billion vs \$2.5 billion at 4% - with 67 million shares out that's \$14.92 a share extra!)

Again, the Japanese earthquake was the catalyst for the market to focus on and improve its view of the global LNG market. The market now believes that LNG will replace a certain amount of nuclear energy over the coming decade.

Because of this I am confident Golar's stock will now go down to having a 4%-5% yield as the market has confidence in the industry and Fredricksen and his management team. So if they double the dividend to \$2.80 by the end of 2013 – 2.75 years away, with the 4 existing FSRUs and 4-6 new ships, that equals a stock price of \$56 at 5% ($2.8/.05$) and \$70 at 4% ($2.8/.04$).

Throw in a couple new FSRU contracts (quite likely to have at least one) and there is even more upside in the stock.

Remember there is no shortage of LNG in the world. There is only a shortage of ships. But I would think that a \$2 billion LNG terminal would have the same issues in an earthquake as a nuclear reactor, so using FSRUs now make even more sense, and Golar is the world leader in FSRUs.

Golar has also said they will now decide what to do with GOLE-NO, their subsidiary. The stock has no liquidity, and the business is hamstrung a bit – trying to buy and sell LNG around the world – when there are no ships to contract. Plus they showed a loss in their derivative trading, so all around this business has not gone well for them. They will likely merge it with GLNG.

In conclusion, management is doing what they are supposed to do – take advantage of the market attention to finance at a good price and create value for shareholders. The key here is that Fredricksen owns 46% of the stock – his interests are perfectly aligned with mine.

This stock has worked out much better, and faster, than I ever expected. There is a lot of emotion as well as fundamentals in the stock – it is having what I call its “Time In the Sun” which is usually a time to sell some stock – when a stock is uber-popular like Golar is now. (Just like I sold all my Cardium plays last January and they didn't hit those levels again for another 10 months). I don't know if I sell half or stay for the whole ride – but this is a FUN choice.

SECOND WAVE PETROLEUM – SCS-TSXV

I don't own Second Wave right now but I have been thinking I might sometime soon. I had a brief chat with CEO Colin Witwer this week after their yearend financials came out. They showed a very small increase in reserves, despite a lot of drilling success at their Pekisko play in central Alberta last year.

The issue was their fire at their processing facility in December. Not only did it cost them about \$7 million cash, it meant they had to stop production and by the rules of the Canadian National Instrument 51-101, Witwer said the evaluators had to take the shortened production of some wells and create well profiles and EURs from this data. Also, the Pekisko wells actually increase in production until month six, then stay steady for several months before starting a much lower decline rate than most investors think about horizontal oil wells having in western Canada. So by far, the low increase in reserves was NOT a geological issue, but a logistical one.

But this all happened against the backdrop of a stock that was priced to absolute perfection. This play is mid grade oil and 35% gas, so the netback (profit per barrel) is only \$24. But it was getting valued as if it was a light oil play generating netbacks twice that.

Part of the reason for that was the large amount of OOIP (Original Oil in Place) at Pekisko – about 1 billion barrels of oil equivalent, with 2/3rds of that being oil. Between primary recovery (drilling) and secondary recovery (waterflood) there is a strong potential for 100 million recoverable barrels of oil & gas here. And The Street likes management and Brookfield (BAM-TSX) owns about half the company.

And they have the potential to have a large increase in reserves, production and netback with the Beaverhill Lake (BHL) formation below Pekisko. They have now joint ventured 60% of the play to Crescent Point (CPG-TSX; I read that in a research report; Witwer would never tell me who it was.) For the next 13 wells, CPG will 85% for 60%, then the wells are 60/40 cost and payout to CPG and Second Wave respectively.

SCS is the operator on the first three BHL wells. The market will be watching these first three very closely as other operators such as Arcan (ARN-TSX) and the privately held Coral Hill have hit wells with 600 bopd IP rates or better (each have hit over 1000 bopd on short term IP rates on a well). Arcan has gone from \$1-\$6 this year on their BHL drilling.

SCS and CPG will drill 8 wells into BHL this year. SCS is close to its debt line now and wants to use somebody else's money to build up their production and cash flow so that by early next year they will be in a position to more aggressively drill out Pekisko. They will also likely have a big new reserve number from both Pekisko and BHL that will give them a greatly increased debt line.

Witwer added that BHL oil is so light they could mix it with the mid-grade Pekisko oil and get a \$5/bbl increase in netback. Fully developed he expects Pekisko to have a netback of \$35, as the fixed operating costs get spread out over a larger daily production. There is the possibility of a \$40 netback in the Pekisko with BHL oil mixed in.

Considering that BHL wells will likely be drilled from the same pads as the Pekisko wells, there is the possibility these wells, if they're as successful as Arcan or Coral Hill, could achieve superior returns due to cost savings of using these pads. I expect BHL wells to have a *netback of \$60 or better on \$100 oil* – maybe not right at the beginning when production is small but by the end of the year that is very possible. Arcan was showing \$40 netback on \$73 oil in their Q3 report last fall.

They have a rough enterprise value (market cap + debt) of \$240 million and production of 2200 boe/d – for a valuation of just under \$109,000 – very generous for a \$24 netback. But of course, the market doesn't price-in the current state of affairs; it is a future pricing mechanism.

The market is still pricing in some success on the BHL – Second Wave has 30,000 net acres of BHL and Gilwood formations even after the CPG deal – enough for roughly 150 net wells. ***And results from the first joint venture BHL well are due in the next month. This could be a catalyst for the stock in the near term.*** I think the emotion of a successful and rapidly developing BHL play will trump the stretched valuation and the stock will move higher.

It's very possible that SCS majority holder Brookfield Asset Mgmt would be very open to holding CPG stock should CPG decide to takeover SCS – isn't it?

OTHER OGIB PORTFOLIO STOCKS

PetroFrontier – PFC – My full report will be made available on the site sometime Monday April 4 at the latest.

Wind River – WVR-TSXv – I had a brief meeting with management – Jack Steinhauser, Alan O'Hare and Paul Cox – while they were in Vancouver this past week. There is nothing to report – they are still trying to sew up land using their exclusive legal title and until they are able to do that, the stock will sit. It does trade better than I thought it would in this market however.

For Canadians, this Niobrara shale oil play – like the Permian Basin in Texas – is tough for us to understand. Large mid-tier producers in the US can see their stock move on only 10,000 – 20,000 acres of land in these plays, while up here in the WCSB (Western Canadian Sedimentary Basin) if you don't have 50,000 acres, you're a nobody. Who cares.

But the incredibly tight spacing allowed in some areas – every 40 acres – means higher production per section I guess and the stock values that get priced in on what I consider small acreages are considerable, generally speaking. I see analyst reports making a big deal out of these small acreages – maybe it's just the culture in the Excited States of America.

So keep your fingers crossed as there are some big land packages in the area where Wind River has its exclusive title.

DeeThree – DTX-TSXv – Macquarie Securities in Canada initiated coverage on DTX with a \$6 target, which is totally dependent on the Alberta Bakken play being successful. I will go through the report in more detail this week and provide a brief summary next week. The company has decided to go horizontal on its second vertical strat well – it also decided to horizontally complete its first strat well and shareholders are now waiting on a frack crew – due this month – to get this rolling. Their gas play (not relevant in the least to their valuation, thankfully) had only a 50% success rate in 2010. I am hoping to meet with management when they are in Vancouver mid-April.

CGX Energy – OYL-TSX – their offshore Guyana Basin play is continuing to attract attention from major brokerage firms, as a host of national oil companies, majors and large intermediates are drilling there this year. This basin has the potential to be one of the biggest discoveries in years – or one of the biggest duds. All this new attention I'm reading in research reports from large firms certainly hasn't helped CGX stock, but President Kerry Sulley did say he was getting in to see more large buy-side institutions – potential buyers of the stock – who hadn't heard the story before.

UPCOMING CONFERENCES

I will be at the Calgary Investment Show April 9-10, next weekend, which is sponsored by Cambridge House, and I hope subscribers come to my booth and say hi and come to the Sunday, subscriber only event at 2 pm.

In May I embark on a 10 day odyssey, attending the Cambridge House Saskatoon Investment Conference May 6-7, fly to New York on the 8th to attend the New York Hard Assets Show May 9-10 which is in the midtown Marriot Marquis, and then I am off to Edmonton to attend the MoneyTalks show on May 14 before finally heading back to Vancouver. Then there is the Vancouver Cambridge House Conference June 5-6.

If you can attend any of these events, please stop by my booth and say hi.

My presentations at these four conferences will focus on the shale revolution, and the three juniors that are the best shale oil plays in the world right now – TAG, Toreador and PetroFrontier. The subscriber only events at each of these shows will mostly be Q&A – I want to hear from YOU.

In an upcoming blog story I will be talking about some plays in Atlantic Canada –

1. Contact Exploration (CEX-TSXv), which I have profiled before,
2. The Anticosti Island shale oil play held by Petrolia (PEA-TSXv) and Corridor (CDH-TSXv)
3. Shoal Point (SHP-CSNX)

I'm telling you this because I do own some stock in Shoal Point and will be disclosing that in the article. It's a very intriguing shale oil play in western Newfoundland that I'm following, mostly because the man who put me onto TAG oil likes it. I do not own a large position; just enough that I follow it.

I don't see it as an OGIB inclusion for several reasons - The company has a horrid share structure – over 200 million shares fully diluted at this early stage (just drilling their first hole) and only having 80% of the play. At 35 cents it already has a market cap of \$70 million. And it's listed on the most junior exchange in all of Canada – the CSNX, and I have no idea how easy/hard it is for non-Canadians to buy that exchange. And management went over budget on their first drill hole.

But it is geologically intriguing – the potential shale thickness here is much more than any other play I've seen - so I am following it. And they do have one of those wild resource estimates from my good friends at AJM that says P50 1.5 billion barrels.

Do not expect me to mention this company again. I might, but best not to expect it.

FUTURE PLANS - I have now booked summer vacation as July 7 – Aug 1 in Europe – I am so excited about this trip to Croatia and Slovakia - and Aug 15-20 fishing in the Queen Charlotte Islands. Love you all, but expect little communication from me during these times.

Lastly, I want to share a book with you that I have been reading – [The Rational Optimist](#). I urge you to read this book – it explains how humanity is progressively better off – which should be self evident. But even the poor of today are much better off than the poor of the industrial revolution in England who were much better off than the poor of the middle ages who were much better off than the poor of during Egyptian civilization etc.

It's **all** better, and will continue to get better. (And yes he admits on the stock chart of human evolution there will be peaks and valleys). BTW oil is the most green technology ever invented and global warming will create more fresh water and higher yields of crops than ever before. ;0)

Doomsday-ers beware. You're in for a soul-changing read. It's written by Matt Ridley who has written several books on genes and genomes. He convincingly argues that it's trade that has shaped evolution, not vice versa, over the last 30,000 years.