

**OGIB Bulletin #61**  
**BI-WEEKLY WRAP – JUNE 10 2011**

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**XTREME COIL DRILLING**

My full report on Xtreme Coil Drilling is complete and will be posted to the website on Monday after I see what all the analysts are saying after the June 8 conference call – I. But I wanted to post something in the Bi-weekly wrap as the stock dropped a lot around some soft Q1 financials – and guidance for continued softness in Q2.

As background, Xtreme has everything I look for in an energy services company – a proprietary technology, strong position in the market, highly valued stock it can use as currency to grow. I like expensive stocks.

And after it dipped down a full \$1/share for a financing (\$5.75-\$4.75) I thought this was an excellent entry point and bought my first position after watching the stock for weeks and interviewing management.

They have three high growth areas

1. the international arena (Saudi Arabia and Australia)
2. service rigs – with 50%-100% higher margins than regular drilling
3. a new mining drilling initiative that would be low cost and high margin

But then on June 7 the company announced soft Q1 2011 financials when it was being valued as a high growth stock. And on June 8 in the conference call they warned that Q2 EBITDA would also be lower than the street was expecting.

I confess I did not see that coming.

The stock was soft on June 7 and closed below the recent issue price of \$4.75, and after that conference call on June 8 it closed down another 5%, though on very small volume.

The reasons were some unexpected downtime on a couple rigs in the US, and a small bit of downtime in Saudi Arabia with partner Baker Hughes.

While the company has a lot going for it  
– \$50 million new equity (total cash now \$15 million) and \$90 million new debt,  
- a fairly new fleet of drills, going from 16-27 including 8 high margin service rigs

I suspect the company's valuation may now suffer for at least the next couple quarters. And what I mean by that is that I see the valuation of Xtreme now being closer to its peer group of 7.5 – 8x EBITDA, vs the 11x plus it had before.

Because it's clear to me that given the timing of its new service rigs being put into service, that 2011 EBITDA for Xtreme will now be much closer to the \$22 million of 2010 than analysts 2011 predictions of \$31 million. There was \$4.1 million in Q1, and management indicated perhaps \$4.6 million in Q2 – a total of \$8.7 million. With most of the service rigs being put into service in Q4, it's unlikely Q3 EBITDA will be over \$7 million. Q4 definitely has potential to be a GREAT quarter, but the new service rig pricing will be to get customers interest. Pricing could move up quickly in 2012 once their proof of concept – "Big 22,000 foot horizontal cleanouts are Xtremely easy and quick" – is complete.

Ok, that last line was a bit facetious. But I need some humour. I hate being underwater on any trade, and I expect to be 10%-15% underwater until at least the next quarterly comes out.

There is A LOT of growth potential here; a lot of moving parts, and the stock is well supported by The Street, it's tightly held (50% by management and a couple institutions)....but now I think there's a good likelihood the stock will trade below the recent financing price until management proves they can build and sell these service rigs on time.

Several analysts were asking about the timing of delivery on these five rigs that Xtreme bought in February and are converting to service rigs. Any delay on that early Q4 delivery time (and management did say it could be Q1 2012 for the last couple) I expect the stock to get punished.

It's tough on both management and the underwriters (and newsletter writers), explaining to retail clients how you could like a company so much and raise \$50 million and then see a couple soft quarters get announced within 10 business days.

At the end of the day it doesn't matter – it is what it is. I now believe there is a strong possibility the stock will trade in the low-mid \$4 range for a couple quarters, especially on light summer volume. This has now become a "Show Me" stock. At least for me it is.

One analyst has lowered their target on the stock by \$1 from \$7.50 to \$6.50, and reduced 2011 EBITDA expectations by \$2 million from \$31 - \$29 million. The analyst still believes in 2012 EBITDA of almost \$60 million – as do I. Another analyst dropped 2011 earnings to 18 cents from 29 cents, but again kept 2012 estimates intact. And that was the theme across the five Canadian analysts that follow the story (Peters, Altacorp, Macquarie, Canaccord, Cormark). My EBITDA guesstimate for 2011 is the lowest of anybody, but not by much.

Potential summer catalysts for the stock include

1. the mining joint venture going ahead (and hopefully an idea on the economics of this business),
2. their two small rigs that are idle being contracted,
3. the arrival of key components for the service rig conversions that would satisfy the market they will be delivered in early October as expected

The good news is that 13 of the current 16 rigs are under long term contract, there is a viable three pronged growth strategy but it may take a quarter or two longer than The Street expected to get traction on that growth. This is only a 1-2 quarter setback and I am not a seller.

## **GOLAR LNG**

Golar announced its Q1 2011 numbers, and made some of the best information both public, and easy to understand – a welcome change!

I'll go through the numbers first and explain their new structure and strategy second.

Overall revenues were \$67.5 million, up from \$64.6 million Q4 2010, despite lower ship utilization. That's because day rates went from \$74,206 to \$80,694 during the quarter, and they said rates are now over \$90,000 a day for LNG tankers. Net income was \$16.3 million, more than three times Q4 2010 net income of \$4.1 million.

Golar Commodities – their trading arm - continues to lose money - \$3.6 million in Q1. They trade physical cargos and financial derivatives – the first makes money, the second one loses money. They did give guidance that some physical cargo trades will show a profit in Q2.

They announced a continued 25 cents a share dividend for this quarter – and that is actually an overall increase in cash as there is now 79.8 million shares outstanding after the complete takeover of Golar Energy, which was listed on the Oslo Stock Exchange only.

That means I now have clarity on share structure and dividend. Plus, their

holding in the new GMLP-NASD listed Golar LNG Partners was worth \$714 million and Golar expects to bring up \$10 million per quarter from GMLP into Golar (GLNG) in GMLP dividends. GLNG owns 67% of GMLP – the public owns the rest, which it bought on the IPO in Q2 at \$22.50.

Now that Golar (GLNG) has absorbed Golar Energy, they have decided to change strategy a bit. Golar Energy was going to do short term, spot business in the LNG market. But then the tight tanker market – while good for GLNG's day rates – made life hell for Golar Energy. There was no product! All the ships were spoken for.

So now Golar (GLNG) will do the short term business, and the newly listed Golar (GMLP) will do both the long term LNG tanker contracts AND ALL THE FSRU business – Floating Storage and Regasification Units. These are the ships that turn Liquid Natural Gas (LNG) back into regular dry natural gas (methane) that you and I can heat our homes with.

So while Golar (GLNG) used to be the long term pubco, it's now the short term one. But Chairman John Frederiksen still owns 46% of Golar (GLNG) and GLNG owns 67% of GMLP, so he still controls everything through GLNG, so that's where I will keep my money.

In giving guidance, management said they expect to hear back on at least three and possibly five FSRU contracts by the end of 2011, on which they have submitted bids. (Golar has never lost an FSRU contract that got completed.) They also intimated they were lucky to get Samsung, the Korean conglomerate, to build them 6 new LNG tankers for 2013 and 2014 as shipbuilding capacity is also very tight globally. 35 new LNG tankers are on order worldwide now, 16 of which were just ordered since January. They should be coming onstream just as the huge Australian LNG plants open. Australia will probably be a bigger LNG exporter than even Qatar then. But for the next 2-3 years, LNG tankers will enjoy a very tight market, and strong pricing power.

In closing, here are the two paragraphs that intrigued me most from their quarterly. Subscribers should remember this is a very exciting time for this industry as it is making LNG a true global market for the first time ever in 2011. It's kind of like horizontal drilling and fracking – they have all been around for awhile now, but are just hitting their stride and being adopted by the masses, creating BIG opportunities for investors – and I have already benefited this as Golar LNG has doubled for me.

"The next wave of midstream LNG solutions continues to be developed inside Golar. Floating LNG to power vessel, floating storage and small scale LNG are all on Golar's drawing board and the Company anticipates they could all add significantly to our growth in the future. It is the Company's target to conclude firm business for at least one of these projects before the end of the year.

"The Board also sees several other interesting opportunities for further growth. Shareholders should anticipate continued high investment activities in the coming quarters."

Very interesting. I love following this company; this industry. It's new, it's global.

### **LYNDEN ENERGY – LVL-TSXv**

Lynden announced a successful production test from the upper zone of its Mitchell Ranch (MR) well Spade-17. This well is just inside the western boundary of the Mitchell Ranch property, which is located in the Permian Basin in Texas. This is the property for which I bought the stock.

With 100,000 gross and 50,000 net acres at MR, Lynden has the potential for a bona fide resource play with size – 312 net drill locations if it's all prospective.

So test results averaging 84 bopd on a vertical well test at 4900 feet is positive. The company intends to do 3D seismic to determine how much they could "see" the aerial extent of the zone.

My hope is that they will quickly test the entire well now, as it appears there are three potentially productive zones – one conventional and one unconventional near the top of the well (4900-5000 ft below surface) and at least one deeper. I would really like to see what a 30 day production test looks like on this entire well.

And I would really like to see a timeline for a development plan for this property – how many wells can they drill how quickly?

At some point, Lynden and CrownQuest will have to exercise their option to acquire the lease on Mitchell Ranch. This will mean an equity raise but also dramatically improves the value of the company.

Despite this good news and the potential for a resource play, I am not a buyer of the stock at these prices. I want to see a realistic but aggressive development plan for this property (as an example, this well has taken longer to get drilled than I thought) and I want to see the stock trade 250,000 shares a day for at least a couple weeks straight. I want to see that somebody else believes in this story.

### **TAG Oil – TAO-TSXv**

TAG has had a very successful spring drilling program in the Taranaki Basin – see the chart below from their latest press release:

### Sidewinder Discovery Flow Test Results

Sidewinder Well	Gas Flow Rate (Million Cubic Feet Per Day)	BOE Flow Rate (Barrels of Oil Equivalent Per Day)	Final Drawdown Rate	Net Oil and Gas Pay Encountered
Sidewinder-1	7.40	1,233	28%	14 Meters
Sidewinder-2	Testing Underway	Testing Underway	Testing Underway	47 Meters
Sidewinder-3	7.21	1,202	40%	15.4 Meters
Sidewinder-4	6.98	1,163	25%	19 Meters
<b>Totals:</b>	<b>21.59 mmcf/day</b>	<b>3,598 BOE/day</b>		

Not only has this team shown they are technically competent, they know how to release news to the market. This little chart leaves the reader doing the math that hmmm...if they get 1200 boe from 15 metres of pay and this last well yet to report has 47 metres of pay, then it could/should flow...STOP THINKING LIKE THIS. It's like a mining exploration company announcing visuals on the core. Just wait for the real numbers – in this lacklustre market we can afford to.

But the stock is reflecting the very good news so far, with *one of the best charts* in the junior markets. I have always loved how this stock trades. The stock came down from its high to touch its 200 day moving average (dma), and has bounced back up into a new uptrend with the 20 dma moving up through the 50 dma, and Relative Strength moving back up over 50 and momentum now in positive territory.

Historic Chart for Cdn:TAO by Stockwatch.com 604.637.1500 - (c) 2011  
Thu Jun 9 2011 Op=6.35 Hi=6.61 Lo=6.35 Cl=6.55 Vol=214.662 Year Hi=7.15 lo=2.31



Here is how one Canadian brokerage firm, Mackie Research, sees as Year End 2011 production figures:

**Figure 1: Production Additions**

<u>Cheal Field</u>	<u>boe/d</u>	
Current Production	1,000	
Cheal Facility Expansion <sup>1</sup>	500	
<b>Total</b>	<b>1,500</b>	

<u>Sidewinder Discovery<sup>2</sup></u>	<u>mmcf/d</u>	<u>boe/d</u>	
Sidewinder 1	10.0	1,667	(management estimated an initial production rate of 10 mmcf/d)
Sidewinder 3	8.0	1,333	(tested at a restricted rate of 7.2 mmcf/d)
Sidewinder 2	6.0	1,000	(estimated based upon Sidewinder 1&3 tests)
Sidewinder 4	6.0	1,000	(estimated based upon Sidewinder 1&3 tests)
<b>Total</b>	<b>30.0</b>	<b>5,000</b>	

<b>Total Potential Exit 2011</b>	<b>6,500</b>
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<sup>1</sup> Expansion of Cheal facilities expected for September 2011

<sup>2</sup> Sidewinder facilities initial capacity of 10 mmcf/d expected to be expanded to 30 mmcf/d by year-end. Assumes no NGL or oil volumes.

*Source: Mackie Research Capital*

Their target for TAG is \$10 without any help from the east coast shale. The company has almost \$75 million in working capital. While it trades at over 3X NAV right now, that valuation will decrease as NAV will increase a lot once these wells come onstream. I am curious to see what gas price management gets as my understanding is that spot gas in New Zealand gets only \$4/mcf and contract gas gets double that.

## **DEETHREE EXPLORATIONS (DTX-TSX)**

DeeThree announced its quarterly financials aftermarket Thursday. They also announced at that time that their second Alberta Bakken well, being drilled 20 miles to the east of their first well, hit water and oil, which is not as good as just hitting oil. CEO Marty Cheyne told they weren't sure where it was coming from, but that they did expect water as a DST (vertical drill stem test, basically a core sample of the target formation) from several years ago also hit water. They do expect the well to be economic, and will be putting a 1000 bopd pump jack on the well and give it a 30 day test.

Water is a four letter word to many oil and gas investors looking at the Alberta Bakken, and it looks like that started getting priced into the stock a week ago as it fell from \$4.60 to \$3.40 – a 26% drop - on no news.

Cheyne said they may consider drilling an adjacent well should rates on this

second well be economic. Analyst reports out this morning were non-committal on the well – they want to see what the 30 day test rate is.

The quarterly financials were as weak as you would expect a company with almost all gas production to be, and that may have contributed to the selloff. Without the Alberta Bakken this company would have been close to bankrupt, or had to dilute heavily at lower prices (their gas play from Encana was not a huge success, always something to keep in mind...).

But, not only do they have that play; they used their premium valuation to buy the Brazeau property, located southwest of Edmonton, which will have 1800 boe/d at year end. For now this property is 40% oil and NGLs but management intends to increase that with drilling this year. There are 100 potential drill locations in that play.

Only nine days of production from Brazeau were included in this Q1 report, so Q2 should show substantially better financials. But as DeeThree still has a premium valuation, the stock will truly live or die on Alberta Bakken drill results. Brazeau just means the stock won't go to zero if the Alberta Bakken is a dud – which we now know it won't be.

One interesting little tidbit from the financials is that the company has to expense all their G&A surrounding the Brazeau property acquisition under the new accounting rules that Canadian companies have to use now – the IFRS – International Financial Reporting Standards. Under the old Canadian GAAP (Generally Accepted Accounting Principles) those costs would have been capitalized. How this shows up on the cash flow statement is that the company had a NEGATIVE NETBACK of \$12.99 a barrel. Never seen a negative netback before, but I bet I see a lot more.

## **IONA ENERGY – INA-TSXv**

Iona is trading exactly as I expected it to. But there are already a couple surprises here, both positive. One is that it looks like their Orlando oil play (35% Working Interest (WI)) will get spud in late July, which is earlier than I expected when I bought the stock three months ago.

While Orlando is still exploration it is very low risk – there is already a discovery well there and Iona has some reserves from that as part of its working interest there. They are paying \$11 million or 42.5% of this well to earn their 35% WI. The lone analyst covering this play so far is suggesting 9000 bopd from this field by the end of 2012 – and Iona gets 35% of that.

The second bit of good news is that they appear to have an option on a heavier oil play called Westwick that could dramatically ramp up production sooner than

expected. They have an option on this play they must exercise before October. This was in the analyst's research report and not on the company's website so I'm not sure about it all yet – I will be calling management next week to learn more.

Corporately, this is great news, but again, in this market, the stock remains unloved.

This company's business plan is to acquire these very low risk development assets as cheap as possible – initially in the North Sea, where management has expertise. They are the original founders of Ithaca Energy (IAE-TSX).

### **COASTAL ENERGY – CEN-TSXv**

Coastal has been on a (positive) roll lately, with several new discoveries, just like TAG. Their latest discovery is The Bua Ban North B-04 well, with 64 feet of net pay in the Miocene zone with average porosity of 27%. Like TAG, they will release flow rates from these wells once they test them, but it should mean more oil "behind pipe" or ready to be produced.

### **BORDER PETROLEUM – BOR-TSXv(repeat from IB# 83 on June 7 2011)**

Border has told me they expect to have their website up and live by next week. I am hoping the market will have a positive reaction when they can see the exact location of their 25 sections of Slave Point formation at Red Earth.

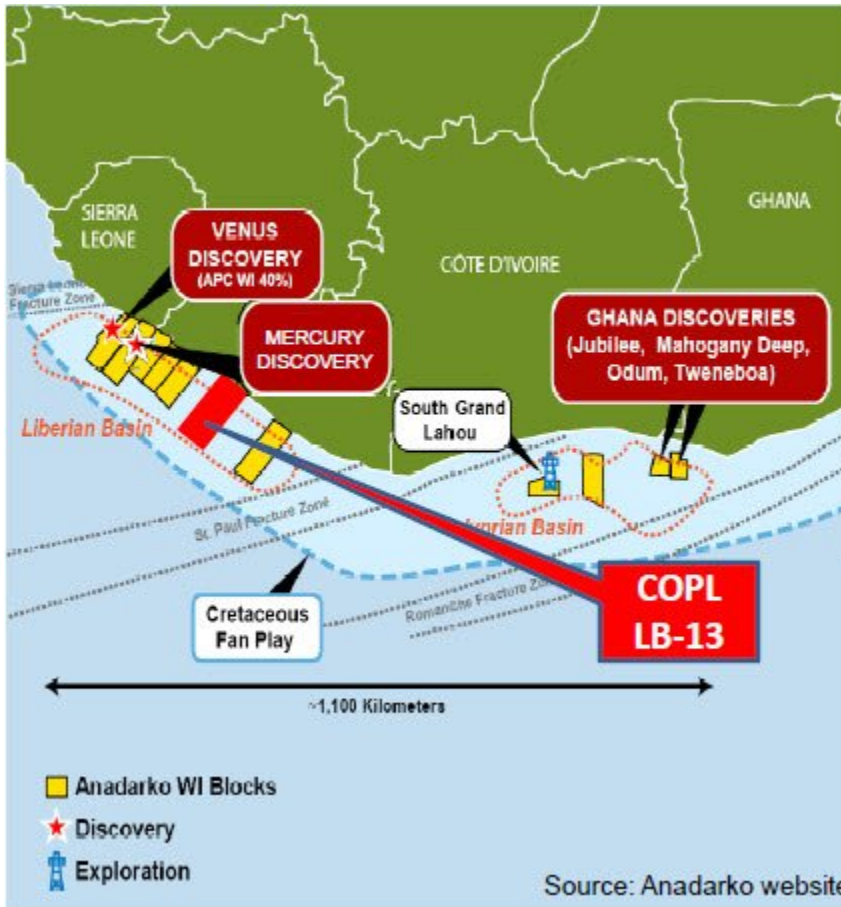
I'm also seeing some very positive trading - blocks of stock going through above 40 cents, then it traded half a million shares in the 35-40 cent range. The 25 cent financing came free trading on Monday June 6.

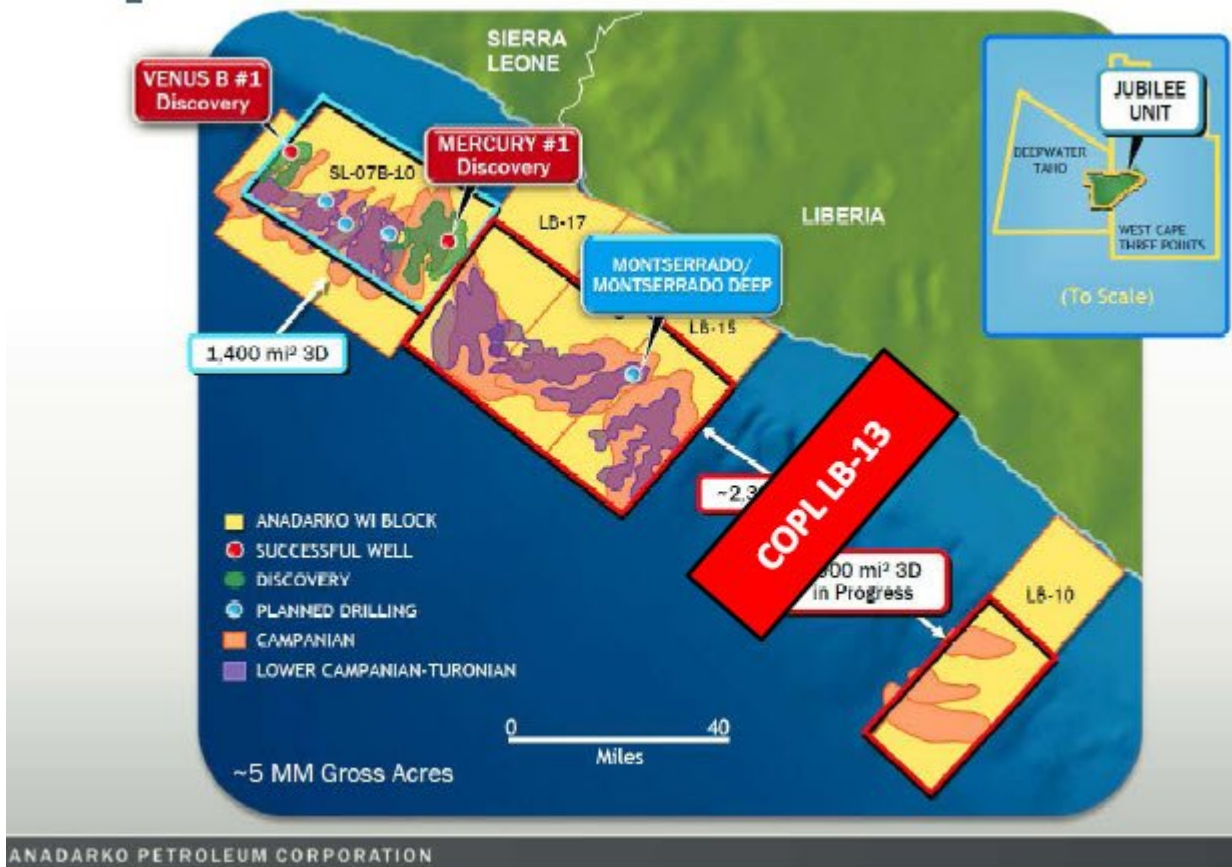
So I'll wait to see what happens next week.

### **CANADIAN OVERSEAS PETROLEUM XOP-TSXv**

XOP has announced one major acquisition recently in offshore Liberia, along the west coast of Africa, and a novel restructuring of two of their plays with one of their North Sea partners, BG Group, in their North Sea plays.

Liberia first – offshore West Africa is one of, if not the hottest oil exploration plays in the world right now, after London listed Tullow Oil found the Jubilee field off the coast of Ghana (southeast of Liberia) a few years ago. Then in the last two years there was the Venus (2009) and Mercury (2010) discoveries offshore Sierra Leone just northwest of the Liberian border.





XOP is spending \$85 million for a 100% in block 13, offshore Liberia – and it already has 3D seismic on it, which XOP was able to see before they bought it. While I wouldn't say they got a deal on the 2400 km<sup>2</sup> package, they have bought into a play where their technical expertise should be invaluable – this geological shelf has the same strong seismic AVO anomalies like the Paleocene targets in the North Sea that XOP is hunting. (Please read the original report on XOP in the Members Centre to learn more about this.)

This is what XOP management says they do as well or better than anyone – they know how to read this type of seismic to get the best opportunities for drilling success.

When investors were forensically dissecting their investment in Oilexco, this management team's previous company that went under in the crash of 2008, one of the rear view mirror epiphanies that they had was that the company had too much focus in one geographic area – the North Sea.

So CEO Arthur Milholland and his team said this time around, they would have some exploration plays in other areas - and now they have.

There will be no work on this play until Q1 2012 at the earliest, and in the meantime, three neighbouring blocks will be drilled through 2011 – their success could have a big impact on XOP's share price.

Now of course, XOP has to PAY for that – part of which will come from the funds investors gave them to drill the North Sea. Much of it will be stock, but \$45-\$50 million has to be cash. XOP now has \$119.2 million cash and the six wells they are now committed to drilling in the North Sea will cost \$81.1 million and \$88.3 million after G&A - leaving a significant cash shortfall of roughly \$35 million once Liberia is put into the mix. See this chart from Canadian brokerage firm Canaccord Genuity (who knows this company better than anyone):

2011e Sources & Uses		Timing	\$mm
Liberia advance	Contingent	Q2	(\$15.0)
Liberia acquisition L-13*	Contingent	Q2/Q3	(\$50.0)
Fulla exploration well	Firm	Q2	(\$10.8)
Bluebell exploration well	Firm	Q3	(\$10.3)
Esperanza exploration well	Firm	Q3	(\$19.7)
Lower Toad exploration well	Firm	Q3	(\$16.6)
Newt exploration well	Firm	Q4	(\$9.5)
W. Columbus explor. well	Firm	Q4/Q1	(\$14.2)
G&A	Firm	Q2-Q4	(\$7.2)
Working capital 3/31/11			\$118.6
	Net cash (shortfall)	Q4	(\$34.6)

\* assumes maximum cash component paid, minimum is \$45.0

In my mind, this Liberian acquisition – as sexy as it is - puts a lot more pressure/emphasis on this first North Sea well. If that first well at Fulla is a miss, I see the stock dropping and I think it would take *2-3 more successful wells* before the stock would claw its way back to a level where the company could finance without taking the share structure to 600 million shares plus – and still have no production for 2-3 years.

The flip side to this negativity is: this is a proven team. They have found a lot of oil, in exactly these types of plays in these waters in these basins. Because of that, I consider this

And in Liberia, all that money only covers the purchase of the offshore acreage; I haven't even begun to talk about a well that will probably be \$50 million. Milholland says he is bringing in a partner for that and his phone is ringing. It will be interesting to see what percentage interest that XOP decides to keep for what price, at the end of the day.

One other item is that the government of Liberia has to approve the sale of this license, but that will happen automatically, says Milholland, 30 days after the deal was announced – June 22. That could be a small catalyst for the stock if the market is in a good mood that day.

Milholland tells me the stock is a bonus for XOP, as one of the reasons they won

the competitive bidding process for this block was because the vendors saw they could get a big block of stock in a highly liquid, highly leveraged junior. Milholland also points out that Australian listed African Oil (ASX-APCL) has a \$1.2 BILLION market cap and is a pure play explorer in this region, with two blocks.

In the North Sea - at their Lower Toad, Newt and West Columbus plays, XOP and the other partners in this play have restructured their deal. BG Group, a large multinational energy player based in the UK, is now going to participate in the wells on these plays, and that is reducing XOP's costs on the well. XOP used those savings to buy another partner's (SSE) interests, so that now COPL pays 79% of these wells to earn a 50% interest, vs paying 83% for 41%.

BG Group and XOP also restructured their agreement on the Esperanza property, so that now XOP is paying 75% to earn 50% vs. paying 100% to earn 50%, and BG gets a tax advantage.

The first asset to be drilled in XOP's North Sea portfolio is the Fulla prospect in the northern part of the North Sea – this should be happening within a couple weeks, so this high stakes exploration game is about to get underway.

## **OVERALL MARKET COMMENTS**

I expect the choppy to negative market we are seeing in the junior energy space to continue, though I am seeing some bright spots, technically. The world's stock markets are screaming that the oil price has to get under control or nobody is going to make any money. The Saudis are listening and will likely unilaterally increase production to get oil down to \$90/bbl.

While this would be actually be good for the juniors in the medium to long term, it could be painful short term. Frankly, I don't even know if this would be successful; things have a way of turning out much differently than you expect. It's quite possible the market will focus on the fact that spare capacity is now even lower than before, and bid oil up with increased Saudi production. Life's like that sometimes.

But it does put the junior producers – and particularly the explorers – in a peculiar spot. These stocks will only rise on very specific catalysts – discoveries. And it also likely means that companies like Donnybrook who want to get bought out, will likely not see any big increase in share price until a transaction is announced – i.e. there will be no speculative run up in advance.

Natural gas prices are touching \$5, but get hammered with hedging, as we saw this week – confirming my opinion that gas is rangebound, and from here my bias is lower gas prices until the fall at least. Liquid rich pricing continues to be

strong however – good news for wet gas producers in North America.

- Keith