

## BULLETIN # 64 JUNE 25 2011 WEEKLY WRAP

**DONNYBROOK ENERGY**  
**ENERGY**  
**CGX ENERGY**  
**TUSCANY DRILLING**

**COASTAL**  
**TAG OIL**

Bulletin # 65, the full company report on Iona Energy, will be posted to the website either late Sunday night or early Monday morning. That stock has a great shot at being a 3-5 bagger in 12 months.

### **DONNYBROOK ENERGY DEI-TSXv**

Donnybrook has been quiet lately because of the big spring break up this year in western Canada. For the second year in a row there is a remarkable amount of water around the prairies and along the Rocky Mountains. The coldest spring in 60 years + didn't help, delaying the winter melt.

They had hoped to properly flow their joint venture well at Resthaven with Celtic (CLT-TSX) by now but that won't happen for another 2-3 weeks potentially. Then there is another 2 weeks after that (or more) until news on what an AOF (Absolute Open Flow) rate would be for the well. This is what I was waiting for BEFORE spring break up to sell all my stock into. **L**

Instead the stock is back here in the mid 40s. If it gets into the 30s I'm a buyer. The bad news is that I was hoping DEI would get bought out about now; **it's probably a year away from that.** :- ( They need to prove up a bit more of their ground – build some PUDs – Proven Undeveloped Reserves by drilling some wells.

So I expect news on the Celtic well in about a month. Then in early August DEI and its partners will drill Bigstone, and we should get a press release on the spud date there.

There at the bottom SE corner of the Montney, the DEI land

packages from west to east are Resthaven with Celtic, Simonette with Cequence Energy (CQE-TSX) and Bigstone with two juniors, Blackbird and Pennant.

DEI will also be drilling three wells at Simonette with Cequence starting August-September.

So there are at least four big horizontal wells getting drilled up into this high profile area; first results will likely be October.

This company not getting sold until next year reduces the price I'm willing to take for my stock, i.e. I'm willing to sell it cheaper now, because they are going to have to raise money in the fall and dilute the stock.

Below is my rough math for what I think the stock could (likely) get bought out for, based on

1. 20 net sections of Simonette and 3 net sections of Resthaven and 5 net sections of BigStone
2. \$8 M NPV10 – before tax - on all the wells (both Cequence presentation and Celtic presentation say this at current prices)

Simonette - 20 sections x 4 wells per section =80 wells

Resthaven- 3 X 4=12

Bigstone 5 x 4=20

**TOTAL # OF NET WELLS - 112**

Now multiply those 112 wells by a (before tax) NPV10 \$8 million and you get \$896 million. Risk that 50% for \$448 million. (Risking 50% means I'm assuming that half the wells come up dry.)

So at the current fully diluted share count for DEI of roughly 182 million shares, that's \$2.46 a share value. So if somebody buys DEI for \$1.23 a share, they're getting a 100% accretive purchase and all the upside of the \$448 million UNRISKED NPV that may unfold for them.

And by the way, I have **not included ANY value for the Duvernay** formation here. Remember that Encana's big \$300 million

Duvernay purchase is right in between Simonette and Bigstone.

I think that is realistic, especially if gas catches a bid between now and then. But I want to tell you something here – very few people other than Encana and Americans have any appreciation for this type of valuation. 28 net sections = 17,920 acres. At \$1.23/share Donnybrook would have a market cap of \$223.6 million, or be worth \$12,500 per acre. Americans will pay that for acreage with production on it in Texas Permian Basin, but few other places.

My sense is Calgary would not pay that kind of valuation. But right now everybody is after the Natural Gas Liquids (NGLs) which are often 30-60 barrels per million cubic feet, and are highly weighted towards the more valuable *condensate* (which often trades at a premium to oil now) so maybe they would.

This type of valuation also, IMHO, eliminates Cequence as a buyer; they're too small a fish to bite that. It has to be an Encana, an Athabasca Oil Sands, or Tourmaline or Apache or ConocoPhillips or somebody that size to pay \$223.8 million for 28 net sections. I would suggest that most oilmen in Calgary would have a hard time paying that kind of money.

Another way to consider valuation is per bcf (billion cubic feet) of gas. Cequence is talking about getting 35 bcfe (bcf equivalent; converting the higher value liquids content to natural gas) per section recoverable from their Simonette lands. Should Donnybrook's 28 net sections be that prolific (and 20 of the 28 are in Simonette, and the 3 net sections at Resthaven actually have \$9 million NPV10s says Celtic), that's 980 bcf – recoverable – just a hair shy of 1 Tcf. At \$1.23 per share or \$223.8 million market cap, that would be \$4.38 million per recoverable bcf, which is \$26.28 per boe at 6:1. (Again, this does NOT include the lower Duvernay shale potential.) That \$26.28 is likely a bit high for what the market will pay.

At 3 wells per section,  $3 \times 28 = 84$  wells,  $\times \$8 \text{ M NPV} = \$672$  million. I would only risk that 33%, leaving a risked valuation of \$450.4 million – with half that being \$225.2 million – so it's not that much different than my first math.

But I don't know how much money management will decide to raise in late 2011. That's going to dilute that \$1-\$1.25 valuation. So starting in September, if I see the stock at 70-80 cents, I will likely start to slowly exit – hopefully selling all the way up to \$1 - unless I see gas catching a bid (which would up valuations and make me pause my selling), but I don't expect that to happen.

## **TUSCANY DRILLING – TID-TSX**

What to do with Tuscany. Sometimes what makes good business sense doesn't make good sense for the stock.

Tuscany announced – out of the blue – a second large acquisition last week – Caroil, for \$232 million. By their accounts it was accretive (increased the value per share of the company) any and every measure you looked at it. The 14 rigs have high utilization rates, good long term contracts for the rigs, the company is well run and it's a cash machine--but the market traded the stock lower. And kept it lower.

This is a new company, though management has built and sold international drilling company before – Chairman Walter Dawson sold Saxon Energy Services a few years ago.

The story the street heard as Tuscany went public in 2010 was (says recent BMO Nesbitt Burns analyst report after this 2<sup>nd</sup> acquisition) that they were going to grow organically from the 17 rigs they started with in South America.

They had some growing pains getting their rigs in country down in South America, and that caused them to miss the Q1 2011 expectations of some analysts. **Strike 1.** In talking with President Reg Greenslade (clearly a kind man) awhile ago on that, he said that's all in the rear view mirror. Those problems are over.

Then they did a big acquisition in Brazil – and paid up for it. They paid 6.5x EBITDA forward EBITDA (8.5x trailing) and it really was not accretive. The Street grumbled, saying this isn't what you said you were going to do, but ok, I understand that you're leapfrogging growth

here by a couple years. Those nine drill rigs took them to 27 rigs and a dominant position in Brazil, with 20% of the market in that country.

(And let's not forget that there is a lot of growth in drilling in South America – see this article -

[http://www.rigzone.com/news/article.asp?a\\_id=108155](http://www.rigzone.com/news/article.asp?a_id=108155)

The mood of the analyst reports was summed up by Macquarie's Oil Field Services Analyst Scott Treadwell: "Tuscany paid around 6.2x 2012 EBITDA for the new rigs. While the deal is expensive, we believe the cost of 'learning as you go' would be just as painful in the medium term and using an existing platform for growth in Brazil is likely the right answer."

Not everybody would call this a **Strike 2**. But from the market's point of view, this was a surprise. When you decide to do that to the market, you go to the penalty box unless it was a really *really* good move. This wasn't accretive enough to be considered in that category.

And not everybody would call this latest acquisition of Caroil a strike, either. (Because after the first acquisition, this one really is accretive). But again, the market doesn't like to be surprised. The current stock price of 90 cents says that this is **Strike 3**, and a chunk of institutional money is out. (You could say that after this acquisition they went to video replay on the first acquisition and decided it really was a Strike 2.)

And outside of the underwriters who made all the commission on the \$1.53 financing, the market is not happy with this management team. I will tell you that I have not run the numbers, but between the two acquisitions I would suggest the value per share here has not increased much if at all.

The Street rewards management teams with high valuations when they do what they say they are going to do and increase value per share.

They've blown out the share structure to have 376 million shares out and \$188 million debt for an Enterprise Value (market cap + debt or –

cash) of roughly \$507 million here at 90 cents.

For that, they have 41 rigs (17 original + 2 organic new builds + 8 + 14) of which 38 are operating. Management is giving guidance for 2012 revenue of \$350 million and operating margins of 34%. Wellington West Capital Markets, which did the \$1.53 financing, is estimating free cash flow (FCF) of \$67 million at the end of 2012.

But the numbers only tell part of The Street's psychology here. Mgmt said organic growth. Management said Latin America. We now have two big acquisitions and half the rigs in the last acquisition are operating in Africa (and they are older rigs). Yes they are operating at 94% capacity and throwing off great cash flow, but that wasn't the story and we're not happy.

My experience in watching these juniors -- those that issue huge amounts of shares to gain size without adding value per share -- don't do well. On the junior producer side, think of Skywest (SKW-TSXv). Think of Novus Energy (NVS-TSXv) all of last year.

The institutions who buy these juniors are a limited pool and a lot of them are hedge funds – hot and fast money. There is so much product out there now in the junior energy space – both producers and service companies – that they move around a lot. And when juniors have share structures like Tuscany, a huge amount of buying has to come in regularly to keep the share price constant, much less going up.

So here is the investor's dilemma: Fundamentally, the stock has limited downside, IMHO. The replacement value on its equipment is probably very close to where the stock is trading now (before this acquisition The Street estimated between 97 cents and \$1.13 per share). And it should be a cash flow machine now. Debt is manageable at roughly 1.6-1.8x cash flow (they have another \$60 million debt capacity).

Management just has to execute – create synergies (rationalize G&A) and a bit of growth and early 2012 the stock could start to have a sustained move up. In that sense this is a simple story.

But that's the thing - I don't think it's going up anytime soon. For the next 6-9 months I suspect this stock will now trade at a discount to its peers (average is 6.5-7x EBITDA).

I don't mind sitting on a GasFrac as it swoons when I'm still up 95% on the stock. I don't mind sitting on Xtreme Coil even when I'm underwater 15% because they have clear catalysts besides their quarterly numbers, and the share structure is tight enough that it can move back up with just a little buying.

Tuscany isn't like that. I'm sitting 20% underwater and the most compelling to reason I can think of to own the stock is that it's cheap. Yes, that's why I bought it in the first place, but this latest acquisition is a blindside hit, and I think it has changed the market's perception of the company – for the worse (for now).

A couple other things are nagging me in the back of my mind on this company. Number one is the original pitch on Tuscany was that day rates for drilling in Latin America were higher than in North America – this would provide higher profitability to the highly competitive North American drillers. That gap in day rates has narrowed in the last year, making the political risk of Latin America and Africa less worthwhile.

And #2, all the stock being given to Caroil is only subject to a four month hold. I would have much preferred a longer voluntary pooling agreement with escrow releases over time.

*So after all that prattling here's my definitive conclusion: I **might** sell the stock.* I'm going to watch how it trades over the coming week or so, but I'm giving notice I *may* take my 15%-20% loss and go. At \$1.11 cost base in the OGIB portfolio, I no longer believe I'm going to make 50% on this trade in 9-12 months. Or if I do, it will be a squeaker.

Surprisingly, not every analyst who follows the story has provided updates yet. Wellington West, who is generally one of the two big cheerleaders for this story and did the \$1.53 financing, reduced their target from \$2.60 - \$2.10. BMO Nesbitt has their 12 month target at \$1.00 per shares. Jennings Capital, who advised on this latest

acquisition, has not issued an updated research piece yet; nor has Macquarie Capital.

### **CGX ENERGY – OYL-TSX** (original report Jan 29 2011, page 20)

CGX is a pure exploration play, the epitome of high risk, high reward. They have a 25% interest in the Georgetown/Eagle prospect offshore Guyana, on the northeast coast of South America. The Guyana Basin as it's called is one of the most exciting exploration plays on the globe.

The Guyana Basin ranked as second most prospective unexplored basin in the world by US Geological Society in 2000 with an estimated resource of 15 billion barrels. CGX anticipates that the resource potential on their 25% WI well in the Guyana Basin would mean 300 million barrels net to them if successful.

As it became clear this junior market was heading south in the spring, I sold most of my CGX at a small loss and hold just 10,000 shares now.

This week CGX announced a new prospective resource on two targets on its secondary property, Corentyne, which it owns 100% - which total 325 million barrels. This number is in addition to other prospective resource reports at Corentyne that showed 315 million barrels, 1,269 million barrels, and 1,241 million barrels in other prospects.

A prospective resource is a funny number. See my public blog story on them here - <http://oilandgas-investments.com/2011/oil-stocks/how-large-new-shale-oil-formations-around-the-globe-are-estimated/>

Independent experts in oil reservoirs look at data like seismic and any historical drill information and come up with a guess on how much oil they think is there, and how much could be recoverable.

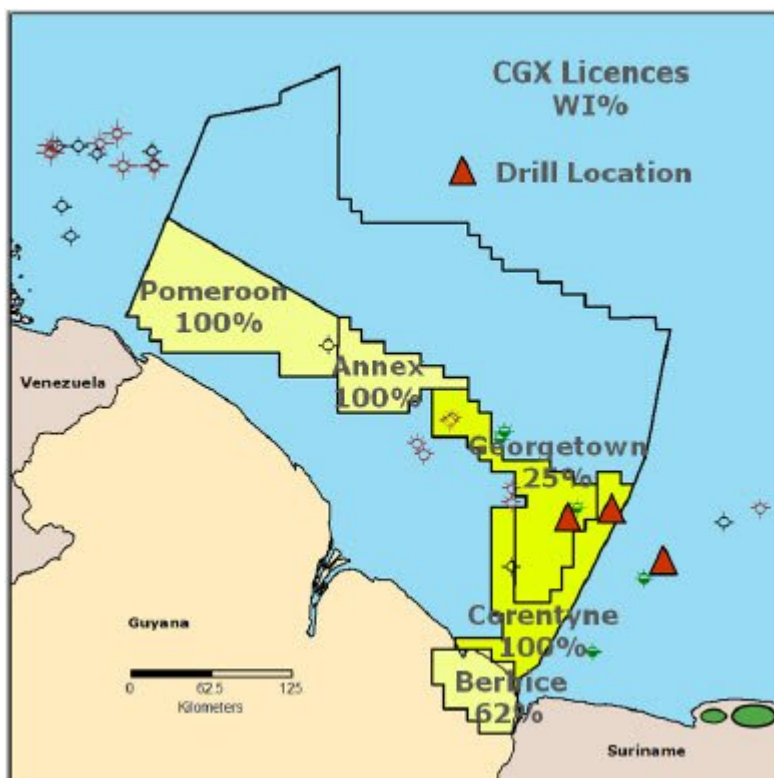
These experts (reservoir engineers) come up with a high (90% chance that amount is there), medium (50%) and low case (10%) for their estimates, and the industry has adopted using the medium as

"best" guess.

But you need money to get that oil out of the ground. CGX is fully funded for its drilling at Georgetown/Eagle, *but doesn't have enough to do anything at Corentyne. So there was no change in analyst targets for the stock on this news.* Drilling at Eagle has been delayed again, now expected in September with results by year end.

Despite having 3D seismic shot at Corentyne, management has not been able to find a partner yet for the play. This is not surprising – everyone wants to wait until Eagle hits or not. Management is obviously hoping a hit at Georgetown/Eagle will not only bring partners but allow them to raise money at a much higher price. In a good market that could happen but if this junior oil market stays like this, *the market **may** not move up the stock until AFTER the money is raised (which means there really is no advantage in owning the stock now).*

Needless to say, if Eagle misses, CGX Energy will have a single digit stock price. The stock chart has been outperforming lately – just staying flat. I may sell all or most of my position once they announce a firm spud date. Or I might get bored & sell anyway, given my comments above. The stock chart has outperformed the last 3 weeks (just by staying flat when everything else down 25%).



## TAG OIL – TAO-TSXv

Tag released the final set of flow rates from its recent four well program. Sidewinder 2, which had the most pay of any of the wells, flowed at an average rate of 1467 boe/d, for a four well total of 5,065 boe/d. Here is a chart which says how the most recent four wells did:

### Sidewinder Discovery Flow Test Results

SIDEWINDER DISCOVERY FLOW TEST RESULTS

Sidewinder well	Gas flow rate (mcf/d)	Boe flow rate (boe/d)	Final drawdown rate	Net oil and gas pay encountered
Sidewinder-1	7.40	1,233	28%	14 metres
Sidewinder-2	8.80	1,467	25%	47 metres
Sidewinder-3	7.21	1,202	40%	15.4 metres
Sidewinder-4	6.98	1,163	25%	19 metres
Totals	30.39 mmcf/day	5,065 boe/day		

These wells should come onstream late August or early September. The spot and long term price for natural gas in New Zealand can be quite different, so I'll be talking to management about what prices they think they will be getting.

Reminder: this stock chart looks very vulnerable. The next big news is two months away when these wells are brought into production, unless something happens on the east coast. So it could dip before fundamentals bring it back up.

## COASTAL ENERGY CEN-TSX

Coastal reported Q1 financials this week. This company has successfully drilled 9 of 10 wells this year and added 41 million barrels of reserves this year. Many of these wells have yet to be brought onstream. Production is up from 7500 to 10125 from Q4 2010 to Q1 2011.

Production should continue to grow with these new wells being brought online later this summer. Songkhla production declines continue at a modest 10% per year.

The following chart represents the Company's Average BOE/D on a quarterly basis



	Offshore (mmbbl)	Onshore (mmboe)	Total (mmboe)
December 31, 2010	27.0	24.0	51.0
Exploration Additions	41.1	0.0	41.1
As of June 15, 2011	68.1	24.0	92.1

*Note: 2011 reserve additions are Coastal internal estimates; a third party certification is underway*

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Offshore reserves have risen by 150% and total Company reserves have risen by 80%

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Costs are increasing as the company hires more people as it grows. The company took an \$18 million non-cash hit on its financial statements this quarter because of their hedge that is underwater.

Production increases should keep the stock steady to an uptrend.

## FINAL NOTE

Reminder I am on holidays July 7 – Aug 1, and there will be little communication then unless there is some stunning market moving news on OGIB stocks.

Starting in August I will continue with bi-weekly wraps, not weekly reports. But sometimes I come across something and I think – I have something to say on that, that will help subscribers understand the market better – and I just have to get it down on paper. (But the #1 people unsubscribe is they say reading all my writing takes up too much of their time!)

Very interesting article in NY Times sent to me by a subscriber where middle-level industry insiders are caught asking questions about reserve life of shale gas while senior executives exhort shale gas as the saviour. The reality is that on economics, the high prices paid for land will likely mean that full cycle economics will rarely show a profit on many plays.

[http://www.nytimes.com/2011/06/26/us/26gas.html?pagewanted=1&\\_](http://www.nytimes.com/2011/06/26/us/26gas.html?pagewanted=1&_)

r=1

This is very similar to the argument Art Berman (not the Canadian BNN-TV Monday morning guest) has been saying for over 2 years – this just has some industry insiders backing him up.

The article doesn't draw any conclusions, and don't rush out to buy natgas stocks just yet, but it is another brick in the wall for the bulls. Natgas stock picking would be like shooting fish in a barrel if the wells in the Haynesville got shut in after 5-6 years. We would all make a lot of money. But I'm willing to miss the first 10-15% of that move to make sure it's real.