Learn, Invest and Prosper in Oil & Gas

OIL AND GAS
INVESTMENTS BULLETIN

BULLETIN #138 – October 15, 2013

ROCK ENERGY RE-TSX; RENFF-PINK

COMPANY ANALYSIS

It usually pays to look in the places that everyone else hates.

Not many places have been hated more for the last two years than small heavy oil producers. The headline noise from oil price differentials—the huge discount that heavy oil was receiving in December 2012—and the delay of the Keystone XL has overwhelmed the fundamentals for these stocks.

The funny thing about Rock Energy is that most people don't even know that it is a heavy oil producer. That is because up until the Board of Directors decided to press the "re-set" button two years ago Rock Energy was known for its Montney natural gas play.

Today Rock has a conventional heavy oil play with fantastic economics (wells with very fast payback), a clean balance sheet (low debt) and a below-peer-group valuation.

On top of that, the company may be poised to announce that it also has 250 drilling locations in the Viking horizontal oil play—directly north of the country's most valued producer--that it picked up on the cheap when nobody was looking.

Rock Energy's stock is cheap without this Viking oil play.

If the Viking play comes in then this one is going to be a big winner… We find out the week of October 15.

…more

QUICK FACTS

Share Price:	$2.35
Current Production:	>3,500 boe per day (90% oil and liquids)
Basic Shares Outstanding:	39.3 million
Market Cap:	$92.3 million
Net Debt:	$8.2 million
Enterprise Value (EV):	$100.5 million
Q3 Estimated Cash Flow:	$0.25 per share
EV / Cash Flow:	2.35 times

http://rockenergy.ca/

POSITIVES

- Low debt – the Canadian market hates debt (especially for small companies)
- Inexpensive, fast payout wells
- Low decline rates
- Able to finance exploration and development internally
- Potential huge catalyst with unveiling of Viking oil play
- Proprietary exploration model

NEGATIVES

- Subject to volatile Canadian heavy oil differentials
- Limited number of development locations on Mantario discovery
- Viking acreage is outside defined limits of the play and is no sure thing
- Financing options limited for small companies, have to be able to self-finance

BACKGROUND

Rock Energy is a company that the market has forgotten about. And I'm jumping in now because that is starting to change.

This isn't the Rock Energy the market used to know.

Rock was formed in 2004 but it was in 2012 that the company decided it was time for a "fresh start" that has brought the company to where it is today.

Rock's CEO Al Bey told me that the fresh start for Rock involved restructuring three things:

- Rock's balance sheet
- Rock's assets
- Rock's team

That is not a minor makeover. That is a "re-start" of pretty much everything.

Step one of the restructuring was to clean up the balance sheet.

The biggest step toward that happened in February 2012, when Rock sold all of its Montney natural gas assets for $46 million. The cash proceeds were used to eliminate all bank debt and completely cleaned up Rock's balance sheet.

Step two in the restructuring involved Rock's assets.

Rock's Board of Directors and top management decided that natural gas producers would continue to face challenges in Canada for the foreseeable future.

For Rock Energy that meant the company would be moving to a focus on oil plays. But according to Bey, for a small company like Rock, only <u>certain types</u> of oil plays will do.

Most of the big name resource plays that get all of the attention today require big bucks to drill wells. The emerging Duvernay play for example, costs up to $15 million per well. For a company with 2,000 barrels of production that just isn't going to work.

Rock decided that it needed to be operating in oil plays that allow them to drill 30 to 40 wells per year, which means that well costs have to be under a million dollars.

To be inexpensive, a well needs to be quite shallow (the deeper a well the longer it takes to drill).

That led Bey and his team back to the plains along the Alberta and Saskatchewan border and into heavy and medium gravity crude.

I'll get into the specific assets in a little bit.

Step 3 of the restructuring involved the people at the company.

As I mentioned Rock is led by Al Bey (President/CEO) who was previously President & CEO of Avid Oil & Gas.

Avid Oil & Gas was founded in May 1996 as a private company (then called Ardent Energy) with an initial offering price of $0.20 per share.

Ardent completed an RTO (reverse takeover) of Avid Oil & Gas in June 1999 at $0.63 share.

The company grew production to 5,700 BOE/d before selling to Husky in June 2001 for $5.85 per Class A share. This generated an 830% return and an impressive 191% CAGR for Avid shareholders from the RTO.

For the Rock restructuring, Bey went back to his days at Avid and brought in some familiar faces.

Key members of Rock's management team who founded/worked at Avid Oil & Gas include Jeff Campbell, (SVP & COO), Josh McDonald (VP Ex), and Stuart Clark (Chairman).

Rock had 25 employees at the time the Board decided that a "fresh start" was needed. Since then 19 people have either been terminated or resigned and 15 new people have come on board.

The last eight quarters Rock has completely transformed its balance sheet, asset base and talent pool.

This is effectively a brand new company.

Not many people have paid attention to the re-start, but the stock chart now tells you that the market is waking up to this transformation.

PROPERTIES

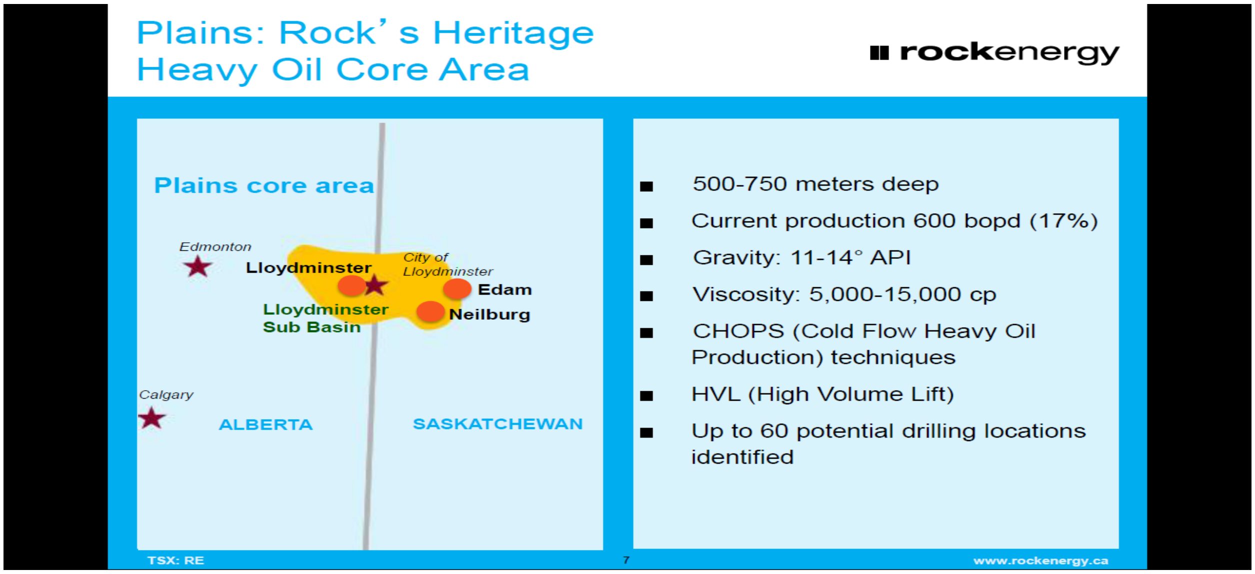
Bey and his team had a very specific set of criteria for the assets that they wanted for a re-start of Rock Energy.

The desired criteria included:

- Oil, not gas
- Shallow depth (manageable well costs)
- Fast payouts (small companies need cash invested paid back quickly)
- Year round access (to limit reliance on other people's infrastructure)
- Low decline rates (to make the company attractive to potential acquirers)

This criteria list led Bey and team back to their heavy oil roots.

<u>Rock’s Heritage Asset – Plains Heavy Oil</u>



Rock didn’t sell all of its assets when it decided to “start over”.

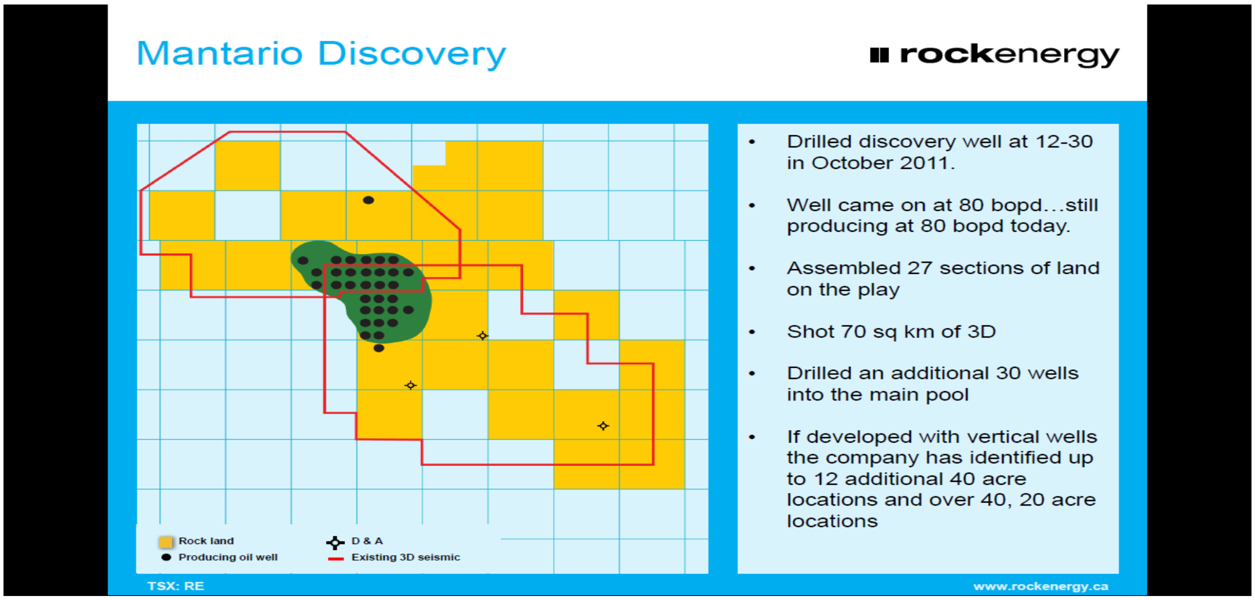
The company kept a heavy oil property near Lloydminster where current production is ~600 barrels per day (bopd).

Operating costs on this property are high ($35 per barrel) so the focus of management has been cost reduction. The attractive thing about this property is that it offers low decline production which can provide cash flow for the other more exciting opportunities that Rock has.

The company currently has 60 development drilling locations on this property and will drill only 3-4 wells in the area in 2013 as money is spent on newer assets.

Rock is milking the cash flow from these Plains assets and using it to develop its new roster of opportunities.

Rock's New Discovery – Mantario



The Mantario pool was an exploration discovery found by Rock in October 2011.

The original well came on production at 80 barrels per day. Today that well is remarkably still producing 80 barrels per day.

Compare that steady production to a typical horizontal light oil well which after two years would be producing at only about 20% of the rate that the well came on production at.

Mantario is also a heavy oil play, but it is a different type of heavy oil than is found further north near Lloydminster in the Plains area.

The gravity of the crude itself in the two locations isn't much different. Both Plains and Mantario are less than 20 degree API.

The difference is that as you move further south in Saskatchewan the heavy oil discoveries are found deeper in the ground where it is hotter and the pressure is higher.

The greater heat and pressure results in the southern Mantario heavy oil being less *viscous* than the northern Plains heavy oil.

What does "less viscous" mean? It basically means less gooey.

Think of the heavy oil at Mantario being like a milkshake, while the heavy oil at Plains is more like molasses.

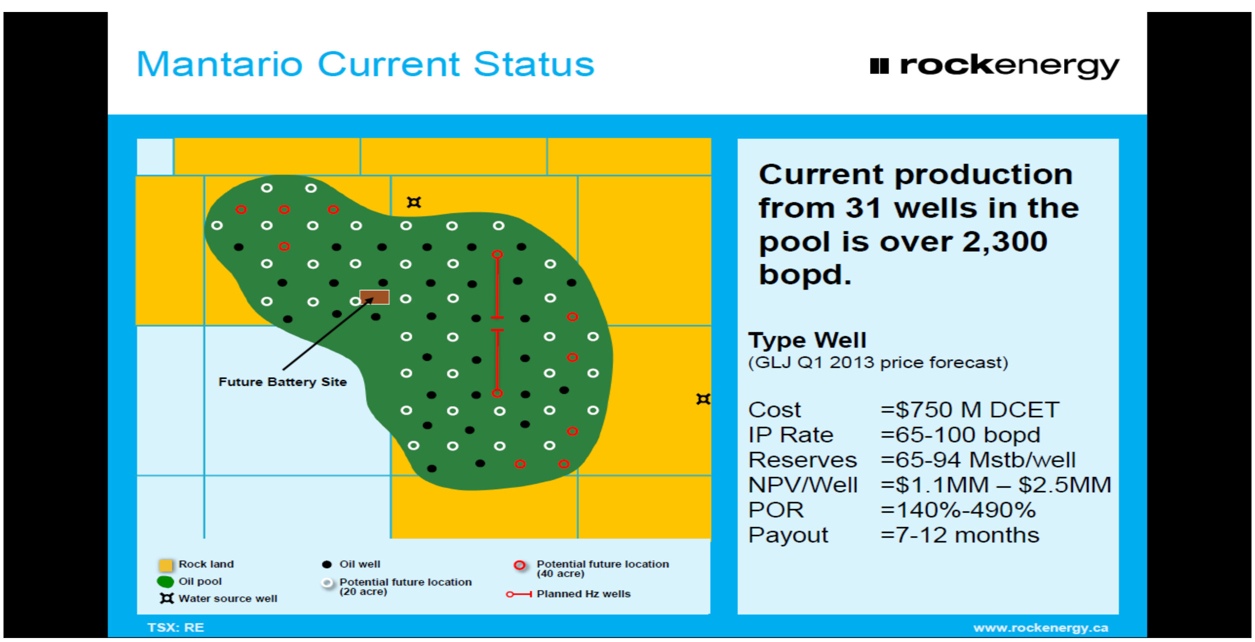
It is much easier to suck a milkshake up a straw than it is to do the same with molasses.

The oil at Mantario therefore flows much easier which means that it can be produced conventionally and does not require the CHOPS (Cold Heavy Oil Processing System) process that is used further north.

This cuts down operating costs and increases the profitability of the well.

Rock has 27.75 sections of land around the Mantario discovery which covers about 3.5 of those sections and has 35 million barrels of oil in place.

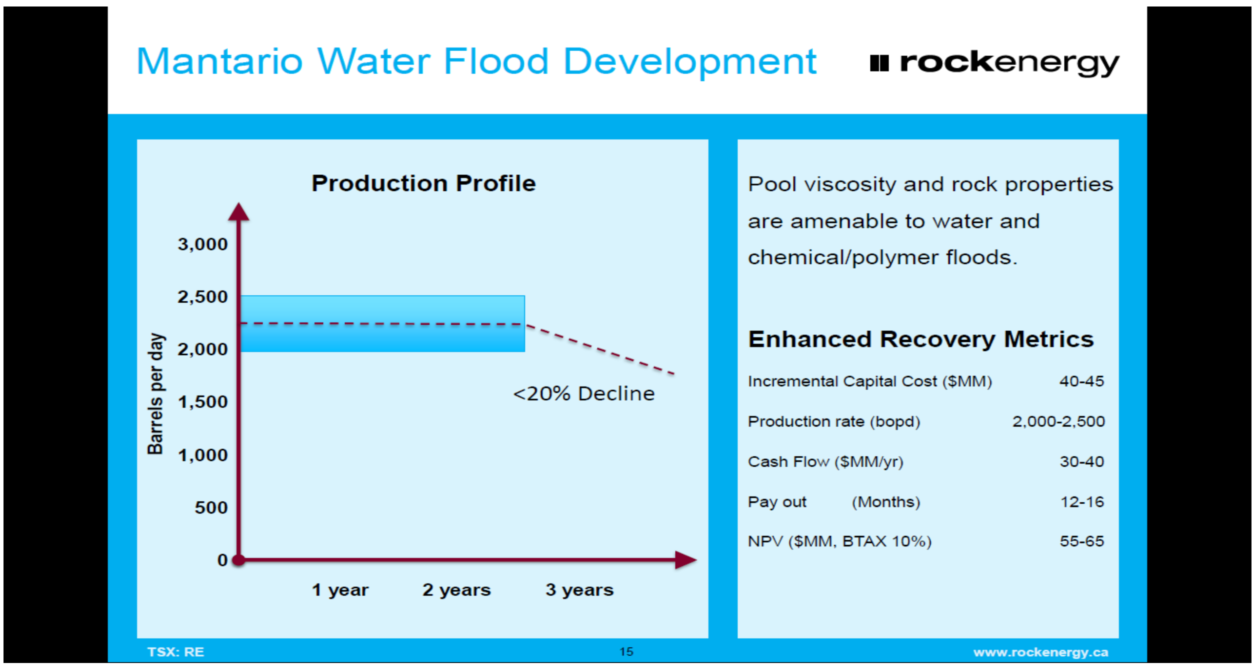
Rock has drilled 30 wells into the discovery and estimates it will need to drill another 50 into it.



The Mantario development wells have <u>outstanding</u> economics with rates of return of up to 500%. These wells offer payback in less than a year in most cases and at current oil prices as little as six months.

That is the benefit of being able to develop a conventional play without having to spend the money to drill horizontally and then “frack” the wells.

On top of the fast payback, these wells also have low decline curves offering flat production for 2-4 years before starting into a <20% annual decline after a full water flood and polymer flood. This very porous formation.



The key to keeping those decline rates low will be water flooding the play.

Rock has already started on a program to water flood this pool even though it isn’t even two years old at this point.

Early flooding this quickly is quite unique as most companies wait for the pool to have its production decline significantly before implementing a water flood.

Rock is instead being proactive and trying to get the most oil possible out of the Mantario pool by having the water flood operational within a year. Rock believes that water flooding sooner will result in more oil being recovered.

After water flooding Rock will follow up with a polymer flood to further increase recovers.

What a polymer flood involves is taking the water than you normally inject into a reservoir and thickening it with a jelly like substance. This helps the water sweep the oil more efficiently into the producing well.

Primary recovery is estimated to recover 7% of the oil in place at Mantario. Rock believes that water flooding will boost recoveries to 14% and then polymer flooding can up that to 21%.

Mantario is clearly a great discovery for Rock.

It has wells that don't decline for two years and then gradually decrease by 20% per year. The wells pay out in less than a year and the return on investment is as high as 500%. It sounds like a dream next to the high decline horizontal resource play wells that are common today.

And it is true. Mantario is a great play.

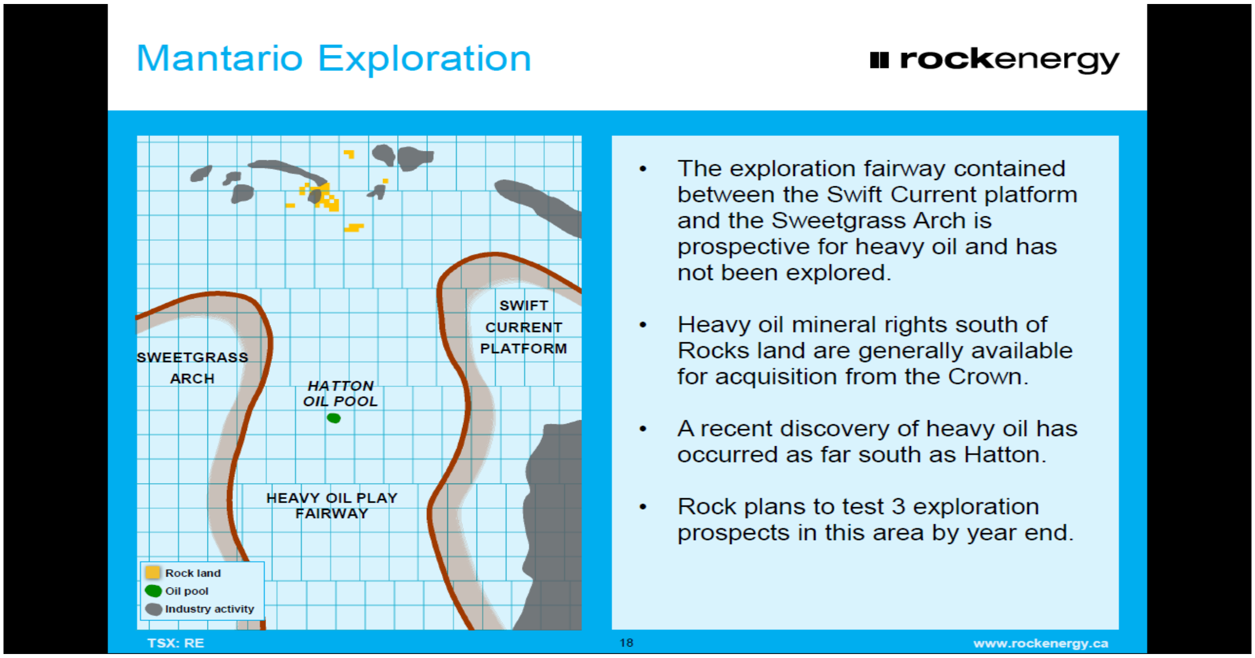
But….

The negative part is that unlike a resource play where you have hundreds of drilling locations, a conventional oil play like Mantario has a limited amount of running room.

Rock has to make additional exploration discoveries in order to keep refilling its inventory of drilling locations. Rock has another 50 development locations at Mantario currently identified.

That gives them another couple of years of drilling to do at current rates.

So Rock needs to find some more oil if it wants to keep growing.



In 2012 Rock shot 72 square kilometres of 3D seismic to better understand the extent of its Mantario pool as well as potential step-out pools nearby.

Management believes it has identified three potential follow up pools which will be tested over the next six to nine months.

These exploration tests are only about a thousand feet deep so they are cheap…about $400,000 a pop.

If Rock puts $10 million of its capital program for next year into exploration that will given them 20 shots at finding "another Mantario"

Those are pretty good odds. All Rock needs is one success to have a "second Mantario".

Rock's Future Assets – Onward / Viking Exploration

Rock acquired its Onward Mannville pool with 200 barrels of heavy oil production in late 2011.

But it isn't heavy oil that Rock is after in this case. Onward is a shot at a major inventory of Viking light oil horizontal drilling locations.

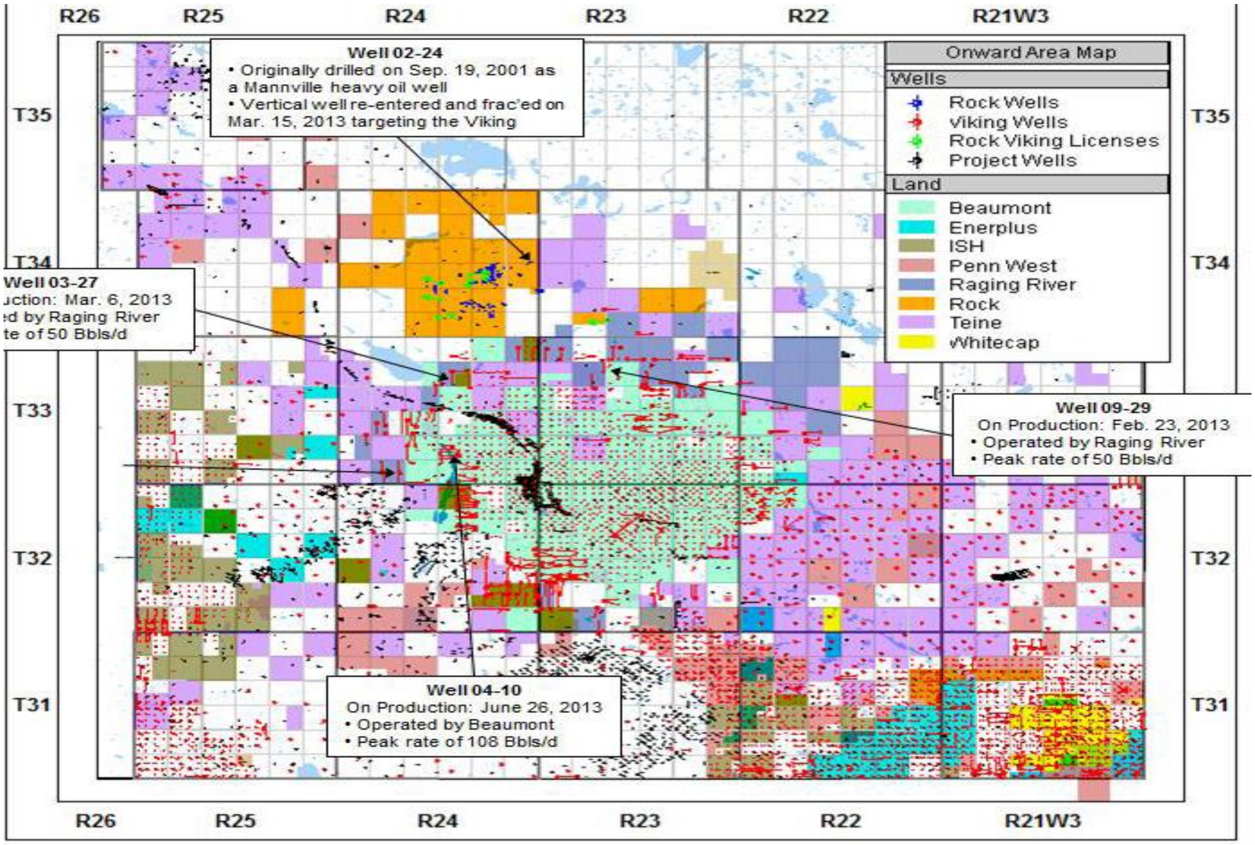
Rock's stock price jumped last week on a research report from a Canadian brokerage firm that suggested that based on 8 wells per section Rock could have 250 Viking drilling locations and with 16 wells per section 500 drilling locations.

The Dundee report was the first "sniff" the market got of this Viking potential for Rock.

250 to 500 drilling locations is HUGE for a company the size of Rock Energy.

Rock is currently testing two Viking horizontal wells with results due October 15 after market. If they are successful, I expect that to be a HUGE catalyst for the stock.

In total Rock has assembled over 36 sections of land and already tested a couple of vertical wells. Additionally they have compared those well results to results from Raging River—RRX-TSX and a major Viking player—that has land one section to the south.



Rock believes that the vertical core samples of their wells look <u>exactly</u> like the Raging River core samples.

You won't find anything in Rock's presentations on the Viking because the company has been quietly continuing to acquire land.

That is music to my ears….these companies <u>have to</u> UNDERPROMISE and OVERDELIVER if they want any respect in this brutal market.

Rock was able to acquire this land right under the nose of the industry as others believed that this acreage was too far "up dip" and in the gas (instead of oil) zone.

Rock's previous vertical test wells have shown otherwise. The results from the horizontal wells will tell us a lot more.

FINANCES

After selling its Montney natural gas assets in the first quarter of 2012 for $46 million Rock has had a clean balance sheet.

The company currently has $10 million of debt and cash flow at the current level of production (3,500 boe/day) is more than $30 million.

Bey expects that the company will exit 2013 with about $15 million of net debt.

Because of the low decline nature of Rock’s Plains and Mantario assets Bey believes it can fund a $75 million capital program next year and still keep debt to cash flow under 1X.

That is the only way to run a junior producer in this debt leery Canadian market. Small companies with debt to cash flow over 1.5 to 1 get no interest from investors.

Rock was one of the first to send crude via rail which has helped to hedge against the heavy oil differential volatility.

Rock has directly leased 30 of its own rail cars for a period of five years, providing capacity of up to 500 Bbs/d. Railing with third parties gives the company another 500 Bbls/d of capacity directly to the US Gulf Coast.

Bey thinks that Rock could fund the development of the Viking internally—with no share dilution--but there isn’t much speculating on that until we really know what they have.

One thing is for certain, and that is having to find a way to finance the development of 250 Viking drilling locations would be a nice complication to have to deal with.

VALUATION

It doesn't always take a rocket scientist to figure out that a company is cheap.

That is DEFINITELY the case with Rock and that is a good thing, because I don't work for NASA and will never be invited to.

Here are a couple of numbers that tell the entire valuation story. Remember that the current stock price is $2.35 (was $2.11 when I bought).

- Based on current production of 3,500 barrels per day, third quarter production is going to be roughly $0.25 per share. That is $1.00 per share on an annualized basis. That means that Rock is trading for just over two times current cash flow.

- For 2014 CEO Bey believes that the Mantario property alone will cash flow $1.00 per share. That means that at the current stock price Rock looks cheap just considering the cash flow from Mantario alone.

- How about one more? At the current share price and enterprise value of $100 million Rock is trading at $28,500 per flowing barrel. That is the kind of metric you might expect to see for an indebted natural gas producer. Not a nearly debt free heavy oil company.

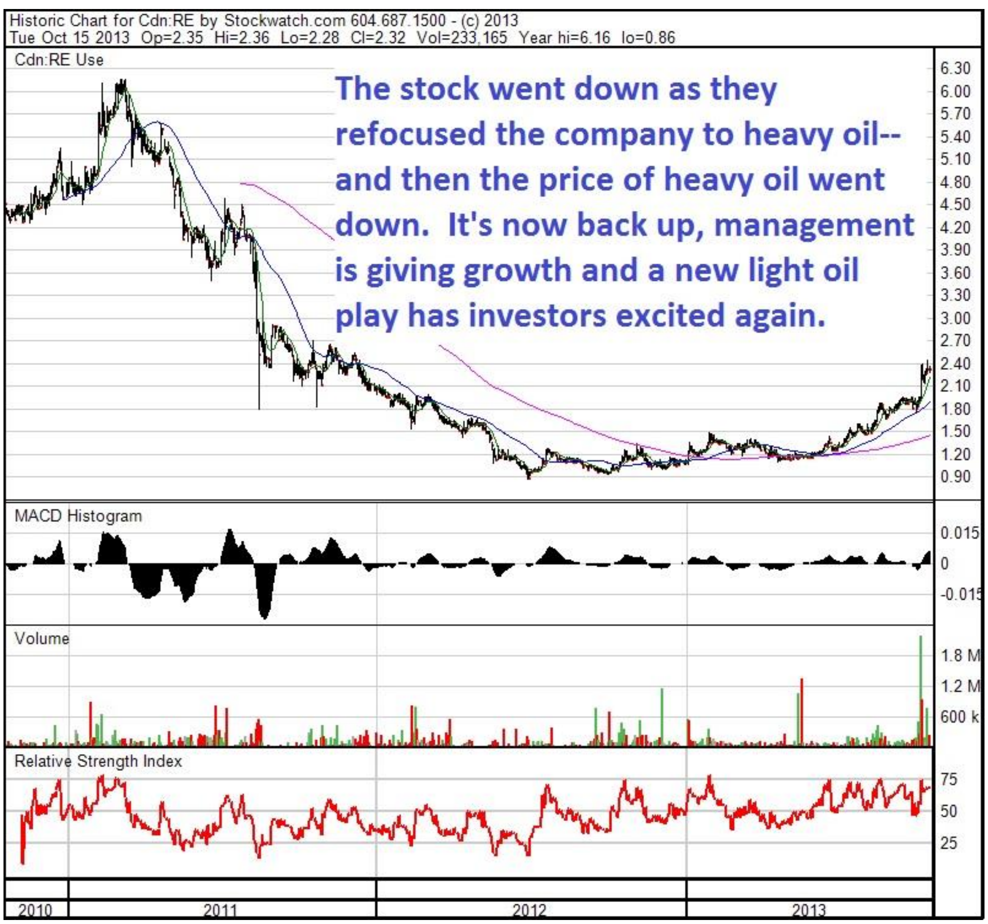
And did I mention that Rock also might have close to 250 Viking light oil drilling locations?

There is no guarantee that the Viking play is going to come in, but at the current share price Rock is cheap based on Mantario alone. That means we pay nothing for the Viking acreage that could be worth more than entire Rock Energy share price.

WHAT THE ANALYSTS SAY (look for these numbers to move up if the Viking play hits…)

FIRM	TARGET PRICE
Acumen Capital	$2.25
Altacorp	$2.40
Dundee Securities	$3.00
First Energy	$2.90
GMP Securities	$2.00
Jennings Capital	$2.00
Paradigm	$2.00
PI Financial	$2.20

STOCK CHART



CONCLUSION

I love to own a stock like this. It has a very low valuation due to the market looking backward to the severe heavy oil discounts of 2012. There is growth here with a clean balance sheet even without the new light oil play in the Viking formation. I own 50,000 shares at $2.11.

About Oil & Gas Investments Bulletin

Keith Schaefer, Editor and Publisher of Oil & Gas Investments Bulletin, writes on oil and natural gas markets - and stocks - in a simple, easy to read manner. He uses research reports and trade magazines, interviews industry experts and executives to identify trends in the oil and gas industry - and writes about them in a public blog. He then finds investments that make money based on that information. Company information is shared only with Oil & Gas Investments subscribers in the Bulletin - they see what he's buying, when he buys it, and why.

The Oil & Gas Investments Bulletin subscription service finds, researches and profiles growing oil and gas companies. The Oil and Gas Investments Bulletin is a completely independent service, written to build subscriber loyalty. Companies do not pay in any way to be profiled. For more information about the Bulletin or to subscribe, please visit: www.oilandgas-investments.com.

Contact Us:
Email: customerservice@oilandgas-investments.com
Customer Service: 1-877-844-8606 / www.oilandgas-investments.com