

15 Jan 2016

EMPIRE OIL & GAS LTD (EGO)

RGN-1.....a promising start

In late December Empire Oil & Gas (EGO) announced the discovery of 53m of net gas pay within the primary target zone of the Red Gully North-1 well (RGN-1). The amount of gas pay exceeded EGO's pre-drill expectations. The Company plans to production test the well in March / April this year. Porosities of the C and D sand were similar to the Gingin 1 well which flowed gas. The well test will confirm gas deliverability potential and allow reserves to be booked. The reserve volume and economics will then determine if EGO expands the Red Gully gas plant or simply uses the reserves to extend the life of the current plant.

Prior to the testing program, EGO expect to complete a volumetric assessment of the RGN-1. Other near term catalysts include the release of the December Quarterly, which should include a sharp increase in operating cash flow associated with Phase 2 of the Alcoa Gas Sales Agreement. We maintain our Speculative Buy recommendation on EGO with a 12-month target price of 63cps (from 75cps). We continue to like that EGO has production and cash flow and a large acreage position in a known petroleum basin.

RGN-1 highlights

In late December last year EGO released an update to the market on the RGN-1 well. The highlights of the well included;

- A total of 53m of net gas pay encountered within the C and D sands of the Cattamarra Coal Measures (primary objective). Gas pay exceeded EGO pre drill expectations.
- Drilling of the primary objective between 3,725m and 4,074m generate elevated gas readings.
- Porosity was initially interpreted as being lower than expected. Interpreted average porosity of the C and D sands was 9% and 10% respectively. Data analysis of nearby wells (Gingin-1, Gingin West-1 and Red Gully-1) enabled EGO to better understand and interpret the pay zones within RGN-1.
- Additional thinner sandstones were encountered beneath the C and D sands. These pay zones are not included in the 53m net pay.
- RGN-1 was completed on time and within EGO's cost estimates. EGO has ordered a production completion designed to allow for zonal isolation in order to complete an enhanced testing program.

Valuation and risks

We have lowered our 12-month target price to 63cps to take into account lower condensate pricing and value of other exploration ground. At the core of our valuation is the Red Gully gas operation, valued at A\$43m or 39cps. The remainder of our 63cps valuation is made up from Red Gully North (9cps), Gin-Gin East and other exploration (18cps). EGO's net debt at the end of September was estimated to be A\$7m. Risks associated with our recommendation include disappointing RGN-1 flow rates and pressure on longer term gas prices. We would also like to see EGO start to reduce balance sheet debt.

Share Price: \$0.39
12mth Price Target: \$0.63

Brief Business Description:

EGO is a gas producer and explorer with a core focus on the Perth Basin. Key asset is the Red Gully Gas plant

Hartleys Brief Investment Conclusion

EGO generates cash flow from gas sales from the Red Gully Gas plant. Flow testing of the Red Gully North-1 exploration well is the most significant near term catalyst for the stock price.

Chairman & CEO:

Antonino (Tony) Iannello Chairman
Ken Aitken CEO

Substantial Shareholders:

ERM Power 19%
Vison Pty Ltd 6%

Company Address:

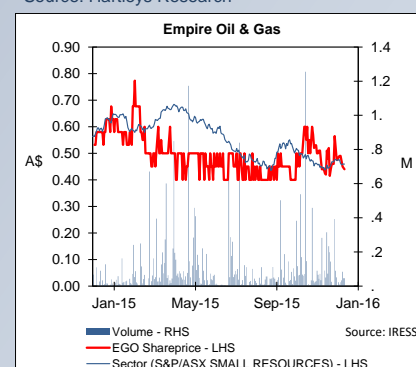
229 Stirling Highway
Claremont

Issued Capital: 102
- fully diluted 112
Market Cap: \$39.9m
- fully diluted \$43.7m
Current Debt \$14.4m
Current Cash \$8.0m

	FY14	FY15F	FY16F
Prod (TJ)	1,855	2,876	2,993
Op Cash Flw	-\$6m	\$0m	\$10m
Free Cash Flw	-\$9m	-\$21m	-\$5m
NPAT* (A\$m)	-\$2m	\$4m	\$3m
EPS (\$, bas)*	-2.03x	3.64x	2.53x
P/E (basic)*	-19.2x	10.7x	15.4x
EV / EBIT	-22.2x	12.1x	13.4x
EV / EBITDA	27.5x	4.4x	4.7x
N.D. / equity	2%	4%	13%
Net Cash End	\$1.9m	-\$1.6m	-\$7.0m

*normalised

Source: Hartleys Research



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SUMMARY MODEL

Empire Oil & Gas NL EGO		Share Price \$0.390				January 2016 Speculative Buy					
Key Market Information						Directors					
Share Price							Company Information				
Market Capitalisation							Ground Floor 229 Stirling Highway Claremont WA 6010 www.empireoil.com.au				
Issued Capital											
Issued Capital (fully diluted inc. ITM options)											
Options											
EV											
Valuation						Substantial Shareholders					
12 Month Price Target	\$ ps						m shares %				
							ERM Power 1,982.6 19.4%				
							Vison Pty Ltd 596.6 6.0%				
P&L						Production Summary					
	Unit	2014A	2015F	2016F	2017F	Unit	2014	2015	2016	2017	
Net Revenue	A\$m	12.4	21.1	20.4	27.7	Gas	TJ	1,855	2,876	2,993	3,195
COGS	A\$m	(4.5)	(5.5)	(5.9)	(5.4)	Condensate	k bbl	88	125	105	120
EBITDAX	A\$m	1.7	10.9	10.3	17.8	Price Assumptions					
Depreciation/Amort	A\$m	(3.9)	(6.9)	(6.7)	(9.1)		Unit	2014	2015	2016	2017
EBIT	A\$m	(2.2)	4.0	3.6	8.8	Gas	A\$/ Gj	4.95	6.00	6.50	6.50
Net Interest	A\$m	(0.1)	(0.2)	(0.8)	(0.5)	Condensate	A\$/bbl	103.33	62.33	53.33	60.00
Pre-Tax Profit	A\$m	(2.3)	3.8	2.8	8.3	FX					
Tax Expense	A\$m	-	0.3	-	-	Share Price Valuation (NAV)					
NPAT	A\$m	(2.3)	4.1	2.8	8.3	A\$m		Un-risked	Risking	Risked	cps
Abnormal Items	A\$m	-	-	-	-	Red Gully Gas Plant		42.9	100%	42.9	38.37
Reported Profit	A\$m	(2.3)	4.1	2.8	8.3	Red Gully North		19.4	50%	9.7	8.67
Balance Sheet											
	Unit	2014A	2015F	2016F	2017F	Gin-Gin East		48.8	20%	9.8	8.72
Cash	A\$m	1.9	12.9	7.4	5.1	Other Exploration				10.0	8.93
Other Current Assets	A\$m	0.8	2.0	1.9	2.5	Cash				12.9	11.51
Total Current Assets	A\$m	2.7	14.8	9.3	7.6	Less: Debt				-14.4	-12.89
Property, Plant & Equip.	A\$m	45.9	57.9	51.3	42.2	Valuation					
Exploration	A\$m	8.0	10.0	25.0	30.0						63.30
Investments/other	A\$m	0.1	0.1	0.1	0.1	Petroleum Tenements					
Tot Non-Curr. Assets	A\$m	54.0	68.1	76.5	72.4	Permit	JV Partner				% Interest
Total Assets	A\$m	56.7	83.0	85.8	80.0	PL-18 ProductionLicence					100%
Payables	A\$m	2.7	2.7	2.7	2.6	PL-19 ProductionLicence					100%
ST Debt + other	A\$m	12.9	1.1	1.1	1.1	PL-96 PipelineLicence					100%
Total Curr. Liabilities	A\$m	15.6	3.8	3.8	3.7	EP 389					100%
Long Term Borrowings	A\$m	0.0	14.4	14.4	0.4	EP 426	EGO				78%
Other	A\$m	4.5	4.5	4.5	4.5		Norwest Energy NL				22%
Total Non-Curr. Liabil.	A\$m	4.5	18.9	18.9	4.9	EP 368	EGO				80%
Total Liabilities	A\$m	20.1	22.8	22.7	8.7		Norwest Energy NL				20%
Net Assets	A\$m	36.6	60.2	63.0	71.3	EP 432	EGO				100%
Cashflow						EP 454					100%
	Unit	2014A	2015F	2016F	2017F	EP 430					100%
EBITDA	A\$m	1.7	10.9	10.3	17.8	EP 416	EGO				40%
Chg WC	A\$m	(1.2)	(1.2)	0.0	(0.7)		Pilot Energy				60%
Interest	A\$m	(0.1)	(0.2)	(0.8)	(0.5)	EP 440					100%
Tax	A\$m	-	0.3	-	-	EP 480	EGO				40%
Other	A\$m	(6.2)	(10.0)	-	-						
Gross Cash Flow	A\$m	(5.8)	(0.2)	9.5	16.7						
Capex	A\$m	(3.3)	(21.0)	(15.0)	(5.0)						
Other	A\$m	-	-	-	-						
Free Cash Flow	A\$m	(9.2)	(21.2)	(5.5)	11.7						
Share Issuance	A\$m	0.0	19.5	0.0	0.0						
Debt Issuance	A\$m	2.0	14.4	0.0	(14.0)						
Dividend	A\$m	0.0	0.0	0.0	0.0						
Other	A\$m	0.2	(1.8)	0.0	0.0						
Net Chang in Cash	A\$m	(7.0)	11.0	(5.5)	(2.3)						
Ratio Analysis											
	Unit	2014A	2015F	2016F	2017F						
Free Cash Flow / share	A¢	(8.2)	(18.9)	(4.9)	10.4						
Cashflow Multiple	X	(4.8)	(2.1)	(8.0)	3.7						
Earnings Per Share	A¢	(2.0)	3.6	2.5	7.4						
Price to Earnings Ratio	X	(19.2)	10.7	15.4	5.3						
EV / EBIT	X	(19.7)	10.7	11.9	4.9						
EV / EBITDA	X	24.4	3.9	4.2	2.4						
Interest Cover	X	na	na	na	na						
Net debt / Equity	%	2%	4%	13%	na						
Analyst : Simon Andrew Phone: +61 8 9268 3020						Last updated January 15, 2016					
Sources: IRESS, Company Information, Hartleys Research											

We value EGO at 63 cps - the Red Gully gas operation accounts for 39cps

VALUATION

We have lowered our 12-month target price to 63cps to take into account lower condensate pricing and value of other exploration ground. At the core of our valuation is the Red Gully gas operation, valued at A\$43m or 39cps. The remainder of our 63cps valuation is made up from Red Gully North (9cps), Gin-Gin East and other exploration (18cps). EGO's net debt at the end of September was estimated to be A\$7m.

Fig. 1: EGO valuation summary

A\$ m	Un-risked	Risking	Risked	cps
Red Gully Gas Plant	42.9	100%	42.9	38.37
Red Gully North	19.4	50%	9.7	8.67
Gin-Gin East	48.8	20%	9.8	8.72
Other Exploration			10.0	8.93
Cash			12.9	11.51
Less: Debt			-14.4	-12.89
Valuation				63.30

Source: Hartleys Research

We expect EGO to refinance the A\$15.1m in debt currently outstanding with ERM Power (ERM). The current debt facility is interest free and due in August 2016 but carries an escalation clause should the EGO share price appreciate above 80cps.

“Under this mechanism, EGO will increase the amount it pays to ERM on top of the \$15.1 million by a percentage equal to 70 per cent of the percentage increase in EGO's share price. For example, if EGO's share price increases by 50 per cent, EGO will increase the amount it pays to ERM by 70 per cent of 50 per cent, or 35 per cent. This would result in an additional payment to ERM of \$5.7 million. This means that the final amount ERM receives from EGO for these assets is closely aligned to EGO's success.”

RISKS

Investment in the oil and gas sector should be considered high risk. There is no guarantee of exploration success. Further to this, producing assets typically decline without further exploration and development. Specific risks include exploration risk, development risk and production risk.

Our exploration valuation includes a risked metric based on prospect size for permits or wells held by the Company. In essence, exploration values assume that the market will recognise a portion of potential value before the results of a well are known. In most cases, we include just 10% of potential prospect value in our valuations. However, this may increase or decrease depending on the type of well being drilled and confidence in the prospect.

SIMPLE S.W.O.T. TABLE

Strengths	Experienced management team Long history in Perth Basin Numerous prospects Near term cashflow Strong domestic gas market
Weaknesses	Balance sheet debt Relatively short reserves life
Opportunities	Red Gully gas plant improves commercial potential of any nearby discovery Other exploration success Continuing exploration and operational success could improve Company reputation
Threats	Production issues Exploration failure Environmental concerns Board/shareholder disputes

Source: Hartleys Research

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Hartleys Recommendation Categories

Buy	Share price appreciation anticipated.
Accumulate	Share price appreciation anticipated but the risk/reward is not as attractive as a "Buy". Alternatively, for the share price to rise it may be contingent on the outcome of an uncertain or distant event. Analyst will often indicate a price level at which it may become a "Buy".
Neutral	Take no action. Upside & downside risk/reward is evenly balanced.
Reduce / Take profits	It is anticipated to be unlikely that there will be gains over the investment time horizon but there is a possibility of some price weakness over that period.
Sell	Significant price depreciation anticipated.
No Rating	No recommendation.
Speculative Buy	Share price could be volatile. While it is anticipated that, on a risk/reward basis, an investment is attractive, there is at least one identifiable risk that has a meaningful possibility of occurring, which, if it did occur, could lead to significant share price reduction. Consequently, the investment is considered high risk.

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