

18 Oct 2016

EMPIRE OIL & GAS LTD (EGO)

Share Price: \$0.31
12mth Price Target: \$0.57

RGN remediation about to begin

The recent weakness in the share price of Empire oil & Gas (EGO) represents an opportunity for investors ahead of the RGN-1 well remediation work. Upon success, EGO would be able to quickly tie the well into the Red Gully gas production facility, located 4km away from the well. We maintain our Speculative Buy recommendation on EGO with a 12-month target price of 57cps (previously 67cps).

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:

Mineral Resource Limited 19%

Company Address:

229 Stirling Highway
Claremont

Issued Capital: 102m
- fully diluted 119m
Market Cap: \$31.7m
- fully diluted \$37.0m
Current Debt: \$0.0m
Current Cash: \$6.0m

Remediation work on RGN expected to begin shortly

Remediation work on the RGN-1 well is expected to begin mid- November. EGO hope to correct excess water production caused by poor cementing around the 7" casing. Following diagnostic testing, EGO has a better understanding of the subsurface issues, and is therefore confident the remediation work will be successful. The work-over rig has been contracted and final environmental and safety approvals have been submitted to the DMP (regulator). The estimated cost for the work-over and well test is estimated to be A\$2.9, of which A\$0.45m has already been spent.

Assuming remediation work is successful, a production test will then be carried out on the Upper D and C sand. The 7.5PJ of contingent reserve can be easily tied into the Red Gully production plant, which is only 4km away. The RGN-1 well was drilled in late 2015 and discovered 53m of net gas pay.

Balance sheet and debt

During the September Quarter EGO finalised the terms of a revolving working capital facility with MIN. The A\$15.1m facility refinanced the ERM Power debt facility which was due to expire on the 31st of August. The MIN facility has a 3-year term with an interest rate of the Bank Bill Swap Rate plus 5% (currently 6.74%). On or prior to drawdown MIN received 7.5m unlisted options with a strike price of 50c and expire 2-years after issue (11 August 2018).

	FY16A	FY17F	FY18F
Prod (TJ)	2,985	2,790	2,880
Op Cash Flw	\$7m	\$11m	\$15m
Free Cash Flw	-\$9m	\$6m	\$10m
NPAT* (A\$m)	\$4m	\$4m	\$7m
EPS (\$, bas)*	3.26x	3.52x	5.72x
P/E (basic)*	9.5x	8.8x	5.4x
EV / EBIT	19.2x	10.3x	7.1x
EV / EBITDA	5.1x	4.3x	3.2x
N.D. / equity	20%	9%	-5%
Net Cash End	-\$12.3m	-\$6.0m	\$3.5m

*normalised

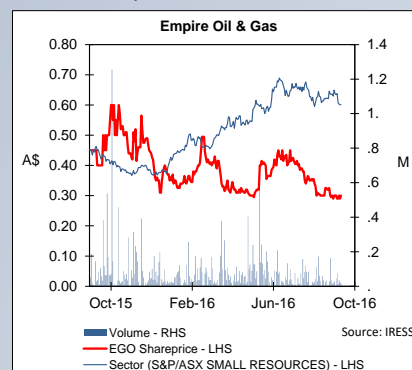
Source: Hartleys Research

Exploration activity

EGO's most promising exploration targets are located on EP368 and EP432. The Lockyer Deep / North Erregulla Deep prospect is located adjacent to Waitsia gas field (2P-2C 630bcf), discovered by AWE earlier in 2016. The target has a prospective resource of up to 256bcf with EGO hoping to drill in 2017. The primary target of the well is the Kingia / High Cliff play. Historical wells in the area encountered hydrocarbons at the Dongara Sandstone level (North Erregulla-1 and Lockyer-1 wells).

Valuation

We have reduced our valuation on EGO to 57cps from 67cps, because of the increase in net debt. At the core of our valuation is the Red Gully gas operation, valued at A\$42m or 35cps. The remainder of our 57cps valuation is made up from Red Gully North (18cps), Gin-Gin East and other exploration (16cps). We currently use a 70% risk factor on Red Gully North (RGN). Should the remediation work be successful, our valuation of RGN would increase from 18cps to 26cps. Net debt at the end of FY16 was A\$12.3m (10cps). Risks associated with our recommendation include a failure to rectify issues at RGN and a decline in gas and condensate pricing.



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SUMMARY MODEL

Empire Oil & Gas NL EGO		Share Price \$0.310					18 October 2016 Speculative Buy																																		
Key Market Information						Directors						Company Information																													
Share Price						Antonino (Tony) Iannello						Chairman																													
Market Capitalisation						Stuart Brown						NED																													
Issued Capital						Philip Garratt						NED																													
Issued Capital (fully diluted inc. ITM options)						Tom Vincent						NED																													
Options						Ken Aitken						CEO																													
EV						Rachel Rees						CFO & Company Secretary																													
Net Debt												Ground Floor																													
Valuation												229 Stirling Highway																													
12 Month Price Target \$ ps						0.57						Claremont																													
												WA 6010																													
												www.empireoil.com.au																													
P&L						Substantial Shareholders						Production Summary																													
Unit						2014A						2015A						2016A						2017F						2018F											
Net Revenue						12.4						19.1						20.0						20.4						25.0											
COGS						(4.5)						(5.3)						(6.2)						(5.3)						(5.5)											
EBITDAX						1.7						9.5						9.6						11.4						15.0											
Depreciation/Amort						(3.9)						(6.9)						(7.1)						(6.7)						(8.2)											
EBIT						(2.2)						2.7						2.5						4.7						6.8											
Net Interest						(0.1)						(0.3)						0.0						(0.5)						-											
Pre-Tax Profit						(2.3)						2.3						2.6						4.2						6.8											
Tax Expense						-						5.3						1.3						-						-											
NPAT						(2.3)						7.6						3.9						4.2						6.8											
Abnormal Items						-						-						7.2						-						-											
Reported Profit						(2.3)						7.6						(3.3)						4.2						6.8											
Balance Sheet						2014A						2015A						2016A						2017F						2018F											
Cash						1.9						11.5						2.9						4.2						8.7											
Other Current Assets						0.8						1.0						3.2						3.3						4.0											
Total Current Assets						2.7						12.5						6.2						7.5						12.7											
Property, Plant & Equip.						45.9						51.8						38.2						31.6						23.4											
Exploration						8.0						15.7						29.9						34.9						39.9											
Investments/other						0.1						5.1						6.4						6.4						6.4											
Tot Non-Curr. Assets						54.0						72.6						74.6						72.9						69.7											
Total Assets						56.7						85.1						80.7						80.4						82.5											
Payables						2.7						2.3						1.9						2.4						2.7											
ST Debt + other						12.9						16.3						15.2						10.2						5.2											
Total Curr. Liabilities						15.6						18.6						17.1						12.6						7.9											
Long Term Borrowings						0.0						3.4						-						-						-											
Other						4.5						-						3.5						3.5						3.5											
Total Non-Curr. Liabil.						4.5						3.4						3.5						3.5						3.5											
Total Liabilities						20.1						21.9						20.6						16.1						11.3											
Net Assets						36.6						63.1						60.1						64.3						71.1											
Cashflow						2014A						2015A						2016A						2017F						2018F											
EBITDA						1.7						9.5						9.6						11.4						15.0											
Chg WC						(1.2)						(0.6)						(2.7)						0.4						(0.5)											
Interest						(0.1)						(0.3)						0.0						(0.5)						-											
Tax						-						5.3						1.3						-						-											
Other						(6.2)						(16.5)						(1.2)						-						-											
Gross Cash Flow						(5.8)						(2.6)						7.1						11.3						14.5											
Capex						(3.3)						(19.3)						(15.6)						(5.0)						(5.0)											
Other						-						-						-						-						-											
Free Cash Flow						(9.2)						(21.9)						(8.6)						6.3						9.5											
Share Issuance						0.0						19.5						0.0						0.0						0.0											
Debt Issuance						2.0						12.9						(0.0)						(5.0)						(5.0)											
Dividend						0.0						0.0						0.0						0.0						0.0											
Other						0.2						(0.9)						0.0						0.0						0.0											
Net Chang in Cash						(7.0)						9.6						(8.6)						1.3						4.5											
Ratio Analysis						Unit						2014A						2015A						2016A						2017F						2018F					
Free Cash Flow / share						A¢						(7.7)						(18.3)						(7.2)						5.3						8.0					
Cashflow Multiple						X						(4.0)						(1.7)						(4.3)						5.9						3.9					
Earnings Per Share						A¢						(1.9)						6.4						3.3						3.5						5.7					
Price to Earnings Ratio						X						(16.3)						4.9						9.5						8.8						5.4					
EV / EBIT						X						(22.4)						18.3						19.2						10.3						7.1					
EV / EBITDA						X						27.7						5.1						5.1						4.3						3.2					
Interest Cover						X						16.6						30.0						na						22.7						na					
Net debt / Equity						%						2%						13%						20%						9%						na					
Share Price Valuation (NAV)						A\$ m						Un-risked						Risking						Risked						cps											
Red Gully Gas Plant						42.0						100%						42.0						35																	
Red Gully North						25.7						70%						18.0						15																	
Gin-Gin East						48.8						20%						9.8						8																	
Other Exploration																		10.0						8																	
Net Debt																		-12.3						-10																	
Valuation																								57																	
Petroleum Tenements						Permit						JV Partner						% Interest																							
PL-18 ProductionLicence																		100%																							
PL-19 ProductionLicence																		100%																							
PL-96 PipelineLicence																		100%																							
EP 389																		100%																							
EP 426												EGO						78%																							
EP 368												Norwest Energy NL						22%																							
												EGO						80%																							
												Norwest Energy NL						20%																							
												EGO						100%																							
EP 432																		100%																							
EP 454																		100%																							
EP 430																		100%																							
EP 416																		40%																							
												EGO						60%																							
EP 440												Pilot Energy						100%																							
EP 480												EGO						40%																							
Analyst : Simon Andrew						Phone: +61 8 9268 3020						Last updated						October 18, 2016																							
Sources: IRESS, Company Information, Hartleys Research																																									

We value EGO at 57 cps - the Red Gully gas operation accounts for 42cps

VALUATION

We have reduced our valuation on EGO to 57cps from 67cps. At the core of our valuation is the Red Gully gas operation, valued at A\$42m or 35cps. The remainder of our 57cps valuation is made up from Red Gully North (18cps), Gin-Gin East and other exploration (16cps). We currently use a 70% risk factor on RGN. Should the remediation work be successful, our valuation of RGN would increase from 18cps to 26cps. Net debt at the end of FY16 was A\$12.3m (10cps).

Fig. 1: EGO valuation summary

A\$ m	Un-risked	Risking	Risked	cps
Red Gully Gas Plant	42.0	100%	42.0	35
Red Gully North	25.7	70%	18.0	15
Gin-Gin East	48.8	20%	9.8	8
Other Exploration			10.0	8
Net Debt			-12.3	-10
Valuation				57

Source: Hartleys Research

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 MIN on the register
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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