

Classical Insights

Global Investment Analysis Based on the Classical Economic Model

Classical Insights Morning Bullet Points April 3, 2009

Calgary E&Ps

Name & ticker	Price (C\$)	Shares out	Mkt cap (C\$ mln)	EV (C\$ mln)	Reserves ('000 bcf)	EV/mcf (US\$/mcf)	Description	
Petrolifera (PDP CN)	1.68	55	\$92	\$139	120	\$0.93	Oil E&P in Argentina, Colombia, Peru	
Highpine (HPX CN)	4.85	67	\$325	\$373	319	\$0.94	E&P in Alberta (60% oil & 40% gas)	
Cirrus (CYR CN)	1.34	75.8	\$102	\$46	53	\$0.69	Oil & gas E&P in Dutch North Sea	
Vero Energy (VRO CN)	3.52	40.1	\$141	\$245	152	\$1.29	Gas in Alberta	
Crew (CR CN)	4.35	71	\$309	\$564	355	\$1.27	Gas & oil in Alberta & B.C.	
WesternZagros (WZR CN)	0.61	170	\$104	-\$21	0	n/a	Pure exploration play in Iraq (Kurdistan)	
Gran Tierra (GTE US)	2.87	Merger in progress w/Solana makes the math complex						Oil E&P in Argentina, Colombia, Peru

There are some exciting and inexpensive E&Ps in Calgary. I met with seven companies this week and liked nearly all of them.

Points:

1) E&Ps here are a good bit cheaper here than in Houston. The firms I met with trade for US\$0.69 to US\$1.29/mcf, vs. about \$1.80/mcf in Houston. Some degree of discount may be justified on the *Canada*-focused E&Ps (due to higher royalties in Alberta, higher costs or lower realized gas prices) but the internationally-focused names such as Cirrus and Petrolifera also carry big discounts to Houston valuations.

2) Crew, Vero and Highpine all are trading around 4x cash flow at US\$4 gas and \$48/bbl. crude. All three are fairly straightforward stories and each can double if gas goes to US\$6/mcf.

3) WesternZagros and Petrolifera have great exploration potential that is being significantly undervalued by the market. Kurdistan, Colombia and Peru are oil-rich countries – but under-explored due to decades of political unrest and uncertainty. There are excellent prospects in these countries – and WesternZagros and Petrolifera both have their share of them.

4) The gas CEOs in Calgary say the same thing as the gas CEOs in Houston: It would be almost impossible for gas to remain this low through next winter because production is set to fall sharply:

- Production from North American gas wells is now declining at a rate of 28% per year. That's up from the 22% decline rate that existed during the 2001 gas-price slump;
- The rig count is down by 40% in North America, so gas production could be down to 52 bcf/day by next winter. That's well below the 57-59 bcf/day (year-round average) needed to meet demand (assuming a mild economic recovery);
- E&Ps generally need \$7/mcf to justify new investment (to cover costs plus generate a 15% return) though that figure should fall some as drilling and production costs fall;
- The ultimate cost of producing shale gas is much higher than generally believed: probably \$7+/mcf. Finding and development costs *alone* are about \$3.75/mcf for shale gas wells. Then you have to tack on operating costs, royalties, G&A and taxes.

5) Still, one has to be a bit concerned about the near-term outlook for both gas and oil: This is the shoulder season for gas (it's neither hot nor cold out), storage is above normal and industrial demand is weak. On the oil side, the oil/gold ratio is now 17.3 barrels per ounce. That's getting

into the “normal” range by historical standards – yet global demand remains weak. One can’t rule out a spike in the oil/gold ratio back to 28-1, which would mean a dip to \$32/bbl. Longer term, a 14-to-1 ratio would be reasonable to posit now, and that would imply \$64/bbl. at \$900/oz. gold.

6) Here is the quick pitch on the seven firms:

Calgary E&Ps: The elevator pitch

Petrolifera	You get the massive Peru & Colombia potential free. (Arg wells justify the EV).
Highpine	Trades at US\$0.94/mcf. In Houston, E&Ps are \$1.80/mcf. F&D costs high, tho.
Cirrus	Trades at \$0.69/mcf and 2.5x 2010 CF. Two fields coming on stream this year.
Vero Energy	Trades at \$1.29/mcf and has 5 years of drilling prospects.
Crew	Trades at \$1.27/mcf and Montney play provides many years of good prospects.
Western Zagros	You get gigantic Kurdistan potential (100-1000 mln bbls) for free (EV is negative).
Gran Tierra	Not sure ... Petrolifera is a similar story but much cheaper (though GT has cash).

7) Two names that have really resonated for me on this trip are WesternZagros and Crew. Western Zagros trades at a negative enterprise value (-C\$21 million) and offers five or six shots at an out-of-the-park home run find in Kurdistan (i.e. 100 million to 1 billion barrels). Crew has years of drilling inventory in the profitable Montney gas play – and the shares are cheap from two key angles: price to cash flow and EV to mcfs in the ground. Vero, Cirrus, Highpine and Petrolifera all are interesting as well and can definitely work. Gran Tierra is probably fine, but Petrolifera gets you access to the same plays (in Argentina, Peru, Colombia) at a much lower price. Highpine has extremely cheap barrels, though it’s in the process of changing its exploration focus, which creates risks.

We’ll be adding Crew, WesternZagros and Petrolifera. (WZR and PDP will go in the EM portfolio.)

Turning to some of the individual companies:

WesternZagros owns a 40% stake in a large exploration block in oil-rich Kurdistan. The potential of this block is huge – especially in relation to the enterprise value of the company (negative C\$26 million). WZR has C\$125 million in cash, which is enough to drill about 5 wells (or more if they bring on partners). Near to WZR’s block sits the massive Kirkuk field (25 billion bbls), and management believes the Kirkuk structure may run through its block. In all, there are about 15 known, oil-bearing rock strata running through all or part of the WZR’s block. Given that even a minor discovery could yield 100 million barrels, this story could work with just one, halfway-successful well.

Kurdistan has never been properly explored because Saddam Hussein disliked the Kurds and wanted to keep the region poor and underdeveloped. WesternZagros was one of the first three or four firms to get in there when the Kurds started leasing out blocks (and thus got a block with a much-higher-than-average number of drillable prospects).

WZR’s first well (Sarqala-1) was drilled last summer and clearly encountered hydrocarbons – but at such high pressure that the well had to be capped before the findings could be logged. Investors viewed this as a major disappointment. The stock, which reached as high as C\$4/share at one point, now goes for C\$0.59/share.

A second well is set to be drilled on the Kurdamir prospect, beginning this spring. This well should be lower pressure than Sarqala-1, and thus easier to control. The drilling process should take 90-180 days, and the plan is to spend the winter analyzing the results.

The top risk here (aside from not finding oil) is political. While WZR’s existing royalty deal is extremely favorable for the Kurdish government (which would get 85% of the oil proceeds), *the Kurds themselves have not finalized a revenue-sharing deal with the Iraqi government.* Until that is done, WZR management is hesitant to commit too much capital (say by drilling more than one well at a time).

There are five potential catalysts that could make this stock rise:

- The Kurdamir well could work;
- A subsequent well could work (though not til 2010);
- The Kurds and Iraqis could reach a revenue-sharing arrangement for oil;
- The market could start to place a higher valuation on exploration-focused E&Ps;
- Oil majors could decide they want to start buying up blocks in Kurdistan. At the moment the majors are only in Iraq proper – they don't want to come to Kurdistan and risk offending the Iraqis.

Petrolifera shares have been hammered harder than any firm in this report (down 93% from their high) – but the firm has great prospects in Colombia and Peru that are being valued at zero. Petrolifera shares shot to C\$25 two years ago after the firm made a big discovery in the Neuquen reservoir in Argentina. But the shares have since plunged below C\$2 due to worsening of the Argentine royalty structure (prices were capped at \$47/bbl.) and the ebbing of production from its Puesto Morales field in Neuquen.

But there are still close to 20 million barrels at Puesto Morales flowing at 7700 boepd, and at the firm's current market cap they are being valued at \$7 each. Management is trying to sell Puesto Morales right now and there's no reason it shouldn't get \$7/bbl. for them. The strategy is to take those proceeds and put them toward exploration in Colombia and Peru.

In Colombia, management thinks it may have 25-50 million barrels on its Sierra Nevada license alone. A test well is underway right now. The well is located 600 meters from an existing, productive well and early results from the test are promising. The going rate for transactions in Colombia and Peru is around \$10/bbl., so if the Sierra Nevada license is as fruitful as management expects, the stock could triple (or more) on this project alone.

Elsewhere in Colombia, Petrolifera has the Terpial license, which is surrounded by three massive fields. The block was dormant for 70 years (1925-1995) and Petrolifera is the first company to shoot seismic on it. Results from the seismic are due late this year or early next year.

In Peru, Petrolifera has three massive blocks, totaling 6 million acres. Peru is a very under-explored country, largely because the Shining Path kept exploration at bay for years. One of the firm's blocks (106) is shaped like a donut – and in the hole is a 75-million-barrel field. Petrolifera is shooting seismic on three prospects surrounding that big field, and would like to start drilling in 2010.

Petrolifera also holds block 107 in the Ucayali basin, which lies 120 miles from a huge, 500-million-barrel field. The block has oil seeps on it, which removes some of the risk. Management says a number of majors have contacted the firm trying to get in on this block.

Eventually, something ought to work out for this company. Colombia and Peru are underexplored countries and Petrolifera has some very promising blocks. At the least, the Sierra Nevada license looks like it's going to be productive. If the firm makes a find in Peru, Petrolifera could be a 10-bagger.

Crew Energy has two main plays, both of which have great economics and plenty of exploration upside. Crew shares have fallen nearly 80% since last summer, to C\$4.35/share. The stock now trades at about 4x expected 2009 cash flow assuming US\$4 gas and US\$48/bbl. WTI (as per management forecasts). The firm has five years of drilling inventory so production can rise (if gas prices warrant it).

Crew shares can double if gas goes back to C\$6-C\$8 per mcf. For the four-year period 2005-2008, Crew posted C\$1.50-2.00 in cash flow every year at gas prices from C\$6 to C\$8. So, if Crew once again posts C\$2.00 in cash flow, there's no reason the market shouldn't put a 4x

multiple on that. Crew has some leverage (C\$255 million) but this isn't a big deal for two reasons: the firm has strong cash flow (even at low gas prices) and it has a fantastic land package – one that could be monetized in a crunch.

The firm's two plays are the Montney gas in British Columbia and the Pekisko light oil in Alberta. The Montney has huge potential. One independent firm ranked it the most profitable shale (or shale-esque) region in North America. So far the firm has booked 2.4 TCF of gas in place, of which 20% are being counted as reserves (i.e. 480 bcf). The figure could triple, though, because Crew controls 184 sections in the Montney, and its current resource estimate only covers 50 of them. Also, recoverable gas may ultimately be closer to 30% of gas in place rather than 20%.

I walked through the economics of the Montney with management. They clear about C\$57 million per section (pre-tax) at C\$5.50 gas. Costs per block (based on four wells) are C\$64 million -- and revenues are C\$121 million. Crew's plan is to do 2-3 sections a year, which would generate roughly C\$135 million in pre-tax, pre-interest-cost cash flow. Crew has 184 of these sections, so the firm will be busy in the Montney for a long time.

The Pekisko Princess oil field also has good economics – and this project has quite a bit of torque. Crew gets 80% of WTI on its production here (so, let's call that C\$48/bbl.). Its costs are on track to be C\$34/bbl. (F&D of \$11/bbl., operating costs of \$11/bbl. and royalties of \$12/bbl. @ \$48/bbl. crude). So, the return on production here is C\$14/bbl. at US\$48/bbl. If oil goes to US\$60/bbl., *the return doubles*. (And, in fact, you can get US\$60/bbl. right now if you hedge to 2010.)

This field is now producing 3,500 bpd for Crew (and thus accounts for about one quarter of the firm's total production).

Last point: Crew is being valued at just US\$1.27/mcf in the ground – and that reflects a very conservative valuation for the Montney gas in place. Crew is a fairly low-risk play operationally with a lot of upside. The top risk is that gas falls to US\$2.50/mcf or so -- thereby creating the potential for debt service issues.

Vero is very similar to Crew in many ways: It trades for almost exactly the same valuation on an EV/mcf-in-the-ground basis, has a similar balance sheet structure, focuses on Western Canadian gas and has 5+ years of drilling inventory. If one goes by management guidance for 2009 cash flow, Vero would appear a bit cheaper (3.3x for Vero vs. 4.0x for Crew). But realistically the difference is within the margin of error. Both companies can muddle through at US\$3.70 gas (or lower) and can do very well at US\$6 gas.

Cirrus Energy operates in the Dutch North Sea, and has two projects coming on stream there this year. Holland is very appealing as an operating environment *because gas trades in lock step with Brent crude (at a 13-to-1 ratio)*. At the current Brent price off \$50/bbl, Cirrus stands to receive \$6.50/mcf.

Cirrus is very cheap on an EV to mcfs-in-the-ground basis (US\$0.69/mcf not including the results of a recent North Sea discovery). It is also cheap on a price-to-2010 cash flow basis (about 2.5x). However, the 2010 cash-flow figure is contingent upon Cirrus management getting two things done:

- Tie in an existing North Sea field to the pipeline;
- Tow a production platform from shore out into the North Sea and bring a second field on to production.

Management expects to have both of these tasks completed by year-end 2009. That would lead to cash flow of C\$20-40 million in 2010 (assuming \$50 Brent), according to management.

Cirrus had the good fortune of doing a financing at the top of the market last summer. Thus, it is cashed up, with C\$56 million and no debt. The capex needed to bring on its two fields is about

C\$40 million. Cirrus has a C\$30 million credit line with RBS that it plans to tap, so that it won't have to spend the bulk of its cash on the above-mentioned projects. Investors are concerned that the credit line will go away (due to problems at RBS) and that Cirrus would then be required to issue more equity to fund additional drilling. Management thinks the credit line will be there (and, really, there's no obvious reason to think it shouldn't be).

The towing of the production platform was supposed to happen last fall, but Cirrus simply ran out of time in the season. (The season for doing work in the North Sea is May-September, and Cirrus was attempting to do this project from September to November).

We would initially value Cirrus at 4x C\$30 million or C\$120 million, plus another \$16 million for left-over balance sheet cash after the necessary capex. That would work out to C\$1.79/share. This would include nothing for exploration upside. Conceptually, the exploration upside offsets the execution risks that exist in 2009. That said, Cirrus is a fairly low-risk operation: They have the cash, and the two tasks to be completed are not terribly difficult.

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