



A Primer on Junior Oil and Gas Investing

Bill Harris & Partners

The junior oil and gas industry is a strangely Canadian phenomenon. In other parts of the world, either most small energy companies are private or the projects themselves are too large to be funded by junior capital pools. Despite this, some enterprising Canadian junior public companies are involved with international projects. The central advantage of investing in junior energy companies is that they are a start-up business that can make money soon after the initial capital is spent. The end product is energy. The challenge is to find a profitable supply.

Where We Are in the Oil and Gas Cycle

Making a judgment call on where we are in the oil and gas cycle will help define what type of company to invest in. A junior energy company generally starts by using one or more of three basic strategies:

- Buy a producing property in the trough of a commodity cycle and hope for a recovery;
- Buy a producing property and exploit it better than the previous owner; and
- Buy land and drill for it.

At these historically high oil and natural gas prices, a company has to have the technical ability to go and find a new supply. A company is referred to as “prospect rich” if they are able to detail their drilling plans for at least the next 12-24 months. In other industries, increased scale is an advantage. However, an efficient small company is probably the best way to manage a smaller oil and gas property.

A Check List

Discovering who the best players are in the industry is an ongoing process. I always like doing most of the research myself. This is a very risky industry, so the best comfort level you can have is your own knowledge base. There is great disclosure from most companies in quarterly reports and presentations filed on their websites. Since they are small companies, their businesses are still relatively simple to understand. Examine these fundamentals:

✓ **Management** is the single most important ingredient for success, yet this assessment is the most subjective. The management team needs to be good at closing deals, have strong technical skills as finders, and the ability to raise capital when needed. Most companies will provide you with a detailed track record.

✓ **Reserves** are what you want to own at the end of the day. Ideally these hydrocarbons will be of higher quality (lighter or less sour) and will be produced over many years. Be advised that reserve accounting is an inexact science.

✓ **Operations** that are low cost will be better insulated against a commodity decline and produce more cash flow to be reinvested in the business. Efficient capital spending will result in low finding costs.

✓ **Measurement** of the company’s performance is best represented by production per share growth over time (annual production/average shares outstanding). As well, most companies will provide a 12-month production forecast, which can then be used to gauge their drilling programs success rate.

Exit Strategy

I always think that it is a little premature to ask a start-up company what their exit strategy is. However, in the oil and gas industry, the average life of a junior is 3-5 years. I like it when management can explain who they are building their assets for. Right now the main buyers of oil and gas properties are the royalty trusts and they are looking for long life-producing properties that require minimal ongoing capital.

Two Valuations

The most common valuation measure for junior oil and gas companies is price to cash flow (stock price/cash flow per share). Here I would encourage you to also use enterprise value to cash flow (market capitalization + debt/cash

flow) as a way to take into account the company's debt burden.

There currently exists a clear distinction in valuation between premium and value companies within the junior oil and gas sector. A typical cash flow multiple for a premium company will be around 6-7 times. These are companies that have previously successful management teams. The second group of value companies trade at cash-flow multiples in the 3-4 times range. Many of these have either stumbled operationally in the recent past or have management teams that are not as well known. Both types of companies come with a different set of risks and rewards and both can be good long-term investments.

The Premium Stock

The stock market is giving these companies a higher valuation because of the expectations that they will grow faster than the overall market. In turn, the company can use this premium valuation to their advantage. This is the real mathematical magic of junior oil and gas investing. In the following example, a seemingly expensive stock can buy a \$20 million property, finance it with an equity issue and emerge at a more compelling valuation. The company still needs to be able to add value to the asset base, but you can see how adding sequentially bigger acquisitions can have a snowball effect.

Time	NAV (Million)	Stock Market Value (Million)	NAV Multiple
Pre-acquisition	\$20	\$40	2 x
Post-acquisition	\$20+\$20=\$40	\$40+\$20 = \$60	1.5 x

NAV = Net Asset Value

A pre-acquisition stock market value of \$40 million (40 million shares outstanding times a stock market price of \$1.00 per share) divided by \$20 million worth of oil and gas property value (net asset value) equals a multiple of 2 times net asset value. The company purchases \$20 million more oil and gas properties which makes the new total net asset value \$40 million. To purchase the new oil and gas properties, the company issues 20 million new shares from treasury at \$1.00 per share. The total shares outstanding are now 60 million. With a stock price of \$1.00 per share, the new market value is \$60 million. The post-acquisition stock market value of \$60 million divided by \$40 million of net asset value equals a multiple of 1.5 times net asset value.

The expectation is that the stock price will quickly rise to a level which reflects a multiple of 2 times net asset value. In this case, \$40 million of net asset value times a multiple of 2 = an implied stock market value of \$80 million divided by 60 million shares outstanding = \$1.33 price per share.

Many of the most successful Canadian oil and gas companies, like Canadian Natural Resources Ltd. and Bonavista Petroleum Ltd., traded at lofty valuations throughout their growth years. For this type of investment, it is nice to get in on the ground floor when the asset base is small. To set appropriate expectations, allow time for management to execute their plan. Again this is a high-risk industry where asset value is hard to determine. Last year, the industry laid another goose egg when, after the winter drilling season, the value of Gauntlet Exploration's producing properties did not exceed its debt level.

The Value Stock

Digging through junior companies that trade at a low cash-flow multiple can result in discovering situations where property value is equal to or greater than the company's market value. The question then becomes: Can this business add value by spending only internally generated cash flow? Share price appreciation may be less dramatic when compared to the previously discussed premium companies, but returns should be less volatile.

Two Examples

A Premium Stock - C1 ENERGY Ltd. (CTT - TSX)

This is an example of a ground floor investment. C1 is the spinout from Navigo Energy Inc. when it converted to a trust in December 2003. The company has a strong management team who has worked on the existing properties for the past two years. Production per share growth and finding cost cannot be calculated at this stage. The investor has to believe that the company can profitably exploit their existing properties and add larger property acquisitions when appropriate.

Current Price: \$1.90	Net Asset Value per Share: \$1.00
5- Week High/Low: \$2.75/\$1.53	Reserve Life in Years: 6
Q4/ 03	Estimates
Shares Outstanding: 17.8 million	2004 Cash Flow per Share: \$0.18
Market Capitalization: \$33 million	Price/ 2004 Cash Flow per Share: 10.5 x
Net Debt: \$0 million	2004/2003 Production Growth: 63%
Production: 400 boed	
% Natural Gas: 15%	
Operating Cost/boed: \$7.50	
Estimates use \$30 oil and \$5.00 natural gas.	
Net asset value is calculated using a 10% discount on proven reserves.	
Boed = Barrel of oil equivalent per day	
Operating Cost/ boed = Operating costs (income statement)/ daily production	

A Value Stock - REAL RESOURCE Inc. (RER - TSX)

Management has successfully grown production since the 1998 cycle low, caused by the Asian collapse. However, over the past two years production increases have not met investors' expectations. This market skepticism has resulted

Year	2001	2002	2003	2004
Year-End Stock Price	\$3.00	\$4.90	\$5.50	na
Production per share	229	242	241	278 estimate

Current Price: \$6.30
52-Week High/Low: \$6.60/\$4.05

Net Asset Value per Share: \$6.30
Reserve Life in Years: 9.4

Q4/ 03

Shares Outstanding: 27.6 million
Market Capitalization: \$174 million
Net Debt: \$40 million
Production: 6,576 boed
% Natural Gas: 48%
Operating Cost/boed: \$7.33
Finding Cost/boe: \$8.40

Estimates

2004 Cash Flow per Share: \$1.60
Price/2004 Cash Flow per Share: 4.0 x
EV/ 2004 Cash Flow per Share: 4.9 x
Net Debt/ 2004 Cash Flow: 0.9
2004/ 2003 Production Growth: 36%

Q4/03 shares and debt adjusted for the March 2004 new issue.

EV = Market Capitalization plus Net Debt

Finding Cost/ boe = Part of the annual reserve report that divides new barrels by the amount of capital spent.

in a low cash-flow valuation. To put it simply, the company is trading at its proven net asset value, while continuing to grow organically by spending its own cash flow. No value is being given for its probable reserves, which could add an additional \$2.00 per share.

(Avenue Investment Management does not own shares in either of the above companies.)

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