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Antares Energy (AZZ)

Some early profits from the Permian

Recommendation
Spec Buy (unchanged)
Price
\$0.41
Target (12 months)
\$1.04 (unchanged)

Expected Return

Capital growth	153%
Dividend yield	0%
Total expected return	153%

Company Data & Ratios

Enterprise value	\$91m
Market cap	\$110m
Issued capital	263.5m
Free float	100%
Avg. daily vol. (52wk)	1.2m
12 month price range	\$0.34-\$0.61
GICS sector	Energy

Price Performance

	(1m)	(3m)	(12m)
Price (A\$)	0.43	0.48	0.45
Absolute (%)	-4.65	-14.58	-7.87
Rel market (%)	-1.79	-3.38	3.14



SOURCE: IRESS

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A modest 1H result but bigger profits ahead

AZZ reported a \$0.8m NPAT for the 1H 2011. This was better than the break-even result from the 1H 2010 and our estimate of a \$0.8m loss. We can't really compare the two periods as the company's assets have changed entirely from the Eagleford shales sold in late 2010, to the Permian shales in 2011. As the Permian assets were acquired during the 1H 2011 and are in the early phase of production ramp-up, the result is not a genuine reflection of the earnings capacity of the project either. Cash was \$27m at June 30 but we understand the current cash is \$17m as spending has stepped up.

No need to change the forward estimates

We have made modest increases to the 2H 2011 as a result of the 1H result, and the fact that another 11 wells have recently started, or are about to contribute to earnings. AZZ provided little commentary with today's result, but last week's presentation to the Good Oil conference in Fremantle contained some new details on the key production wells, which should give investors increased confidence in the expected production profiles. We have revised our DD&A charges in the longer term estimates but our risked Price Target is unchanged at \$1.04/share, and unrisked at \$1.54.

Investment View

AZZ represents a very attractive investment opportunity in our view, and we recommend a Spec Buy with 155% upside to our Price Target of \$1.04. The Permian basin of West Texas is one of the oldest and most productive oil regions in the US, and has enjoyed a new lease of life in recent years as the technology to extract hydrocarbons from shales has revolutionised the industry. The Permian is a hive of activity, with about 300 drilling rigs active in the area, and M&A transactions pointing to further upside. BHP's purchase of Petrohawk for \$15B is noteworthy as 325,000 acres of that company's land holdings are in the Permian basin. BHP paid \$15,100/acre for Petrohawk. It would be premature to use that benchmark for AZZ but if we value its 30,000 net acres at \$5,000/acre we derive an EV of \$150m (\$0.57/share) and at \$10,000/acre \$300m or \$1.14/share. The stock is undervalued.

Earnings Forecast

Year ending 31 Dec	2011E	2012E	2013E	2014E
Revenue (\$m)	10	57	91	124
EBITDA (\$m)	2	39	65	89
NPAT - reported (\$m)	(1)	11	19	28
NPAT - adjusted (\$m)	(1)	11	19	28
EPS - adjusted (c/sh)	(0.3)	3.8	6.6	9.6
EPS growth (%)	-	n.m	73%	44%
PER (x)	-	10.7x	6.2x	4.3x
FCF yield (%)	-33%	-29%	-7%	7%
EV/EBITDA (x)	40.3x	2.3x	1.4x	1.0x
Dividend (c/sh)	-	-	-	-
Yield (%)	-	-	-	-
ROE (%)	-	10%	15%	18%

SOURCE: BELL POTTER SECURITIES ESTIMATES

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The Permian is ramping up

A small profit is a good start

AZZ reported a small \$0.8m NPAT for the 1H 2011 which was better than the pcpr result and higher than our estimated loss of \$0.8m.

Table 1 - AZZ Interim result 2011

June Half Year result	Unit	1H11A	1H10A	1H11E	Diff (%)	Comments
Sales revenue	\$m	3.4	3.7	2.2	57%	Production is ramping up better than forecast
Production costs	\$m	(0.2)	(0.1)	(0.9)	-78%	Production costs seem low
Exploration expensed	\$m	-	(1.4)	-		
Other costs	\$m	(2.5)	(0.9)	(1.8)	39%	"Other" costs seem high
Total expenses	\$m	(2.7)	(2.4)	(2.7)	1%	All up cash costs were in line
EBITDA	\$m	0.7	1.3	(0.5)		We had a conservative estimate for 1H
Depreciation & amortisation	\$m	(0.3)	(1.7)	(0.4)	-25%	
EBIT	\$m	0.4	(0.3)	(0.9)		
Net interest	\$m	(2.3)	(0.6)	(1.0)	130%	Unexpectedly high finance costs (one-offs)
PBT	\$m	(1.9)	(1.0)	(1.9)	-1%	
Tax expense	\$m	2.7	-	1.1	145%	A tax benefit by re-investing capital gains
NPAT (reported)	\$m	0.8	(1.0)	(0.8)		
NPAT (underlying)	\$m	0.8	(0.1)	(0.8)		2H should lift further

SOURCE: COMPANY DATA AND BELL POTTER SECURITIES ESTIMATES

We are not drawing too many conclusions from AZZ's interim result. Production and revenue generation appears to be running ahead of our expectations, and that is the key positive, but it is also very early days.

The company's definition of operating costs may differ to our approach and while we anticipate AZZ to be a low cost operator, we will continue to watch how the costs behave as production ramps up. If "Other" costs are fixed in nature, then the apparent low field production costs will be very beneficial as output ramps up over the coming year.

We believe net interest expense was higher than the 10% on the 7.5m convertible notes because of the asset transactions undertaken during the period. These additional expenses should be a one-off.

A tax benefit of \$2.7m was higher than anticipated but this is very difficult to forecast. This again is associated with the asset transactions recently undertaken.

The balance sheet showed cash of \$27.8m at June 30, but we note from last week's presentation to the Good Oil conference that the company currently holds \$17m of cash. This is expected to go down further in the short term as the company has a CGT liability of \$7-8m from last year's asset sale and capex on the three Permian oil projects has continued.

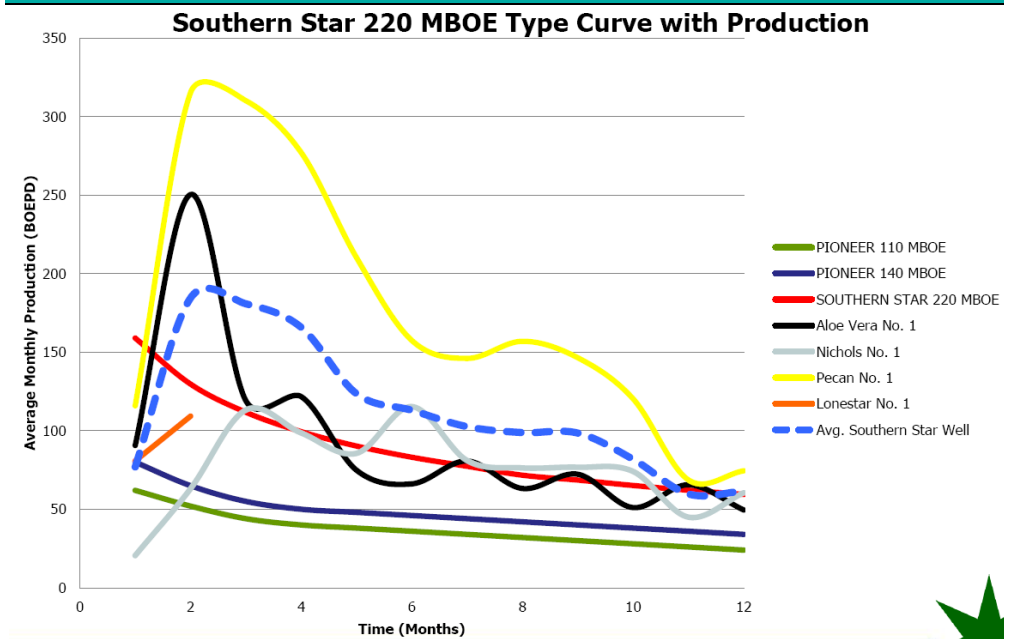
Cash flow was a negative of \$45m as the company spent \$80m on acquisitions in the Permian basin, offset by the second instalment from the Eagleford asset sale. The company also paid CGT of \$8.2m and bought back shares for \$8.5m.

Good Oil presentation showed some good data

MD James Cruickshank presented to the annual Good Oil conference in Fremantle last week which provided some new data on the producing wells in the Permian basin.

The following chart shows how the company’s three modern wells at the Southern Star project have performed in the first 12 months of production. Pecan-1 has produced strongly and Aloe Vera-1 had a great start while Nichols-1 was a bit slow to start with. The average compares very well to the type curve (red) predicted by AZZ, and much better than the older type curves from Pioneer Resources, which holds some neighbouring acreage.

Figure 1 - Southern Star type curve



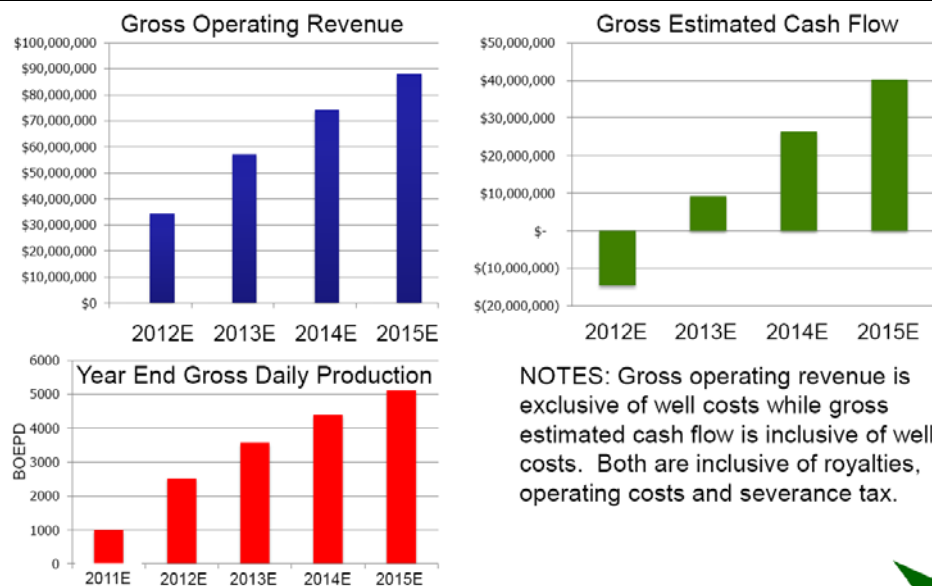
SOURCE: COMPANY DATA

Three wells still represent a relatively small sample in a project with 173 probable well locations but it is undoubtedly an encouraging beginning. Our projections for AZZ still uses the original (red) type curve for the financial modelling of the company but if these promising results continue from the ongoing development program, we will have to make upward revisions.

Southern Star cash flow projections 20% higher than ours

AZZ's Good Oil presentation also contained the following chart with future revenues, production and cash flows from the Southern Star project.

Figure 2 - Southern Star forward looking summary



SOURCE: COMPANY DATA

The numbers look like being about 15-20% higher compared to our projections for Southern Star, and we acknowledge that our assumptions may be conservative. This should lead to positive "surprises" or at least upward revisions as the project matures.

Our total AZZ production, cash flow and revenue projections are higher than the above figures illustrate as we also include future contributions from the company's Big Star and Northern Star projects. As these two projects are still in an early stage of definition, we have only included 50% of the potential value.

A reminder why we like this US shale play

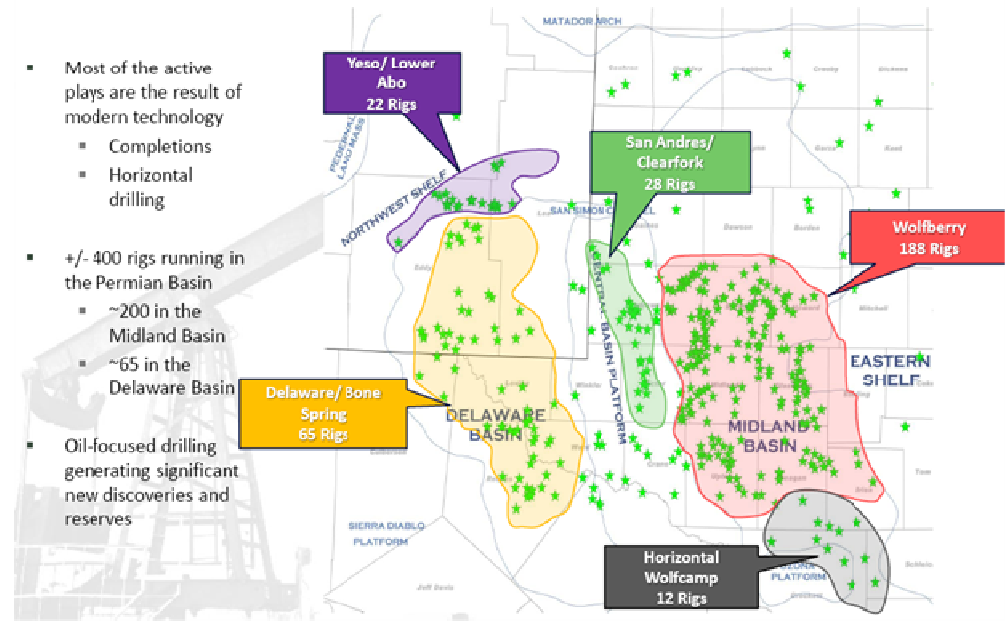
As discussed in our research initiation on 25 July 2011, we believe AZZ is undervalued and an attractive Spec Buy for the following key reasons:

AZZ is cheap on an EV of \$3.26/boe of 2P reserves and \$2,989/acre

- It's cheap on an EV of \$3.26/boe for 2P reserves of 27mmbbl, one of the lowest valuation metrics for energy stocks listed on the ASX. We value Southern Star's reserves at \$10.80/boe and the other projects at around \$3/boe risked.
- It's cheap on an EV of \$2,989/acre for its 29,445 net acres, which compares to the recent BHP purchase of Petrohawk at a cost of \$15,100/acre (owner of 325,000 acres in the Permian, one-third of the Petrohawk portfolio).
- Our valuation is \$1.04/share on a risked basis, with upside to \$1.54 unrisked. We forecast good earnings from next year with a PE of 10.7x in 2012 and 6.12x in 2013. There are genuine upside risks to our earnings estimates.
- Focused on the Permian basin, one of the established but still strongest growing shale oil plays of the US. The Permian is attractive and lower risk due to its thick stratigraphic section of several conventional and shale oil targets, enabling low cost vertical drilling, but with upside from horizontal drilling and/or down-spacing.

- We like the focus on the Permian basin and specifically the Wolfberry trend in the Midland basin, with majority ownership in all projects and some portfolio diversification through three sub-regional acreage packages.
- Management has learnt some lessons from the Eagleford, and is applying a lower cost, lower risk approach to building a profitable, repeatable business.

Figure 3 - AZZ's area of interest in the Permian basin of West Texas



COMPANY DESCRIPTION

AZZ is an oil & gas company focused on the Permian basin of West Texas, with three projects located in the Midland sub-basin, where the development emphasis is on the so-called Wolfberry trend. The trend extends over an area 6,000 square miles big and produces at around 150,000boepd from 13,000 wells.

The company's three key managers are located in Texas. Chairman & CEO James Cruickshank is assisted by Matt Gentry Director & COO plus Greg Shoemaker, Director & Chief Scientist.

STRATEGY

AZZ has established a material position of almost 30,000 net acres in the Permian since the beginning of this year. Current production is about 850boepd, but this is expected to grow to over 1,000boepd before the end of the year and 2,000boepd next year.

The company is very cost conscious and has chosen the Permian basin for its lower operating costs as you can access significant oil columns through the drilling of vertical wells, which are much cheaper to drill than horizontals. This has enabled the company to own majority equity stakes in all its projects and to control where and when drilling will take place.

VALUATION

Our risked valuation for AZZ is \$1.04/share. We have assumed a conservative development program compared to guidance from the company, with a production profile based on 20mmboe of reserves at Southern Star compared to the 27mmboe 2P reserves quoted. This still generates an NPV of \$217m or \$0.79/share for this asset alone. We have also modelled the Big Star and Northern Star potential developments but have risked these NPV's at 50% to reflect the uncertain scale and timing of these projects. Our unrisked valuation is \$1.54/share.

RISKS

AZZ faces normal oil and gas industry risks and has some specific risks:

- Prices for oil are inherently volatile, and strongly linked to the world economy and market conditions. All of AZZ's cash flows will be generated from oil dominated production.
- Political risks exist in all jurisdictions but the US is regarded as relatively low risk.
- Some regulatory risk exists with regards to fracking, as community concerns have grown in recent times. We don't believe that significant changes will be implemented, particularly in Texas where the oil & gas industry is a very big part of the economy.
- The specific risks relating to fracking include the potential for the fracked zones becoming connected to the overlying groundwater, causing contamination. This appears to have occurred in a few shale gas wells located at relatively shallow depths, or as a result of poor cement jobs when setting the casing strings in the well. This would lead to severe damages. Such risks appear very unlikely for AZZ in the Permian due to the great depths >7,500 feet (2,300m) and the oily nature of the shales.
- Operational and environmental risks are high in the oil and gas industry, with high safety standards required to avoid explosions, fires, oil spills etc.
- Exploration risks are low for shale plays. The main risk is that wells don't flow at the rates required to ensure commerciality.

Table 2 - Financial summary

PROFIT AND LOSS						FINANCIAL RATIOS								
Year ending 31 Dec	Unit	2011E	2012E	2013E	2014E	2015E	Year ending 31 Dec	Unit	2011E	2012E	2013E	2014E	2015E	
Revenue	\$m	10	57	91	124	153	VALUATION							
Expense	\$m	(8)	(18)	(26)	(34)	(41)	NPAT (adjusted)	\$m	(1)	11	19	28	39	
EBITDA	\$m	2	39	65	89	111	EPS (adjusted)	c/sh	(0.3)	3.8	6.6	9.6	13.3	
Depreciation	\$m	(3)	(22)	(34)	(46)	(55)	EPS growth	%		n.m	73%	44%	39%	
EBIT	\$m	(1)	17	31	43	56	PER	x	-149.6x	10.7x	6.2x	4.3x	3.1x	
Net interest expense	\$m	(2)	(0)	(2)	(1)	0	DPS	c/sh	-	-	-	-	-	
PBT	\$m	(3)	17	29	42	57	Yield	%	-	-	-	-	-	
Tax expense	\$m	2	(6)	(10)	(14)	(18)	EV/EBITDA	x	40.3x	2.3x	1.4x	1.0x	0.8x	
NPAT (reported)	\$m	(1)	11	19	28	39	PROFITABILITY RATIOS							
Abnormal items	\$m	-	-	-	-	-	EBITDA margin	%		69%	71%	72%	73%	
NPAT (adjusted)	\$m	(1)	11	19	28	39	EBIT margin	%		30%	34%	35%	37%	
							Return on assets	%		8%	12%	14%	17%	
							Return on equity	%		10%	15%	18%	21%	
							LIQUIDITY & LEVERAGE							
							(Net debt) / cash	\$m	19	(14)	(8)	1	28	
							ND / E	%	16%	19%	12%	9%	7%	
							ND / (ND + E)	%	13%	16%	11%	8%	7%	
							ASSUMPTIONS							
							Year ending 31 Dec	Unit	2011E	2012E	2013E	2014E	2015E	
							PRICES							
							Gas	US\$/mcf	4.2	4.2	4.3	4.4	4.5	
							Oil	US\$/bbl	87.5	87.5	90.0	90.6	93.2	
							NGL	US\$/bbl	43.8	43.8	45.0	45.3	46.6	
							CURRENCY							
							AUD/USD		0.98	1.07	1.03	0.95	0.92	
							INFLATION							
							US	%	2.2%	1.6%	1.4%	1.7%	1.9%	
							SOTP VALUATION							
								Net reserves (mmboe)	Unrisked NPV (\$m)	\$/sh	Risking	Risked NPV (\$m)	\$/sh	
								Southern Star (2P)	20	217	0.79	100%	217	0.79
								Big Star (3P)	17	162	0.59	50%	81	0.30
								Northern Star (3P)	28	127	0.46	50%	64	0.23
								Net asset value	65	506	1.84		361	1.32
								Group / unallocated	(80)				(80)	
								(Net debt) / cash	19				19	
								Equity value	445				300	
								NoSh - diluted (m)	290				290	
								Value per share (\$/sh)	1.54				1.04	
								VALUATION SENSITIVITIES						
								OIL PRICES		US\$/bbl	\$m	\$/sh	% diff	
								Base	87.5	300	1.04			
								-10%	Low	78.8	219	0.75	-27%	
								+10%	High	96.3	382	1.32	27%	
								EXCHANGE RATE (long term)		AUD/USD	\$m	\$/sh	% diff	
								Base	0.85	300	1.04			
								+0.1	Low	0.95	266	0.92	-11%	
								-0.1	High	0.75	343	1.19	14%	
								WACC (post tax)		\$m	\$/sh	% diff		
								Base	12.0%	300	1.04			
								Low	13.0%	270	0.93	-10%		
								High	11.0%	335	1.16	12%		
								EPS SENSITIVITIES						
								OIL PRICES		2011E	2012E	2013E	2014E	2015E
								Oil US\$87.5/bbl	Base	(0.3)	3.8	6.6	9.6	13.3
								-10%	Low	(0.5)	2.4	4.4	6.5	9.4
								+10%	High	(0.1)	5.2	8.9	12.6	17.0
								EPS	Low	77%	-36%	-34%	-32%	-30%
									High	-77%	36%	34%	31%	28%
								PER	Low	-1.2x	5.9x	10.7x	15.8x	22.9x
									High	-0.2x	12.7x	21.7x	30.6x	41.5x

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Spec Buy: Expect >30% total return on a 12 month view but carries significantly higher risk than its sector

Buy: Expect >15% total return on a 12 month view

Accumulate: Expect total return between 5% and 15% on a 12 month view

Hold: Expect total return between -5% and 5% on a 12 month view

Reduce: Expect total return between -15% and -5% on a 12 month view

Sell: Expect <-15% total return on a 12 month view

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