

Analyst

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Authorisation

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Antares Energy (AZZ)

Meeting milestones

Recommendation
Spec Buy (unchanged)
Price
\$0.42
Target (12 months)
\$0.85 (previously \$0.97)

Expected Return

Capital growth	101%
Dividend yield	0%
Total expected return	101%

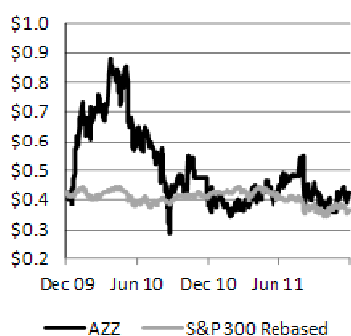
Company Data & Ratios

Enterprise value	\$110m
Market cap	\$111m
Issued capital	263m
Free float	100%
Avg. daily vol. (52wk)	1.1m
12 month price range	\$0.34-0.56
GICS sector	Energy

Price Performance

	(1m)	(3m)	(12m)
Price (A\$)	0.37	0.40	0.48
Absolute (%)	15.07	5.00	-11.58
Rel market (%)	20.24	7.29	-1.08

Absolute Price



SOURCE: IRESS

Producing over 1,000boepd net, doubling in 12 months

AZZ has achieved its late 2011 production target of 1,000boepd net (1,400boepd gross) from its Texas shale oil project at Southern Star. The company has also reaffirmed its 2012 gross production targets of 2,500boepd and 4,000boepd for 2013. These may be seen as aggressive objectives, but funding is not an issue due to the recent \$200m debt facility. This should lead to at least 30 wells over the next 12 months, making production targets comfortably achievable based on our analysis.

Earnings reduced, valuation trimmed

Despite the strong drilling program planned for calendar 2012, we have revised our production growth to better reflect the company's own revenue and cash flow guidance provided. The revisions are large in percentage terms as the company is building up profitability from a base of zero. The EPS estimate is 55% lower for FY12 and 41% lower in FY13, while FY14 is reduced by 17%. The resultant PEs are 17.7x in FY12, 8.0x in FY13 and an attractive 5.2x in FY14.

The valuation has not been as severely impacted, down 11% to \$0.85/share. Our unrisks valuation is down 10% to \$1.20/share, which is a realistic upside case if the Northern Star and Big Star projects prove to be commercially attractive.

Investment view remains positive for the new year

We believe that AZZ remains significantly undervalued, even with our more conservative production assumptions. The news flow for 2012 should show strong and steady improvements in production, and as these results are delivered, it will be increasingly difficult for the market to ignore them. We like the company's focus on the oily Permian basin in Texas and the low cost drilling campaign, which is fully funded for the next three years. We maintain a Spec Buy recommendation on AZZ.

Earnings Forecast

Year ending 31 Dec	2011E	2012E	2013E	2014E
Revenue (\$m)	10	42	79	110
EBITDA (\$m)	2	27	55	78
NPAT - reported (\$m)	(0)	6	14	22
NPAT - adjusted (\$m)	(0)	6	14	22
EPS - adjusted (c/sh)	(0.2)	2.4	5.2	8.0
EPS growth (%)	-	n.m	120%	54%
PER (x)	-233.2x	17.7x	8.0x	5.2x
FCF yield (%)	-45%	-28%	-11%	4%
EV/EBITDA (x)	49.4x	4.1x	2.0x	1.4x
Dividend (c/sh)	-	-	-	-
Yield (%)	-	-	-	-
Franking (%)	-	-	-	-
ROE (%)	-	7%	13%	16%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Good results will get recognition

AZZ has delivered one of its first key milestones

AZZ announced on 28 November 2011 that it had achieved its goal of more than 1,000boepd net from its oil projects in the Permian basin of West Texas. The key Southern Star project is producing in excess of 1,400boepd gross where the company owns an average 75% net revenue interest.

AZZ acquired the Southern Star project in March 2011, where 24 old oil wells have been drilled, but only three of them completed with fracking of the thick, oil rich shales that exist in this area known as the Midland basin. AZZ has drilled 10 more wells since the acquisition, which has lifted production to the current level of 1,400boepd.

Production objectives look achievable

AZZ has maintained its production targets for 2012 and 2013 from the Southern Star project. A gross production target of 2,500boepd by the end of 2012 does not appear a big challenge. The bulk of the current 1,400boepd is coming from the 10 recent wells drilled, and while decline curves are steep in the first year of production (at around 73%), they should still produce around 50-60boepd each or 500boepd in aggregate at the end of next year. The other, older wells generate about 200boepd in aggregate with modest declines. When we add the 24 new wells planned at an average of 90-100boepd the grand total of Southern Star should reach 2,800-3,000boepd gross. In other words, the company's end 2012 objective of 2,500boepd looks eminently achievable.

Production revisions by us has cut earnings estimates

While the projections by the company are good, we have reviewed our own estimates. When AZZ announced the US\$200m debt facility on 31 October 2011, we increased the drilling program at Southern Star from 12 to 24 wells. However, there will be a more gradual phasing-in of production than what we had assumed.

We have also reduced production forecasts from the Big Star and Northern Star projects. AZZ plans to drill 3 wells in each of these projects in 1Q 2012, and then review the results to determine future drilling plans. If the results are good, there is likely to be a continued drilling program, so our estimates may well be understating the outlook for these projects.

The combined production cuts are quite large, which has led to much lower earnings in the short to medium term, as shown below.

Figure 1 - Production and earnings changes

Year end December	2011E	2012E	2013E	2014E
Old production gross (boepd)	400	3,185	4,932	5,300
New production gross (boepd)	400	1,904	3,302	4,240
	0%	-40%	-33%	-20%
Old NPAT - adjusted (\$m)	(1)	15	25	28
New NPAT - adjusted (\$m)	(0)	6	14	22
	-51%	-58%	-43%	-20%
Old EPS - adjusted (c/sh)	(0)	5	9	10
New EPS - adjusted (c/sh)	(0)	2	5	8
% change	-55%	-55%	-41%	-17%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Valuation of \$0.85

The valuation has reduced from \$0.97 to \$0.85/share as a result of the lower production forecasts. The Southern Star project alone is still worth \$0.91/share. We haven't changed our risking of 50% for the Big Star and Northern Star projects, but the values have declined as the drilling plans have been curtailed, as discussed. Our unrisksed valuation is down 10% to \$1.20/share, as shown in the valuation summary below.

Figure 2 - AZZ valuation

	Net reserves		Unrisksed		Risksed	
	(mmboe)	NPV (\$m)	\$/sh	Risking	NPV (\$m)	\$/sh
Southern Star (2P)	20	239	0.91	100%	239	0.91
Big Star (3C)	17	72	0.27	50%	36	0.14
Northern Star (3C)	28	124	0.47	50%	62	0.24
Net asset value	65	435	1.65		337	1.28
Group / unallocated		(71)			(71)	
(Net debt) / cash		(31)			(31)	
Equity value					235	
NoSh - diluted (m)		278			278	
Value per share (\$/sh)			1.20			0.85

SOURCE: BELL POTTER SECURITIES ESTIMATES

Northern Star valuation analogue

AZZ has included an interesting new slide in its most recent presentation, which included the company's 12,400 acres on trend with a recent asset transaction by W&T Offshore.

W&T has paid US\$399.5m for 1P reserves of 30mmboe, or 55mmboe of 2P reserves, valuing the deal at US\$7.25/boe. W&T has paid a high US\$18,000/acre but this is not a comparative value for AZZ acres, as no reserves have been booked. We have done DCF analysis for our valuation purposes which equates to about \$5,000/acre, but the W&T transaction effectively shows the upside if the land is comparable, and it probably is.

Figure 3 - Northern Star position relative to W&T Offshore acquisition

W&T Offshore Recent Acquisition

Newly Acquired Assets in West Texas: Martin, Dawson, Andrews & Gaines Counties

- Acquired 21,400 net acres in May 2011 for \$399.5 million
- Currently producing 2,777 Boe per day from 90 wells
- Proved reserves of 30 MMBoe and probable reserves of 25 MMBoe
- EUR of ~100 MBoe net per well and 40 acre spacing on PUDs
- Days to drill to total depth: 15 to 19 days (average of 17 days)
- Oil and liquids are 91% of proved reserves

Above, Antares' Northern Star acreage position is overlain on W&T's acreage position.

SOURCE: COMPANY DATA

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 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 about 30,000 net acres in the Permian since the beginning of this year. Current production is about 1,000boepd net, and this is expected to grow to 2,500boepd before the end of 2012.

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 at about \$2m compared to horizontals which can cost up to \$10m. This has enabled the company to own majority equity stakes in all its projects and to control where and when drilling will take place. A new US\$200m debt facility is sufficient to fund the next three years of development drilling.

VALUATION

Our risked valuation for AZZ is \$0.85/share. We have assumed a development program in line with the company's guidance, with production based on 20mmboe of reserves at Southern Star compared to the 27mmboe 2P reserves quoted. This still generates an NPV of \$239m or \$0.91/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 \$1.20/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 CBM and 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 1 - Financial summary

PROFIT AND LOSS						
Year ending 31 Dec	Unit	2011E	2012E	2013E	2014E	2015E
Revenue	\$m	10	42	79	110	138
Expense	\$m	(8)	(15)	(24)	(33)	(40)
EBITDA	\$m	2	27	55	78	99
Depreciation	\$m	(3)	(15)	(29)	(40)	(49)
EBIT	\$m	(1)	12	26	38	50
Net interest expense	\$m	(2)	(1)	(3)	(3)	(1)
PBT	\$m	(3)	11	23	35	48
Tax expense	\$m	2	(5)	(9)	(12)	(16)
NPAT (reported)	\$m	(0)	6	14	22	32
Abnormal items	\$m	-	-	-	-	-
NPAT (adjusted)	\$m	(0)	6	14	22	32

CASH FLOW						
Year ending 31 Dec	Unit	2011E	2012E	2013E	2014E	2015E
OPERATING CASHFLOW						
NPAT	\$m	(0)	6	14	22	32
Add: non-cash items	\$m	3	15	29	40	49
Change in working capital	\$m	52	(9)	(6)	(5)	(4)
Operating cash flow	\$m	54	12	37	58	77
INVESTING CASHFLOW						
Net PP&E	\$m	(105)	(43)	(50)	(53)	(55)
Exploration & evaluation	\$m	-	-	-	-	-
Other	\$m	-	-	-	-	-
Investing cash flow	\$m	(105)	(43)	(50)	(53)	(55)
FINANCING CASHFLOW						
Share capital	\$m	(12)	-	15	-	-
Interest bearing debt	\$m	-	20	1	(1)	(19)
Financing cash flow	\$m	(12)	20	16	(1)	(19)
Change in cash	\$m	(63)	(10)	4	3	3

BALANCE SHEET						
Year ending 31 Dec	Unit	2011E	2012E	2013E	2014E	2015E
ASSETS						
Cash	\$m	14	4	8	11	14
Accounts receivable	\$m	2	11	20	28	35
Oil & gas properties	\$m	105	132	153	166	173
Exploration & evaluation assets	\$m	0	0	0	0	0
Other	\$m	0	0	0	0	0
Total assets	\$m	121	147	181	205	221
LIABILITIES						
Accounts payable	\$m	5	4	8	11	14
Deferred tax liabilities	\$m	10	10	10	10	10
Borrowings	\$m	15	35	36	35	16
Provisions	\$m	0	0	0	0	0
Total liabilities	\$m	31	50	55	57	41
SHAREHOLDER'S EQUITY						
Share capital	\$m	91	91	106	106	106
Retained earnings	\$m	8	14	28	51	83
Reserves & outside equity	\$m	(8)	(8)	(8)	(8)	(8)
Total equity	\$m	91	97	126	148	181
Weighted average NoSh	m	275	263	270	278	278

PRODUCTION ESTIMATES (Gross)						
Year ending 31 Dec	Unit	2011E	2012E	2013E	2014E	2015E
PROJECTS						
Southern Star	boepd	400	1,539	2,515	3,197	3,756
Big Star	boepd	-	182	333	431	510
Northern Star	boepd	-	182	454	612	737
Total	boepd	400	1,904	3,302	4,240	5,003
Total net	mmboe	0.1	0.7	1.2	1.5	1.8

FINANCIAL RATIOS						
Year ending 31 Dec	Unit	2011E	2012E	2013E	2014E	2015E
VALUATION						
NPAT (adjusted)	\$m	(0)	6	14	22	32
EPS (adjusted)	c/sh	(0.2)	2.4	5.2	8.0	11.6
EPS growth	%		n.m	120%	54%	45%
PER	x	-233.2x	17.7x	8.0x	5.2x	3.6x
DPS	c/sh	-	-	-	-	-
Yield	%	-	-	-	-	-
EV/EBITDA	x	49.4x	4.1x	2.0x	1.4x	1.1x
PROFITABILITY RATIOS						
EBITDA margin	%		65%	69%	70%	71%
EBIT margin	%		28%	33%	34%	36%
Return on assets	%		5%	9%	12%	15%
Return on equity	%		7%	13%	16%	20%
LIQUIDITY & LEVERAGE						
(Net debt) / cash	\$m	(1)	(31)	(28)	(24)	(2)
ND / E	%	16%	37%	29%	24%	9%
ND / (ND + E)	%	14%	27%	22%	19%	8%

ASSUMPTIONS						
Year ending 31 Dec	Unit	2011E	2012E	2013E	2014E	2015E
PRICES						
Gas	US\$/mcf	3.5	3.8	3.9	4.0	4.0
Oil	US\$/bbl	98.1	87.5	90.0	90.6	93.2
NGL	US\$/bbl	49.1	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	239	0.91	100%	239	0.91
Big Star (3C)	17	72	0.27	50%	36	0.14
Northern Star (3C)	28	124	0.47	50%	62	0.24
Net asset value	65	435	1.65		337	1.28
Group / unallocated		(71)			(71)	
(Net debt) / cash		(31)			(31)	
Equity value		333			235	
NoSh - diluted (m)		278			278	
Value per share (\$/sh)		1.20			0.85	

VALUATION SENSITIVITIES					
OIL PRICES		US\$/bbl	\$m	\$/sh	% diff
	Base	98.4	235	0.85	
-10%	Low	88.6	176	0.63	-25%
+10%	High	108.3	294	1.06	25%
EXCHANGE RATE (long term)					
	Base	0.85	235	0.85	
+0.1	Low	0.95	203	0.73	-14%
-0.1	High	0.75	276	0.99	17%
WACC (post tax)					
	Base	12.0%	235	0.85	
	Low	13.0%	205	0.74	-13%
	High	11.0%	269	0.97	15%

EPS SENSITIVITIES						
OIL PRICES		2011E	2012E	2013E	2014E	2015E
Oil US\$98.4/bbl	Base	(0.2)	2.4	5.2	8.0	11.6
-10%	Low	(0.2)	2.4	5.2	8.0	11.6
+10%	High	(0.2)	2.4	5.2	8.0	11.6
EPS	Low	0%	0%	0%	0%	0%
	High	0%	0%	0%	0%	0%
PER	Low	-233.2x	17.7x	8.0x	5.2x	3.6x
	High	-233.2x	17.7x	8.0x	5.2x	3.6x

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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