Conventional Oil & Gas: Explorer

PCL.asx
Speculative Buy

PANCONTINENTAL OIL AND GAS NL (PCL)

East not being outdone by West

Not to be outdone by the drilling activity offshore West Africa in 2014, PCL has announced that its drilling campaign will start offshore Kenya in January 2014. PCL and its joint venture partners in the L10A block offshore Kenya have approved the Sunbird-1 well with drilling expected to commence in mid-January 2014. This is a significant catalyst for PCL's share price and therefore investors should position themselves well before drilling begins. We maintain our Speculative Buy recommendation on the stock with a 12-month target price of 23c.

The Sunbird-1 target

PCL and its joint venture partners have not released an estimate of the prospective resource contained in the Sunbird-1 target however our rough calculation estimates gross un-risked oil in place of approximately 830m bbls. Put differently, a company with the production and reserve base of BG would not be testing this target if it did not think it had the potential to be a significant commercial discovery. Numerous examples exist around the world, especially in South-East Asia, of significant Miocene reef discoveries containing both oil and gas. The drill ship "Deepsea Metro" will drill the Sunbird-1 well after it completes its current assignment offshore Tanzania.

Well timing and cost

According to the announcement the well will be drilled to a depth of 3,000m below sea level in a water depth of 721m, with an option to drill to a depth of 3,700m. We assume a dry hole cost of US$80 -100m of which PCL will pay 18.75% (US$15-19m). It should be noted that PCL's interest in the 10A block has increased to 18.75% because Premier Oil has withdrawn from the block. In our view the withdrawal is more to do with Premier conserving cash rather than being concerned with the geology because they have not withdrawn from L10B. A discovery in 10A would significantly de-risk many of the targets identified in L10B. It is worth noting the well will be "plugged and abandoned", as per industry best practice, because the rig is not equipped for production testing, however PCL will receive full well log and sampling data.

Beyond Sunbird-1 – multiple other targets

Should the Sunbird-1 drilling confirm a working hydrocarbon system it opens up the potential of similar targets within the L10A block but also a play fairway running north into the Block L6 and L8. PCL and operator FAR are in the process of farming down their respective interests in L6.

Valuation and target price

In valuing PCL we place a significant discount on the risked prospective reserves valuation (75%) to derive our target price. We maintain our Speculative Buy recommendation. We increase our target price from 21c to 23c primarily because we have assumed a larger prospective resource for L10A. Other near term catalysts for the stock include a farm down of PCL's 40% stake in the L6, possible farm down of L8 and a second well in L10B. We expect PCL to have approximately A$15m cash post Sunbird-1.

17 Dec 2013

Share Price:	$0.058
12mth Price Target:	$0.23

Hartleys Brief Investment Conclusion

PCL holds a large acreage position offshore Kenya and Namibia. PCL is participating in up to three wells offshore Kenya over the next 12 to 18 months. Plenty of activity in Kenya and Namibia to provide catalysts for PCL.

Key Personnel

David Kennedy	Chairman
Barry Rushworth	CEO
Ernest Myers	Finance Director

Top Shareholders:

Sundowner International Limited	11.6%

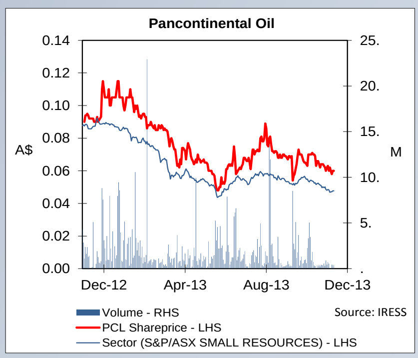
Company Address:
Ground Floor, 288 Stirling St
Perth, WA, 6000

Valuation:	$0.91
Issued Capital:	1151.0m
- fully diluted	1156.0m
Market Cap:	$66.8m
- fully diluted	$67.0m
Cash Equiv Sep '13):	$30.0m
Debt (Sep '13):	$0.0m

Valuation Summary

Asset	Value A$m	Risked cps	Unrisked cps
Exploration			
L8 (30%)	174.5	0.15	0.89
L6 (40%)	512.8	0.44	7.39
L10A (18.75%)	163.8	0.14	1.42
L10B (15%)	23.7	0.02	0.68
EL 0037 (30%)	177.8	0.15	1.54
Total	**1,052.6**	**0.91**	**11.92**

Source: Hartleys Research



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Hartleys has provided corporate advice within the past 12 months and continues to provide corporate advice to Pancontinental Oil & Gas NL, for which it has earned fees and continues to earn fees. The Analyst is a director of a private company that owns 23,553,334 shares in PCL. Whilst the Analyst does not own any shares in this private company he does have a beneficial interest in unlisted company options

SUMMARY MODEL

Pancontinental Oil and Gas PCL

Share Price $0.058

17 Dec 13

Speculative Buy

Key Market Information	
Share Price	**$0.058**
Market Capitalisation	$67m
Net Debt (cash)	$30.0m
Issued Capital	1151.0m
ITM options	0.0m
Options	5.0m @ A$0.13
Issued Capital (fully diluted ITM options)	1156.0m
Issued Capital (fully diluted all options)	1156.0m
EV	$36.8m
Valuation	**$0.91**
12Mth Price Target	**$0.23**

Directors	Company Details
David Kennedy	Chairman
Barry Rushworth	CEO
Ernest Myers	Finance Director

Top Shareholders	m shs	%
Sundowner International Limited	134.1	11.6%

Projects	Interest	Location	Commodity
L6	40%	Kenya	Oil/Gas
L8	30%	Kenya	Oil/Gas
L10A	18.75%	Kenya	Oil/Gas
L10B	15%	Kenya	Oil/Gas
EL0037	30%	Namibia	Oil/Gas

Investment Summary

Pancontinental has a large acreage position offshore Kenya and Namibia. The Company has managed to partner with the likes of Apache, BG and Tullow to explore for large scale, commercial oil and gas reservoirs.

Valuation Summary

Asset	Value A$m	Risked cps	Unrisked cps
Exploration			
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Expected News flow		Project
1Q 14	BG well in L10A	Kenya
1Q 14	Seismic program (Tullow)	Namibia
1Q 14	Farm-down of L6	Kenya
2Q 14	Announcement regarding L8	Kenya
3Q 14	2nd well in L10A or 10B	Kenya

Unpaid Capital	No (m)	$ (m)	Ave Pr	% Ord
30-Jun-15	2.3	0.3	0.13	0.2%
30-Jun-16	-	-	0.00	0.0%
30-Jun-17	2.8	0.3	0.12	0.2%

Comments

We believe there are several catalysts that could provide further positive impetus for the PCL share price over the next 6 months. These most signficant of these will be BG drilling an exploration wellin L10A offshore Kenya in January 2014. Other catalysts include the farm down of an interest in the L6 concession offshore Kenya, expected early in 2014.

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Last Updated: 17/12/2013

Sources: IRESS, Company Information, Hartleys Research

SUNBIRD-1

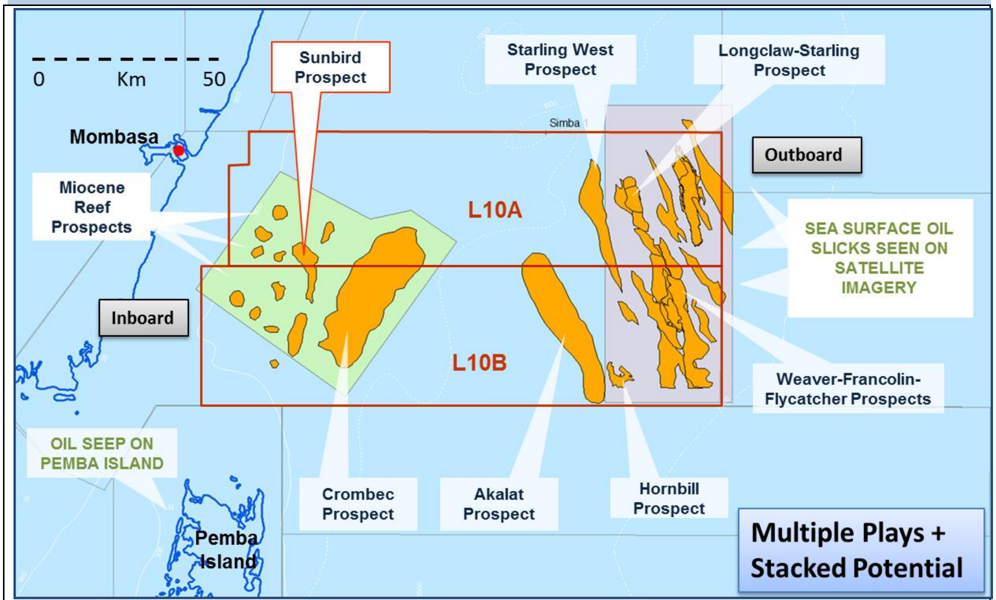
The Sunbird-1 target will be the first of its type to be drilled offshore East Africa

Target: The Sunbird-1 target is a Miocene reef build up and will be the first target of its type to be drilled offshore East Africa. The prospect has an area of 73sq km and a gross vertical relief of 700m. PCL believe the target may be oil prone. Using some very basic calculations we calculate the gross un-risked recoverable oil in place of 830m bbls. Some of our key assumptions include 150m of net pay, 20% porosity and recovery factor of 20%.

Wilson et al **(Tectonic Influences of SE Asian Carbonate Systems and their Reservoir Development, 2010)** highlight the prolific nature of carbonate reservoirs in South East Asia. The report also highlights that dry carbonate build ups are often caused by poor seal integrity caused by faulting on the crest of the build-up.

Sunbird-1 is located 50km from Mombasa which does reduce the hurdle to achieve a commercial gas discovery. It is unlikely that an LNG development would be considered unless the discovery was 4tcf or higher. Should a discovery be in the 1-3 tcf range it may be considered for domestic power generation (the Kenyan Government has expressed a desire to convert existing power plants to gas).

Fig. 1: Block L10A / L10B Targets and Leads

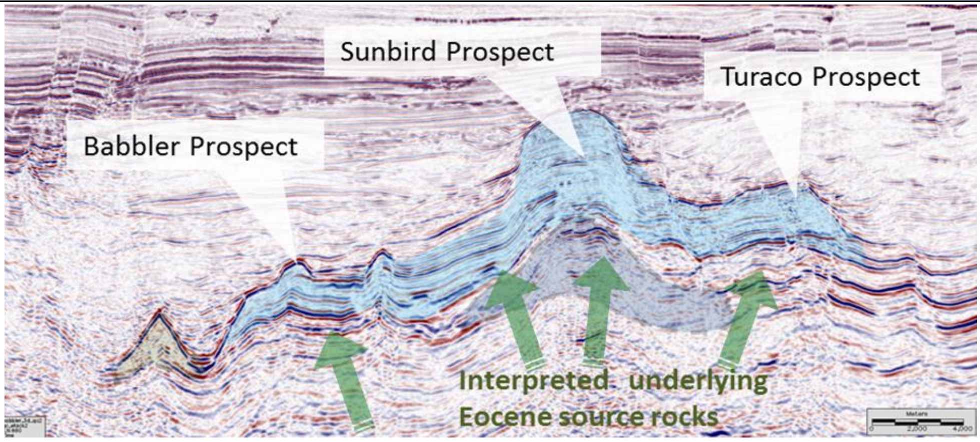


Source: Company Presentation

Cost: We estimate the cost of the Sunbird-1 well to be US$80m based on 60 days of drilling and a rig day rate of approximately US$1.3m /day. Should the JV choose to drill the well to the deeper target the cost may increase to US$100m. PCL's contribution to the well will therefore range from US$15-19m. This will leave PCL with a cash balance of approximately US$15m post the well. The Company's cash balance could be bolstered by receipt of back costs associated with a farm-out of L6 and reimbursement associated with Apache's withdrawal from the L8 block.

Timing: Once the "Deepsea Metro" has completed its current drilling campaign offshore Tanzania it will move directly to Kenya to drilling the Sunbird-1 target. At this stage we believe the well will spud in mid-January. It is expected to take 50-60 days to reach the target depth of 3,000m and longer should a decision is made to drill to 3,700m.

Fig. 2: Seismic - Sunbird-1



Source: Company Presentation

A reminder that PCL executed a significant farm-out deal with Tullow on its acreage offshore Namibia

Namibia: Tullow recently farmed into 65% in exchange for US$130m in spend

This is not new news but the market needs to be reminded that this deal is significant. The basic details require Tullow to free carry PCL through an extensive 2D (1000km) and 3D (3000sq km) seismic program and an optional exploration well to earn a 65% interest in EL0037. The value of the work is assumed by PCL to be in the range of US$110m-130m. PCL will retain a 30% interest in EL0037. Tullow will reimburse PCL to 65% of back costs (approximately US$500k). The seismic program must begin by December 2014 (PCL expect the seismic acquisition to begin by early 2014). Paragon Oil and Gas retain the remaining 5% interest in EL0037.

There are some unique aspects to this agreement that should be highlighted. Should Tullow choose not to proceed with the exploration well after completion of the 2D and 3D seismic program then the 65% interest will be re-assigned to PCL at no cost. To withdraw Tullow must inform PCL in writing no later than 16 months after capture of the 3D seismic data or 13 months prior to the expiry of the First Renewal Exploration Period, whichever is earliest. If we assume the seismic program is complete by end 1QCY14 then the first withdrawal deadline will be July 2015. This clause is unique to recent farm out agreements that usually include an "optional well".

No spending cap

An important aspect of the agreement with Tullow is that there is no spending cap on the work program. In other farm out agreements a spending cap is usually set which means that when costs exceed a certain amount the junior partner (or farmor) is on the hook for cost overruns.

RISKS

The key risks for PCL (like most oil & gas exploration companies) is making an economic discovery and obtaining the funding for ongoing exploration. Other risks include delays, key person risk, country/sovereign risk, weather, JV partner obligations, cost inflation. Investing in explorers is very risky given the exploration value of the company in essence assumes that the market will recognise a portion of potential value before the results of an exploration program are known, conscious that the ultimate chance of success is low (typically 1%-20%) and that failure is much more likely, in most cases. Other risks are earnings disappointments given the industry is volatile and earnings can disappoint due to cost overruns, project delays, cost inflation, environmental regulations, resource estimate errors and management performance and contract negotiation skills. High financial leverage (if it exists at that time) would add to the problem.

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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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