ADX Energy

Full year results

Edison investment research

Sicily farm-out unlocks value

Oil & gas

5 October 2012

Price	A$0.018
Market cap	A$9m
	US$1.03/A$
Shares in issue	485.6m
Free float	85%
Code	ADX
Primary exchange	ASX

Share price performance

%	1m	3m	12m
Abs	(70.9)	(72.5)	(76.2)
Rel (local)	(71.1)	(71.0)	(72.9)
52-week high/low		A$0.100	A$0.018

Business description

ADX Energy is an oil and gas exploration and appraisal company with assets in Tunisia, Italy and Romania. It is listed on the Australian stock exchange. It also has a 26% share of an Australian-listed mining asset Riedel Resources.

Next events

Romania approval	Q412
Funding facility	Q412
Sicily farm-out	Q412/Q113

Analysts

Colin McEnery +44(0)20 3077 5731

Ian McLelland +44(0)20 3077 5756

oilandgas@edisoninvestmentresearch.co.uk

Edison profile page

While news of ADX's unsuccessful Sidi Dhaher well test was clearly disappointing, the company still has the potential to create significant shareholder value through its Sicily Channel, Romanian and onshore Tunisian assets. However, with funds at a premium, the near-term challenges are largely commercial before it can demonstrate further progress with the drill bit. The Sicily Channel assets in particular offer considerable upside as confirmed by a recent independent resource opinion. However, to achieve this we believe ADX must secure alternative funding ahead of a suitable farm-out before any drill commitments can be made. Based on the farm-out terms ultimately achieved, we could derive a valuation range for the Sicily assets of 3.5-5.9c. This would imply a nominal valuation range for ADX of 5.3-7.8c.

Year end	Revenue (A$m)	EBITDA (A$m)	PBT* (A$m)	Debt (A$m)	Net cash (debt) (A$m)	Capex (A$m)
06/10	0.0	(1.0)	(2.1)	0.0	2.3	(8.8)
06/11	0.0	(9.8)	(9.8)	0.0	0.8	(8.2)
06/12	0.0	(11.2)	(11.1)	0.0	0.5	(3.3)
06/13e	0.0	(1.8)	(1.8)	0.0	3.6	(0.0)

Note: *PBT is normalised, excluding intangible amortisation and exceptional items.

Sicily Channel and Romania: Near-term catalysts

In June 2012 ADX announced that its onshore Tunisia Sidi Dhaher well was unsuccessful, removing the potential for near-term cash flow. However, the company remains a dedicated explorer with key assets in the Sicily Channel and Romania as well as onshore Tunisia. Its current 60% interest in the Sicily Channel, if de-risked, could still prove transformational, especially after a review in February 2012 that indicated 1.2bn bbls of un-risked prospective and contingent resources could exist across its acreage covered by 3D seismic. Meanwhile, Romania offers an interesting lower risk entry with cash coverage although this requires ADX to first obtain government ratification of its already signed concession agreement, possibly in Q412.

Key: Farm-outs, funding and share price momentum

Critical to ADX's strategy will be successful and favourable execution of farm-outs of its onshore Tunisia and offshore Sicily Channel blocks. However, we do not exclude the possibility of ADX obtaining a funding facility to bear a higher level of capex to retain more working interest. This, and its activities in Romania, will be key to ADX achieving share price momentum to unlock the ability to raise capital through equity.

Valuation: Sicily Farm-out unlocks value

We judge the Sicily assets as offering most material investor upside. With 33mmboe of contingent resources, on a net entitlement basis, de-risking through exploration and appraisal would represent a step change in its resource base. Based on a recent deal on the licence, we are able to derive a post farm-out un-diluted valuation range of 3.5-5.9c. If successful, adding this to our core and risked NAV would imply a valuation range for ADX of 5.3c to 7.8c per un-diluted share.

The funding conundrum: Timing is key

ADX holds an asset portfolio with potentially significant value. Its key assets in the Sicily Channel Islands are in a proven oil and gas producing area. The resources are sizable but require substantial amounts of capital to monetise. If the company can secure funding we see potential for material investor upside.

Crystallising the value of ADX's assets is critically dependent on successful farm-outs. In particular the Sicily Channel block, which potentially has 1.2bn barrels of un-risked gross prospective and contingent resources could be transformational if proven commercial. This includes the Dougga gas condensate field appraisal project that was recently independently reviewed. However, before ADX can even drill these assets the company faces significant commercial challenges before investors will be ready to ascribe material value to its Sicily Channel acreage. Management is actively seeking a farm-out for the Sicily Channel, successful outcome of which could lead to drilling in 2014.

While we would expect ADX to seek a full carry with any farm-out, there remains the question of it potentially having to contribute capital to a future drill programme in the Sicily Channel. The recent disappointing results from Sidi Dhaher resulted in ADX's share price suffering significantly, limiting the access to economically viable equity finance. Management emphasises its strategy is to minimize equity funding and focus on farm-outs.

To avoid punitive dilution and to raise capital that would allow the company to participate in the block at a material level, the share price will have to be higher. There are a number of newsflow catalysts over the next 18-20 months that should help ADX achieve this. We list these below with the most significant ones in bold.

- Romanian licence government approval – Q412
- **Funding facility announcement – Q412**
- Data room for the Sicily Channel block closed – Q412
- **Farm-in partner announced – Q412/Q113**
- Seismic survey completion in Romania – Q113
- Spudding of first well in Romania – H113
- Order FEED items/tender rig for Sicily Channel wells – H113
- Secure semi-sub rig for Sicily channel wells – H213
- Seismic campaign for Chorbane – Onshore Tunisia – H213
- Chorbane exploration well – 2014
- **Drill results of Sicily Channel block – 2014**
- Drill second exploration well Romania – 2014

Sicily Channel: Substantial resource upgrade

Billion-barrel hub potential

ADX Energy holds 60% of the Kerkouane (Tunisia) and Pantelleria (Italy) block. These blocks are adjacent to each other in the Sicily Channel but are divided by the Italy/Tunisian maritime boundary. The Dougga asset, a discovery by Shell in 1981, is in the Kerkouane block. Lambouka, a well drilled by ADX in 2010, straddles the Tunisian and Italian border.

In 2011, TRACS – independent petroleum consultant – allocated 74mmboe (33mmboe net) of 2C resources against Dougga. ADX has also identified further prospective resource potential in Dougga West – an extension of the main Dougga field on high resolution 3D data. In February 2012, further work was performed by independent petroleum consultant, ISIS, which significantly increases the size of the resource potential of Dougga and of a prospect in the North East part of Kerkouane. This new report reviewed reservoir engineering information that was not previously analysed by TRACS. We list below the updated resources. All resource numbers are prospective except Dougga, which is contingent on appraisal.

Exhibit 1: Project summary

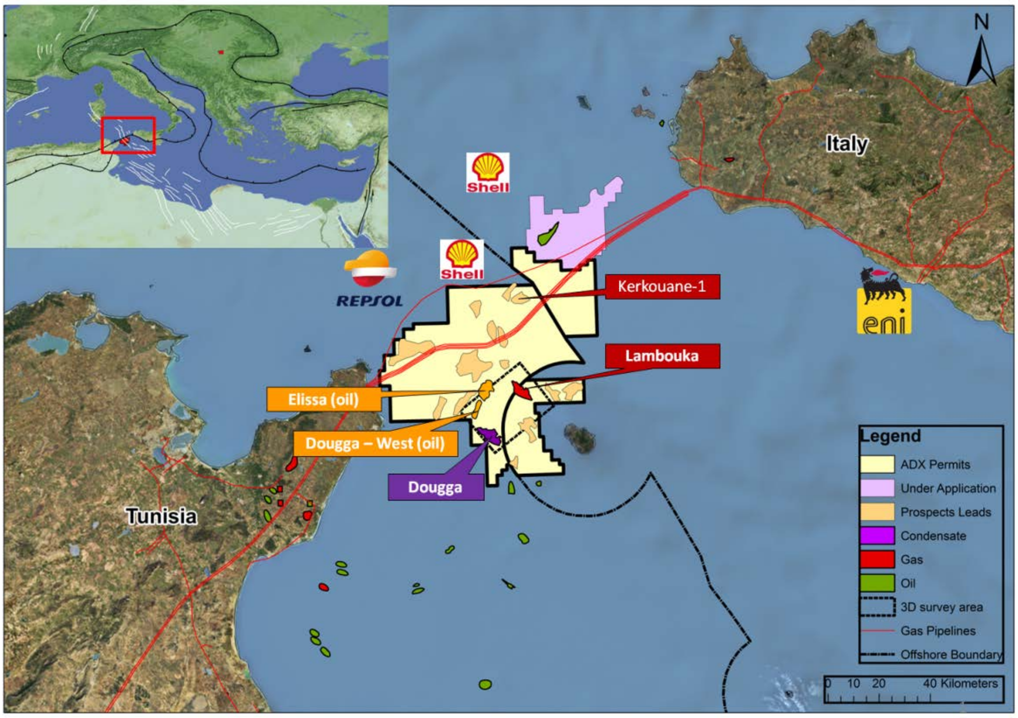
3D project name	Status	Pmean resource (mmboe)	Expected hydrocarbon
Dougga	Appraisal of contingent resources	173	Gas condensate
Lambouka	Appraisal	52	Gas only, condensate potential not quantified, estimated at 24mmbbls
Lambouka – Deep	Drill Deeper – Exploration	126	Gas condensate
Dougga West	Near Field – Exploration	226	Oil or gas condensate (resource given for oil case in Birsa)
Elissa	Exploration	616	Oil (Birsa) or condensate (Abiod)
Total covered by 3D seismic		1,193	

Source: ADX Energy

ADX owns a 60% working interest in the Dougga asset and has a 45% net entitlement under its PSC terms. The asset is a fractured carbonate gas condensate field that is liquid rich; this is a benefit as condensates generally receive a premium against crude. It is a complex asset that will be costly to develop due to the nature of extracting gas condensate, splitting it and dealing with the associated CO_2. However, ADX's strategy is purely one of exploration and appraisal. If it can prove and de-risk the asset through appraisal drilling, we expect the company to farm-down significantly or divest its working interest completely to larger companies already active in the region ones or to others looking to gain exposure to the Mediterranean. Lambouka – a discovery – is an earlier-stage asset with currently no allocated contingent resources.

Beyond Dougga and Lambouka there are further prospects such as extension of the main fields (Dougga West and Lambouka Deep) and the nearby large Elissa prospect. Management views the Sicily Channel as not only having one or two prospects but the potential for a hub development, with Dougga as the key development linked to sizeable satellite fields. The hub prospects are all covered by high resolution 3D seismic, which reduces the associated geological risks. The new seismic information – which was not previously available when ADX initially farmed out – should enhance the interest in farm-out discussions as they occur.

Exhibit 2: Sicily Channel block assets



Source: ADX

Challenges: Funding and farm-out

Dougga will require an appraisal well and Lambouka will require a re-entry to test the well and test the recently identified deeper potential. These are costly. ADX estimates that, combined, the appraisal wells on Dougga and Lambouka could cost a total of c US$55m gross (US$33m net). However, partner Gulfsands has indicated that well costs could be lower at c US$35m, which would have a positive impact to terms of the farm-out deal that ADX would need to achieve.

Management has indicated that it would ideally seek a two-for-one farm-out for Dougga and Lambouka. However, we think it is unlikely the company will achieve this without having to contribute some capital towards the appraisal programme.

Romania: Onshore potential with an attractive farm-out

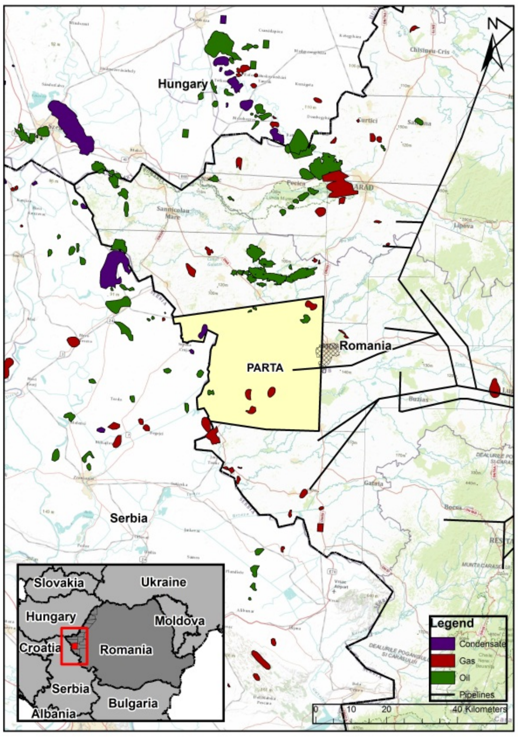
ADX has a 50% working interest in the PARTA block located in onshore Romania. Through a farm-out in May 2012 to Rohoelaufsuchungsgesellschaft (RAG), a cash-rich privately-held Austrian oil company, ADX secured a cash payment of €3.25m (A$4.01m). The committed work programme consists of:

- 2D and 3D seismic –estimated gross cost €2.5m, expected to complete Q412/Q113;
- two wells – estimated gross combined cost €4m, first well 2013, second well 2014; and
- at a net overall cost to ADX of €3.25m.

The key concern over the company's activities in Romania is the time it takes obtaining approval from all the government ministries. The exploration licence has to be approved by five ministries. Due to the departure of government ministers the process of ratification has had to be restarted, causing delays to the work programme and receipt of farm-out cash. Barring any further ministerial changes we estimate that ADX could receive approval in Q412.

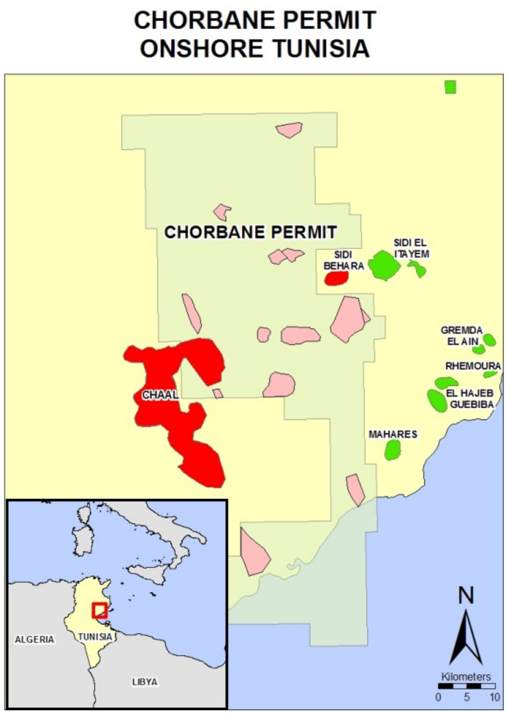
In September ADX signed a contract with S.C. PROSPECTIUNI S.A. to perform the seismic survey. Management indicate that once approval from the government has been received the survey can begin within a month, with the first well expected in 2013.

Exhibit 3: PARTA block – Onshore Romania



Source: ADX Energy

Exhibit 4: Chorbane block – Onshore Tunisia



Source: ADX Energy

Chorbane block: Second time lucky?

Dry Sidi Dhaher well: Loss of near-term production

In June 2012 ADX announced that the Sidi Dhaher well in Tunisia failed to flow commercial levels of oil. As the water leg of the well was perforated, the flow of water and mud into the well bore increased. The water had preferential flow over the oil in the lower reservoir, which meant the well was effectively cutting 100% water and no oil was reaching the well bore. Without any commercial levels of oil reaching the well bore, the well was declared non-commercial and was plugged and abandoned.

Implications

The key consequence of an un-commercial well test is the loss of near-term production. If the well had been successful ADX could have had access to cash flow within a year, which would have helped finance its other assets in the offshore Sicily Channel block.

Without Sidi Dhaher, ADX is now actively seeking a favourable farm-out deal on its offshore prospects Dougga and Lambouka. Without the right farm-out deal, management may be required to bridge a funding gap.

Renewal of Chorbane licence – onshore Tunisia

ADX announced on 23 July 2012 that it had agreed a three-year renewal of the exploration licence on the Tunisian onshore Chorbane block. The committed work programme consists of one well, which we estimate to cost c US$5m (A$5.15m) gross. It will likely include new 2D or 3D seismic, which we estimate to cost gross US$1.6m. We expect that after the large but more risky Sidi Dhaher prospect area, ADX will concentrate its efforts in the eastern part of the licence, where a proven oil and gas kitchen area has sourced several proximate producing oil and gas fields.

The company has significant experience operating in Tunisia and has learnt lessons post its failed Sidi Dhaher well. We estimate costs are:

- new seismic: US$1.6m(A$1.65m) gross;
- one well: US$5m (A$5.15m) gross; and
- net cost to ADX: US$2.64m (A$2.72m) at 40% WI.

With a high working interest of 40%, ADX has the ability to farm-out for a carry on the work programme. If we assume the company is able to obtain a full carry on the seismic work programme and a 50% carry on the well, this would result in ADX having to finance US$1m (A$1.03).

We estimate that the seismic will be completed in 2013 with the well drilled in 2014. As this capex commitment could be two years away, ADX may be in a better position to finance the well programme, especially with successful execution of its activities in Romania and offshore Sicily Channel, accompanied by farm-outs.

Financials

At end June 2012 ADX had net cash of A$0.5m. This was bolstered in August 2012 by completion of an A$0.8m equity issue. Over the whole year (to June 2013), given that we do not expect any significant capital expenditure requirements until 2014, we estimate operating cash out flows of A$1.8m. The A$4m farm-out of the Romanian licence in combination with the August financing leads to our forecast end June 2013 net cash estimate of A$3.6m. We expect the capital issued in August to be applied to working capital, given the anticipated delay in receiving the farm-out cash from its Romanian partner RAG.

Financing options

ADX's current outlays comprise only a minimal G&A spend due in part by being the operator of its assets, which allows the company to effectively control costs. The company's funding requirements will depend on timing of its exploration and appraisal activities and any farm-in agreements.

2012

– No capex requirements for onshore Tunisia, offshore Sicily Channel.
– On Romanian government approval, ADX should receive €3.25m (A$4.02m) in cash from farm-in partner RAG.

2013

– Assuming a full carry on the onshore Tunisian seismic campaign, no capex would be needed.
– No expenditure in Romania as the cash received should cover the work programme.

2014

– Onshore Tunisia well – assumed US$1m of capex required.

– Offshore Sicily Channel block.

Our timing and assumptions above may well change. However, if ADX follows this timetable and achieves farm-outs for onshore Tunisia and offshore Sicily Channel block, we forecast that the company will not require any material capex until 2014. However, the capex required in 2014 is entirely dependent on the farm-out terms.

As of end June 2012 ADX had net cash of A$0.5m. In our view ADX has three possible funding options:

- It could opt for a straightforward equity issue. Any equity issue at current prices would have to be extremely dilutive to raise sufficient capital for future operations. Management has stated its strategy to focus on farm-outs and to minimise equity funding.
- The company could opt for a finance facility from a specialist oil and gas fund. This could involve private placement of shares. ADX previously had an agreement with Trafalgar Advisors, which lapsed in April 2012.
- Finally, ADX could consider raising funds from its joint venture partners or from potential divestment of all or part of its legacy mining asset – Riedel Resources – which ADX holds a 26% working interest in and its share is currently worth c US$1.7m (A$1.65m).

Valuation: Farm-out in Sicily unlocks value

ADX's Sicily Channel assets offer the investor the most upside. However, due to the necessity of farm-out we cannot yet include these assets in our risked NAV but, through using a recent deal and a dollar per barrel calculation, can derive a valuation range of 3.5c to 5.9c. If the company is able to achieve a farm-out, adding this valuation range to ADX's NAV, would imply a valuation range of 5.3c to 7.8c per share.

Xstate Resources/Gulfsands deal

On 20 September 2012, it was reported that Gulfsands had agreed a preliminary deal to purchase Xstate's 10% working interest in the onshore Tunisian Chorbane and offshore Kerkouane/Pantelleria block. While the deal has not been concluded, it has been reported that Xstate will receive $0.68m in cash and $0.2m in back costs. A cash bonus of $0.5m, contingent on achieving first oil from the Kerkouane/Pantelleria block, also formed part of the reported deal.

Assuming first oil is achieved and we do not discount the cash bonus to a present value, the deal values 100% of the block at US$14m. This deal could be used as a read-across for the value of ADX's assets. For ease, we will assume the deal was executed for the material offshore assets alone.

There are a number of differences between a farm-out deal that ADX could execute and the Xstate/Gulfsands deal. As ADX is operator with a 60% working interest in the licence, we would expect any deal involving a large portion of the interest and, potentially, operatorship to receive a premium. We must also consider the context of the Xstate deal. As communicated publicly by Xstate, the company was looking for a swift exit out of Tunisia and Italy. The poor share performance plus possible pressure from shareholders to exit could have caused the company to divest the 10% at a 'fire sale' price. Taking these points into consideration, we would expect an ADX deal to be done at a premium.

Using the Xstate/Gulfsands deal we can generate a valuation range for the offshore assets.

In the follow scenarios we assume:

1. ADX pays 20% of its appraisal well cost.
2. The implied gross valuation of the offshore asset ranges from:
   a. US$14m – as per the Xstate/Gulfsands deal above;
   b. US$20m

   c. US$30m.
3. Gross well costs on Dougga and Lambouka range between:
   a. US$55m, as per ADX's estimates; and
   b. US$35m, as per Gulfsands estimates.
4. Chance of success 35% (geological – 70%, commercial- 50%).

Using the assumptions set out above we can create a framework that enables us to derive a valuation range for the Sicily Channel assets.

Assuming a gross asset valuation of US$20m (under the US$55m well cost assumption), we calculate that ADX would have to farm-down to 19% working interest. Using a $5/bbl net-back and Dougga's independently reviewed contingent resources of net 33mmboe we derive a valuation of 3.5c per share. Reducing the well cost assumption to US$35m and increasing the implied gross asset valuation of the entire block to US$30m results in the company having to farm-down to only 31%. Under this scenario we generate a valuation of 5.9c per share.

Exhibit 5: Implied valuation range – Sicily Channel block (un-diluted cents per share)

	Implied total asset value (US$m)		
Well cost (US$m)	14	20	30
55	2.7	**3.5**	4.5
35	3.8	4.8	**5.9**

Source: Edison Investment Research

If a successful farm-out is executed, we would consider introducing the Sicily Channel assets into our risked valuation of 1.8c, which currently includes cash and a risked value for the Romanian asset. Under the lower case assumption of US$20m gross asset value and gross well costs of US$55m, this would imply a nominal overall risked valuation for ADX of 5.3c per un-diluted share. Increasing the gross asset value to US$30m and decreasing gross well costs to US$35m would increase our nominal overall valuation to 7.8c per un-diluted share.

Exhibit 6: Implied valuation range for ADX (un-diluted cents per share)

	Implied total asset value (US$m)		
Well cost (US$m)	14	20	30
55	4.5	**5.3**	6.3
35	5.6	6.6	**7.8**

Source: Edison Investment Research

Edison investment research

Exhibit 7: Financial Summary

A$000's	2010	2011	2012	2013e
June	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	0	0	0	0
Cost of Sales	0	0	0	0
Gross Profit	0	0	0	0
EBITDA	(975)	(9,793)	(11,152)	(1,772)
Operating Profit (before amort. and except.)	(2,192)	(9,831)	(11,152)	(1,772)
Intangible Amortisation	0	0	0	0
Exceptionals	0	3,941	(2,000)	4,017
Other	0	0	0	0
Operating Profit	(2,192)	(5,890)	(13,152)	2,245
Net Interest	51	53	27	10
Profit Before Tax (norm)	(2,141)	(9,778)	(11,125)	(1,762)
Profit Before Tax (FRS 3)	(2,141)	(5,837)	(13,125)	2,255
Tax	0	0	(17)	0
Profit After Tax (norm)	(2,141)	(9,778)	(11,142)	(1,762)
Profit After Tax (FRS 3)	(2,141)	(5,837)	(13,142)	2,255
Average Number of Shares Outstanding (m)	277.4	370.8	424.5	485.6
EPS - normalised (c)	(0.8)	(2.6)	(2.6)	(0.4)
EPS - normalised and fully diluted (c)	(0.8)	(2.6)	(2.6)	(0.4)
EPS - (IFRS) (c)	(0.8)	(1.6)	(3.1)	0.5
Dividend per share (c)	0.0	0.0	0.0	0.0
Gross Margin (%)	N/A	N/A	N/A	N/A
EBITDA Margin (%)	N/A	N/A	N/A	N/A
Operating Margin (before GW and except.) (%)	N/A	N/A	N/A	N/A
BALANCE SHEET				
Fixed Assets	14,188	14,475	8,458	8,458
Intangible Assets	12,826	9,578	6,201	6,201
Tangible Assets	113	119	247	209
Investments	1,249	4,778	2,010	2,048
Current Assets	7,629	3,608	1,898	4,953
Stocks	0	0	110	0
Debtors	4,253	2,818	1,280	1,280
Cash	2,271	783	500	3,555
Other	1,105	7	8	118
Current Liabilities	(3,029)	(1,525)	(2,514)	(2,514)
Creditors	(3,029)	(1,525)	(2,493)	(2,514)
Provisions	0	0	(21)	0
Long Term Liabilities	0	0	(666)	(666)
Long term borrowings	0	0	0	0
Other long term liabilities	0	0	(666)	(666)
Net Assets	18,788	16,558	7,176	10,231
CASH FLOW				
Operating Cash Flow	(792)	(1,621)	(879)	(1,762)
Net Interest	0	0	0	0
Tax	0	0	0	0
Capex	(8,752)	(8,213)	(3,316)	0
Acquisitions/disposals	0	0	0	0
Financing	10,918	8,366	3,796	4,817
Dividends	0	0	0	0
Net Cash Flow	1,374	(1,468)	(399)	3,055
Opening net debt/(cash)	(942)	(2,271)	(783)	(500)
FX Movements	(45)	(20)	116	0
Other	0	0	0	0
Closing net debt/(cash)	(2,271)	(783)	(500)	(3,555)

Source: Edison Investment Research

London +44 (0)20 3077 5700
Lincoln House, 296-302 High Holborn
London, WC1V 7JH, UK

New York +1 212 551 1118
380 Lexington Avenue, Suite 1724
NY 10168, New York, US

Sydney +61 (0)2 9258 1162
Level 33, Australia Square, 264 George St,
Sydney, NSW 2000, Australia