

Seismic reflections

Quickest route to investor value crystallization?

Shell's recent takeover bid for Cove Energy and the expected windfall for shareholders have again highlighted the strategy of focusing on exploration and appraisal as the quickest and most value-creating part of the E&P cycle for the investor. With frontier exploration players targeting large prospects, capex requirements are often too onerous for an independent company to bear. By focusing on the front end of the E&P cycle companies are able to extract significant value and avoid excessive equity dilution by selling out to a larger player who will take the asset to development and production.

Cove crystallizes exploration and appraisal value

On 22 February Shell announced a £1bn takeover approach for Cove Energy. Cove's strategy has always been to focus on the exploration and appraisal stages of the E&P cycle. Value creation is achieved through acquiring participation in exploration assets and taking them through to appraisal. These frontier exploration companies avoid the significant levels of capex required during development, which generally adds relatively less value than the earlier exploration and appraisal stages. Cove unashamedly stated it intended to appraise up prospects then exit. This has proved to be a successful strategy, with shareholders receiving a 100% return over the year and management achieving an estimated £38m windfall from the deal.

Short-term value crystallization over long-term dilution

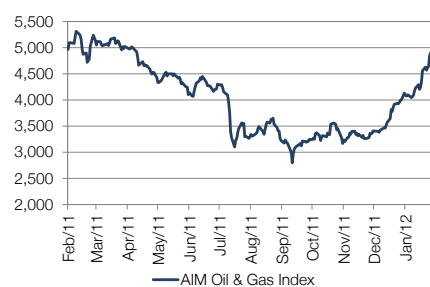
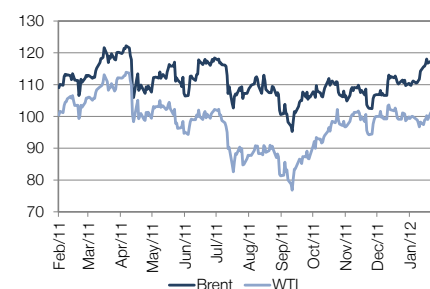
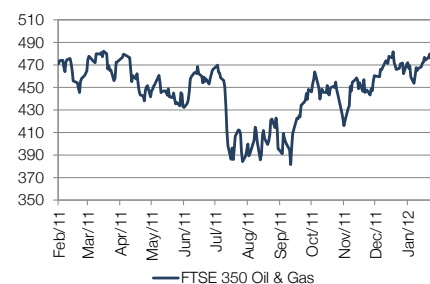
Extracting value from exploration and appraisal and avoiding the onerous costs of development is not a new strategy. However, Cove's recent takeover approach has highlighted the growing relevance of the strategy when exploration companies are focusing more and more on elephant hunting. The capex requirements during exploration and appraisal are generally manageable. However, development costs on the larger discoveries are usually too substantial for an independent to fully fund. Thus its working interest is ultimately farmed out or sold on completely. This can apply even at the larger level with, for example, Cobalt's recent pre-salt Angolan discovery set to cost the \$12.5bn market cap company an estimated \$4.4bn to develop. Given the level of potential dilution to achieve funding we would suggest a rationale exists for farming down some of its working interest. Investors are wary of equity dilution and companies that lack the breadth of exploration and importantly production could be best placed to crystallize value through divestment. Closer to home the mid-sized exploration players in the sector; Rockhopper, Bowleven, Gulfkeystone and Chariot to name a few, will no doubt be considering unlocking some or all of the upside value through farm downs or disposals which could benefit the shorter-term investor. Given recent discussions with Dragon Oil, Bowleven could be the next company to crystallize value for its shareholders.



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Exhibit 1: Best and worst performers

		1 week			
No.	Best performers	% change	No.	Worst performers	% change
1	BOWLEVEN PLC	60.1%	1	PETRONOFT RESOURCES	(31.6%)
2	BPC LIMITED	36.6%	2	TOWER RESOURCES	(19.2%)
3	AURELIAN OIL AND GAS	32.8%	3	XCITE ENERGY	(15.3%)
4	COVE ENERGY PLC	29.8%	4	MELROSE RESOURCES	(6.6%)
5	AMINEX PLC	21.8%	5	URALS ENERGY PUBLIC COMPANY	(4.8%)

		1 month			
No.	Best performers	% change	No.	Worst performers	% change
1	BPC LIMITED	97.2%	1	PETRONOFT RESOURCES	(38.5%)
2	LENI GAS AND OIL	64.8%	2	PETREL RESOURCES	(30.2%)
3	NIGHTHAWK ENERGY	61.5%	3	TOWER RESOURCES	(28.8%)
4	BOWLEVEN PLC	47.7%	4	PETRO MATAD	(25.3%)
5	COVE ENERGY PLC	43.5%	5	ANTRIM ENERGY INC	(23.6%)

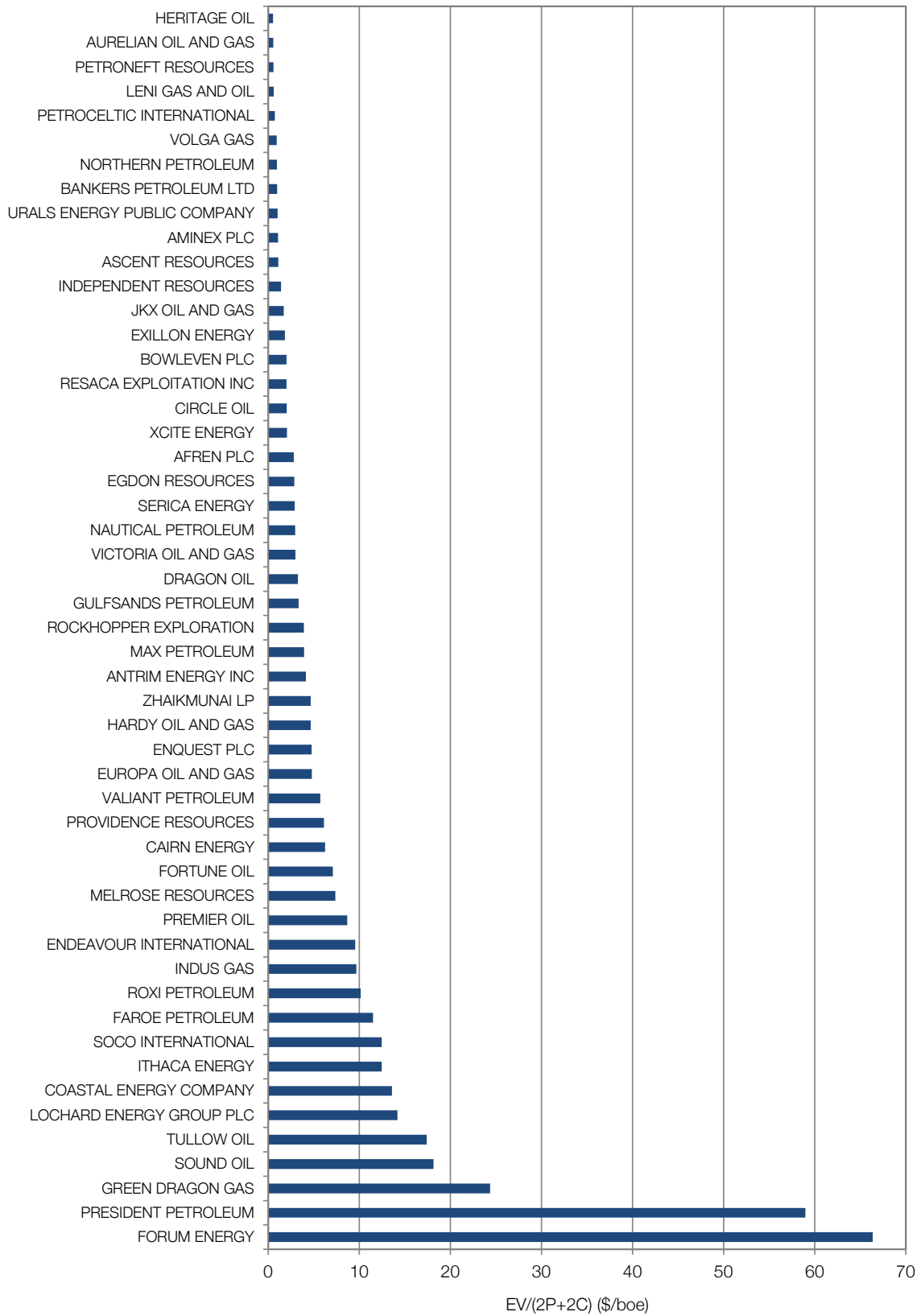
		3 months			
No.	Best performers	% change	No.	Worst performers	% change
1	COVE ENERGY PLC	148.9%	1	PETRONOFT RESOURCES	(53.8%)
2	GULF KEYSTONE PETROLEUM	118.6%	2	RESACA EXPLOITATION INC	(23.8%)
3	BPC LIMITED	114.1%	3	SOUND OIL	(21.1%)
4	ENEGI OIL	113.9%	4	GLOBAL ENERGY DEVELOPMENT	(17.1%)
5	ASCENT RESOURCES	101.5%	5	GASOL PLC	(10.5%)

		6 months			
No.	Best performers	% change	No.	Worst performers	% change
1	GULF KEYSTONE PETROLEUM	186.6%	1	PETRONOFT RESOURCES	(65.5%)
2	COVE ENERGY PLC	183.3%	2	PETRO MATAD	(64.3%)
3	COASTAL ENERGY COMPANY	16.0%	3	FRONTERA RESOURCES CORPORATION	(56.0%)
4	ROXI PETROLEUM	109.5%	4	AURELIAN OIL AND GAS	(51.6%)
5	PRESIDENT PETROLEUM	86.3%	5	RESACA EXPLOITATION INC	(49.8%)

		1 year			
No.	Best performers	% change	No.	Worst performers	% change
1	COASTAL ENERGY COMPANY	194.9%	1	PETRONOFT RESOURCES	(84.1%)
2	GULF KEYSTONE PETROLEUM	172.8%	2	FRONTERA RESOURCES CORPORATION	(82.7%)
3	COVE ENERGY PLC	114.0%	3	PETRO MATAD	(76.6%)
4	ROCKHOPPER EXPLORATION	60.9%	4	AURELIAN OIL AND GAS	(73.0%)
5	FORUM ENERGY	58.4%	5	PETREL RESOURCES	(71.7%)

Source: Bloomberg

Exhibit 2: EV/2P + 2C rankings



Source: Bloomberg, company releases, Edison Investment Research

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