EDISON

SDX Energy

South Disouq first gas and H219 drilling

2019 activity preview

Oil & gas

2019 will be an active year for SDX with H119 focused on delivery of first gas at South Disouq, ahead of a return to the drill bit in H219. An eight to nine well programme targets both oil and gas prospectivity in Egypt and appraisal/development locations in Morocco. Drilling activity is expected to be financed through cash flow, undrawn debt ($10m accessible under a reserve-based facility) and an estimated end-FY18 cash position of $15.9m. We expect first gas from South Disouq and increased gas production in Morocco to provide cash flow to support a FY19 capital programme of an estimated US$38m. Our updated risked valuation stands at 99.6p/share (up from 92.7p/share, driven by FX and roll forward of NAV), but we drop our sales and cash flow forecasts for FY19 – a key driver being deferred gas sales in Morocco and a later start-up at South Disouq. Morocco and South Disouq combined make up 67% of our core valuation with contracted sale volumes not levered to the oil price.

Year end	Revenue ($m)	PBT* ($m)	Operating cash flow ($m)	Net cash ($m)	Capex ($m)
12/16	12.9	(26.7)	(1.9)	4.7	(11.9)
12/17	39.2	32.8	21.6	25.8	(24.9)**
12/18e	53.1	12.1	31.5	15.9	(42.6)
12/19e	73.3	34.2	43.5	23.0	(38.3)

Note: *PBT is normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments. **Excludes Circle acquisition ($28.1m).

South Disouq first gas in H119

SDX aims to deliver first gas at South Disouq in H119 on completion of construction activity, well tie-ins and a 10km export pipeline. We expect cash generated from South Disouq gas sales, priced at $2.85/mcf, to provide funds for incremental well inventory beyond the four existing producers across SD-1X and Ibn Yunus.

H219 – a return to exploration

Exploration drilling will focus on Ibn Yunus lookalikes in Egypt, with at least two wells planned for H219. In addition, an upcoming bid round in Egypt could provide SDX with an option to extend its acreage position to include further Kafr el Sheik targets. SDX's upcoming Egypt work programme will also likely include a test of oil potential at South Disouq through the four-way dip, 50mmbo unrisked Young prospect in H219/2020. In Morocco, SDX has an 87% appraisal/development well success rate based on calibrated 3D seismic and is looking to leverage this success targeting 20bcf of gross unrisked resource in H219/2020. Of the total 12-well programme planned for Morocco, three to four are expected in H219. We include risked exploration/appraisal potential in our valuation.

Valuation: 99.6p/share, 7% increase driven by FX

SDX's share price has fallen alongside the wider UK E&P sector, despite its gas bias. We believe SDX needs to deliver South Disouq and Morocco sales growth in order to provide comfort on short-term cash flow projections. The increase in our valuation is driven by updating FX and rolling forward the NAV to a January 2019 discount date.

8 January 2019

Price	**43.0p**
Market cap	**£88m**
	US$/£0.78
Net cash ($m) at end September 2018	18.7
Shares in issue	204.7m
Free float	86%
Code	SDX
Primary exchange	AIM
Secondary exchange	TSX Venture

Share price performance

%	1m	3m	12m
Abs	0.6	(25.7)	(20.8)
Rel (local)	0.1	(19.7)	(9.8)
52-week high/low		73.0p	34.1p

Business description

SDX Energy is a North African E&P listed in London and Toronto. It has oil and gas production in Egypt and Moroccan gas production.

Next events

FY18 results	February 2019

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Edison profile page

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2019 activity overview

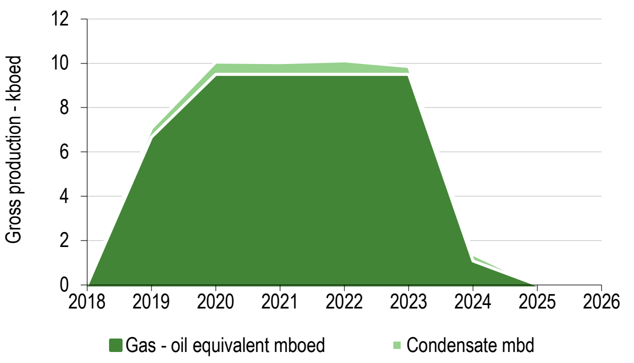
A key catalyst for SDX shareholders in H119 will be the delivery of first gas at South Disouq, Egypt. This should provide visibility of a return on investment in processing and transportation infrastructure which management expects to total net US$26.5m over 2018 and H119. This spend will provide the basis for the monetisation of incremental gas resource as SDX targets lookalike prospective resource in H219.

After the recent pause in drilling activity, H219 looks to be another active drilling period for SDX with the potential to drive organic growth in both Egypt and Morocco. Drilling is targeting gas prospectivity in proven-basins close to existing discoveries and infrastructure in addition to a more speculative well targeting the Young prospect looking to prove up oil potential mapped on SDX's Egyptian acreage.

South Disouq first gas in H119

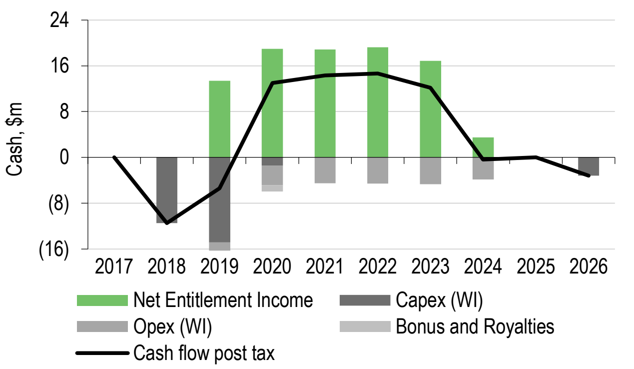
The delivery of first gas at South Disouq in H119 is a key milestone for SDX energy, and a key driver of group production volume and cash flow growth. Gross plateau production at 50–60mmscfd gross (55% SDX working interest) will add c 5.5kboed to group production in H119 (production is estimated at c 4kboed for FY18), at a price of $2.85/mcf, which is low when compared to SDX's realised prices in Morocco of $10.50/mcf. Our valuation of South Disouq is based on a 100bcf development, with incremental volumes beyond this to be de-risked through further exploration.

Exhibit 1: South Disouq production forecasts



Source: Edison Investment Research

Exhibit 2: South Disouq 100bcf development cash flow forecasts*

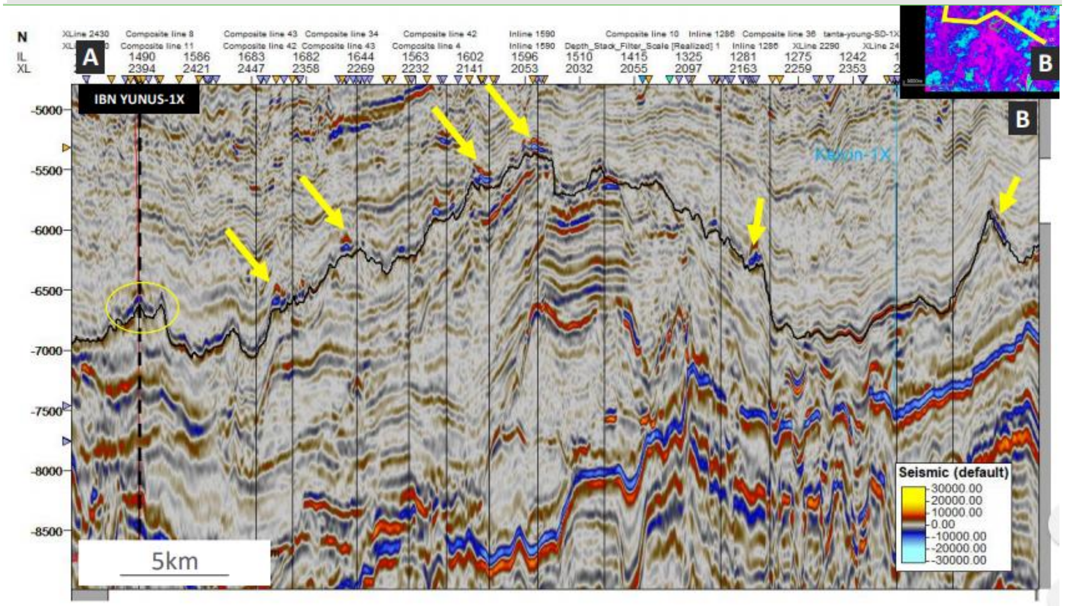


Source: Edison Investment Research. Note: *Cashflow prior to changes in working capital.

H219 exploration campaign – incremental volumes

The focus of SDX's follow-on drilling campaign in Egypt will be Ibn Yunus lookalike prospects, stratigraphic features that are identifiable as amplitude highs on 3D seismic. The mean prospective resource attributable of four worked-up Kafr el Sheik (KES) prospects is estimated at 70bcf unrisked, with at least one prospect to be drilled in H219. As shown in Exhibit 3, amplitude highs indicative of reservoir pay in stratigraphic traps are readily visible on 3D seismic above the Kafr el Sheik, shown as a dark black line.

Exhibit 3: South Disouq Kafr el Sheik prospectivity



Source: SDX Energy

In addition to the Kafr el Sheik prospect planned for H219, the company has identified another SD-1X analogue: a four-way dip closure with estimated mean recoverable volume of 17bcf. Our valuation includes five drill-ready prospects (unchanged), which we expect to be drilled over the next 18-24 months, but does not include potential incremental upside, which management estimates at more than 1tcf. Further prospects are likely to be worked up as SDX is currently acquiring an additional 170km^2 3D seismic survey on acreage to the south of SD-1X, which should provide detail on Abu Madi and KES potential in the southern end of the block.

South Disouq oil potential – contingent well for H219?

Encouragement for further oil potential can be found in the producing oil fields in the Western Desert, 100km to the west, together with oil shows in four offset wells close to South Disouq. The prolific Western Desert Bahariya and Kharita reservoir sands were encountered at the SD-1X well location; the unlogged Kharita sands showed elevated gas readings, potentially indicating a sign of thermogenic source. Vitrinite reflectance analysis suggests that the Jurassic source rock at South Disouq is present in the oil window and SDX has identified a four-way dip structure with multiple mapped reservoir intervals to test the basin for liquids potential. The 50mmbo mean unrisked (four reservoir intervals) Young prospect is a contingent well that may be drilled in late 2019 or 2020 – we include Young with a 25% geological chance of success in our valuation (risked value of 7.4p/share). The key risks to oil prospectivity at South Disouq are migration and charge.

H219 Morocco exploration campaign

More than 60 leads have been identified across the basin, targeting unrisked potential in excess of 60bcf. The majority of these leads have been derisked by existing or recently acquired 3D seismic data coverage. A 240km^2 3D seismic survey (Guebbas 3D) was conducted across the Gharb basin in 2018, with first data expected to be delivered in early 2019.

Should this dataset highlight better targets, up to three wells from the 12-well 2019/20 drilling campaign could be drilled across the area covered by this upcoming survey (these wells will be drilled towards the end of the campaign to ensure sufficient time for seismic interpretation).

We include 12 drill-ready prospects in our valuation, targeting 20bcf of mid-case, unrisked resource (three to four of these wells are likely to be drilled in H219). We view the Sebou/Gharb Centre wells as appraisal/development wells, given the company's ability to locate gas-bearing sands on calibrated 3D seismic with more than an 80% chance of success. We include this upcoming, 12-well programme and the yet to be tested Lalla Mimouna discoveries in our core value, albeit with an 80% chance of success to reflect the potential for the discovery of some sand packages that fall below the minimum economic threshold for commerciality.

The discovery of thermogenic gas at Lalla Mimouna provides further confidence that deeper oil or gas potential exists in the pre-Nappe. Existing oil discoveries in the onshore Rharb Basin are small and of poor quality in the carbonate/fractured basement reservoir, but SDX would be targeting larger prospects in the Jurassic/Miocene sandstones below the Nappe. Exploration of deeper potential remains at an early stage and we do not include it in our valuation at this point in time.

Gas market development and demand expectations

SDX's current gas production in Morocco matches the requirements of its current customer base, with existing producing wells being choked back to match demand and ensure prudent reservoir management.

SDX's current gas customer base is dominated by two large customers: Super Cerame and CMCP, which combined are forecast to consume approximately 6mmscfd of natural gas. Incremental demand is set to come from Peugeot, where test sales began in Q418 alongside a number of ancillary equipment manufacturers including Citic Dicastal (an alloy wheel manufacturer) and Omnium Plastic (a leader in automotive exterior plastics), along with existing local manufacturers such as GPC (paper manufacturer) and Setaxam (food processor) switching from fuel oil to natural gas to fire their burners.

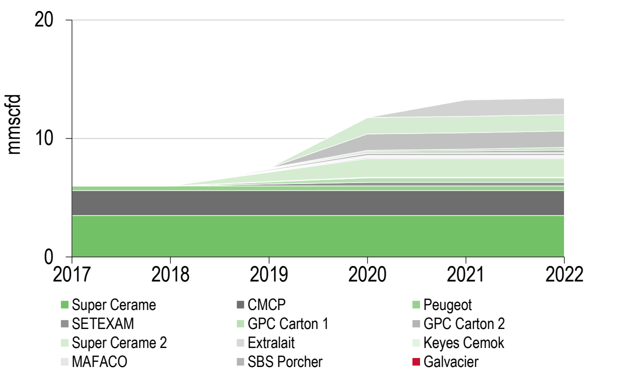
We update our market demand estimates based on company analysis of identified natural gas customers and SDX's connection goals for 2018. We see a slightly lower rate of gas sales ramp-up in 2019 as customer tie-ins are completed (as per our July 2018 outlook note, we were below company guidance for 2018 at a 6mmscfd sales gas exit rate relative to guidance of 8–10mmscfd), but the underlying demand picture remains robust with Edison forecasting 9.5mmscfd of gas sales in 2019. Demand analysis suggests that piped gas sales have the potential to increase materially over the next two to three years.

Our 2019 demand forecast is based on our analysis of risked projected market demand. Here we use a simplistic approach, applying a 90% chance of success for sales to existing customer Super Cerame's second plant, a 50% chance of success for new thermal customers and a 10% chance of success for large-scale power plant consumers. Our risked demand profile is shown in Exhibit 5, which implies a 2018 average gas sales rate of just over 6mmscfd, growing to 15mmscfd over the medium term.

Gas sales for FY19 have been deferred relative to our prior forecasts, which are a key driver of our lower sales and cash flow forecasts for FY19 in addition to our lower oil price assumption of $61/bbl Brent (from 71$/bbl Brent). FY19 revenues fall from $86.7m to $73.3m as a result. The NAV impact of this deferment is clearly less material as unsold gas volumes are monetised at a later date in our DCF rather than lost, but continued growth in customer connections, gas sales and adding to behind-pipe reserve is key to supporting our NAV estimate.

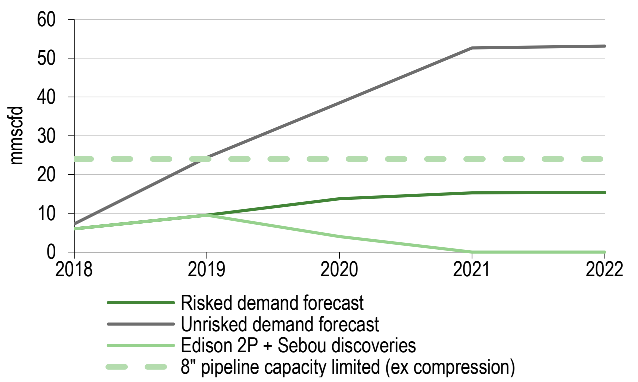
We constrain our valuation of SDX's Moroccan booked gas reserves and contingent resource based on our expectations of market demand, with inclusion of the risk factors mentioned above.

Exhibit 4: Morocco risked gas demand forecasts



Source: Edison Investment Research, SDX Energy

Exhibit 5: Key consumers – risked demand



Source: Edison Investment Research, SDX Energy

Valuation update

Key changes include a slower sales gas ramp-up in Morocco, aligning our capex forecasts with Q318 reported actuals, rolling forward the discount date to 2019, and a reduction in short-term oil price assumptions, which move to US$71.7/bbl and US$61.0/bbl for 2019. Our long-term oil price assumption remains at US$70.0/bbl Brent (2022).

We note that SDX is relatively insensitive to oil price assumptions, with the bulk of the valuation consisting of gas sales at 5-year fixed contracted prices in Morocco that average $10.5/mcf. Our FX assumption has also changed slightly to US$/£0.78, based on the average of the last six months of 2018.

As a result, we have slightly increased our RENAV from 92.7p/share to 99.6p/share (+7%), with our core value standing at 83.6p/share. We note that our valuation has a significant core value component at 84% of our RENAV.

Exhibit 6: Changes to our valuation

	Old (p/share)	New (p/share)	Change (%)
Core NAV	78.8	83.6	6
Development NAV	3.4	4.7	30
Exploration risked upside	10.6	11.3	8
Group RENAV	**92.7**	**99.6**	**7**

Source: Edison Investment Research

A full breakdown of our risked valuation is provided in the table below. We split our valuation between core value, which includes booked 2P reserves, recent discoveries and low-risk development upside in Morocco. We include risked development upside at Meseda and Gemsa and risked exploration potential at South Disouq in our risked exploration NAV (RENAV).

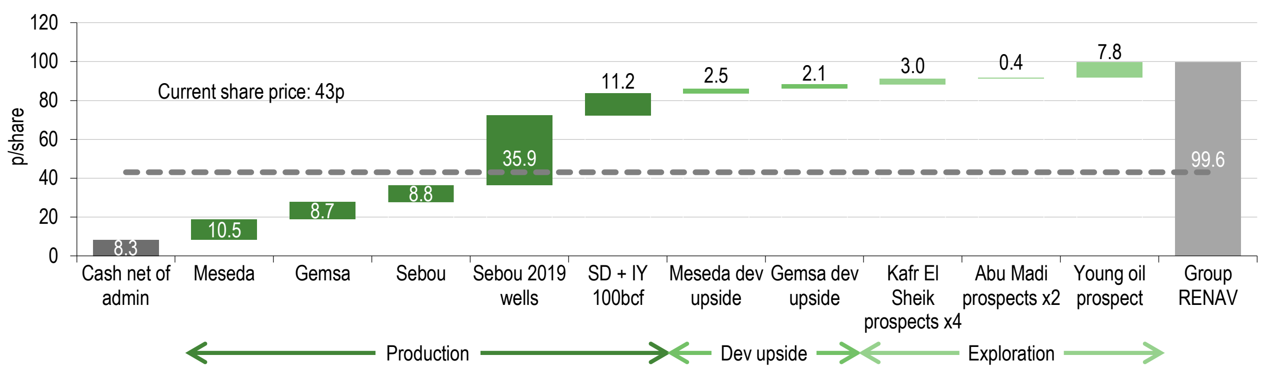
Exhibit 7: SDX Energy detailed valuation

Asset	Country	Diluted WI	CoS	Recoverable reserves Gross	Net WI	Net	Net risked value @12.5% NPV	Absolute	GBp/ share	C$/ share
		%	%	mmboe	mmboe	mmboe	$/boe	$m		
Net (debt)/cash – December 2018e		100%	100%					15.9	6.1	0.1
SG&A – $NPV_{12.5}$ of 3 years		100%	100%					(13.0)	(5.0)	(0.1)
E&A expense for exploration prospects		100%	100%					(14.2)	(5.4)	(0.1)
NPV of net receivable recovery		100%	100%					16.8	6.4	0.1
Sebou pipeline residual value (50% cost)		100%	100%					16.4	6.2	0.1
Production										
Meseda Base + Workovers + Rabul	Egypt	50%	90%	8.4	4.2	1.6	7.3	27.7	10.5	0.2
Gemsa 2P	Egypt	50%	100%	4.2	2.1	2.1	11.0	22.9	8.7	0.1
Sebou 2P volume + discoveries to be booked	Morocco	75%	100%	0.8	0.6	0.6	37.7	23.2	8.8	0.2
Sebou 12-well 2019 programme	Morocco	75%	75%	5.3	4.0	4.0	31.8	94.5	35.9	0.6
South Disouq/Ibn Yunus	Egypt	55%	100%	17.7	9.7	9.7	3.0	29.6	11.2	0.2
Core NAV				**36.4**	**20.6**	**18.0**	**9.6**	**219.8**	**83.6**	**1.4**
Development upside										
Meseda Waterflood Upside	Egypt	50%	50%	5.3	2.6	1.0	5.0	6.7	2.5	0.0
Gemsa - Edison modelling on full field	Egypt	50%	75%	1.6	0.8	0.8	9.5	5.6	2.1	0.0
Exploration (known)										
Kafr el Sheik prospects x4	Egypt	55%	27%	33.6	18.5	18.5	1.6	8.0	3.0	0.1
Abu Madi prospect x2	Egypt	55%	23%	5.7	3.1	3.1	1.6	1.1	0.4	0.0
Young oil prospect	Egypt	55%	19%	50.0	27.5	27.5	4.0	20.6	7.8	0.1
Group RENAV				**132.0**	**73.2**	**68.9**		**261.8**	**99.6**	**1.7**

Source: Edison Investment Research. Note: Number of shares = 204.7m, FX = US$/£0.78.

The waterfall diagram below shows our valuation relative to the current share price. SDX currently trades at a material discount to our core valuation, and we see potential for a re-rating as the company delivers first gas at South Disouq and continued gas sales ramp up in Morocco, demonstrating the FCF generation potential of these key value components.

Exhibit 8: SDX Energy valuation waterfall



Source: Edison Investment Research

Given recent oil price volatility, we provide a valuation sensitivity to our long-term Brent price (from 2022) in the table below. SDX shows relatively low oil price gearing for a UK-listed E&P given that fixed-price gas contracts in Egypt (South Disouq) and Morocco (Sebou) make up c 67% of our core valuation.

Exhibit 9: RENAV sensitivity to long-term Brent crude

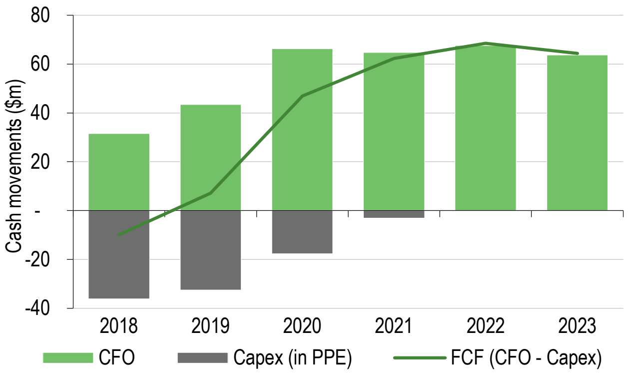
WACC (%)/Brent ($/bbl)	50	60	70	80
10.0%	99	103	107	111
12.5%	92	96	100	103
15.0%	86	89	93	96

Source: Edison Investment Research

Financial summary

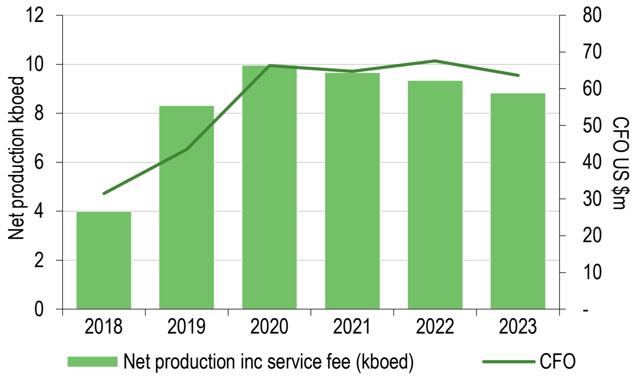
SDX retains a robust balance sheet with cash and equivalents of $18.7m as of Q318 and no drawn debt. The company has access to up to $10m accessible of its RBL borrowing base, which can be drawn down if required. Forecast cash or net debt at the end of 2019 will be driven by a combination of production start-up at South Disouq, production growth in Morocco and oil prices, as well as phasing of the company's planned drilling programme. On our base case, we expect SDX to end FY19 with $23.0m of cash, but with a significant range of uncertainty without firm dates for the start-up of South Disouq, timing of Morocco gas sales and management guidance on the FY19 budget.

Exhibit 10: Cashflow forecasts and committed capex



Source: Edison Investment Research

Exhibit 11: Group production expectations



Source: Edison Investment Research

Exhibit 12: Financial summary

Accounts: IFRS, Yr end: December, USD: Thousands	2014	2015	2016	2017	2018e	2019e	2020e
Total revenues	24,533	11,372	12,914	39,166	53,116	73,270	86,742
Cost of sales	(5,241)	(7,030)	(8,548)	(28,078)	(27,216)	(34,180)	(34,318)
Gross profit	19,292	4,342	4,366	11,088	25,900	39,090	52,425
SG&A (expenses)	(2,898)	(4,770)	(3,679)	(8,793)	(5,500)	(5,775)	(6,064)
Other income/(expense)	1,130	1,021	1,701	1,820	1,186	1,914	1,526
Exceptionals and adjustments	(3,831)	(7,676)	(29,089)	(725)	(9,500)	(1,000)	(1,000)
Depreciation and amortisation	(1,602)	(2,057)	(3,266)	(17,824)	(13,153)	(15,960)	(17,690)
Reported EBIT	13,693	(7,083)	(26,701)	3,390	12,086	34,229	46,888
Finance income/(expense)	(1,009)	(96)	4	(129)	0	0	0
Other income/(expense)	0	18,289	0	29,558	0	0	0
Exceptionals and adjustments	0	0	0	0	0	0	0
Reported PBT	12,684	11,110	(26,697)	32,819	12,086	34,229	46,888
Income tax expense (includes exceptionals)	(4,328)	(1,063)	(1,503)	(4,541)	(5,785)	(2,300)	(2,319)
Reported net income	8,356	10,047	(28,200)	28,278	6,302	31,929	44,569
Shares at end of period - basic	376	38	80	204	205	205	205
Balance sheet							
Property, plant and equipment	9,392	18,401	12,605	54,445	76,910	93,446	93,465
Goodwill	0	0	0	0	0	0	0
Intangible assets	16,460	23,473	10,623	15,231	13,700	19,521	22,693
Other non-current assets	1,999	2,106	2,503	2,724	2,724	2,724	2,724
Total non-current assets	27,851	43,980	25,731	72,400	93,334	115,691	118,881
Cash and equivalents	17,935	8,170	4,725	25,844	15,946	23,025	69,971
Inventories	0	1,188	1,698	5,157	4,999	6,278	6,303
Trade and other receivables	3,306	6,678	9,463	37,656	28,242	29,094	23,275
Other current assets	0	0	0	0	0	0	0
Total current assets	21,241	16,036	15,886	68,657	49,187	58,397	99,549
Non-current loans and borrowings	0	0	0	0	0	0	0
Other non-current liabilities	608	286	290	4,506	4,506	4,506	4,506
Total non-current liabilities	608	286	290	4,506	4,506	4,506	4,506
Trade and other payables	1,686	3,556	3,674	19,459	13,621	12,259	11,033
Current loans and borrowings	2,207	0	0	0	0	0	0
Other current liabilities	5,142	928	389	2,473	2,473	2,473	2,473
Total current liabilities	9,035	4,484	4,063	21,932	16,094	14,732	13,506
Equity attributable to company	39,449	55,246	37,264	114,619	121,921	154,849	200,418
Non-controlling interest	0	0	0	0	0	0	0
Cashflow statement							
Profit before tax	12,684	11,110	(26,697)	32,819	12,086	34,229	46,888
Net finance expenses	0	0	0	0	0	0	0
Depreciation and amortisation	1,602	2,057	3,266	17,824	13,153	15,960	17,690
Share based payments	1,064	761	(47)	538	1,000	1,000	1,000
Other adjustments	1,670	(12,281)	25,742	(34,613)	7,314	(1,914)	(1,526)
Movements in working capital	12,941	(2,183)	(3,440)	5,412	3,735	(3,493)	4,568
Interest paid / received	0	0	0	0	0	0	0
Income taxes paid	(4,430)	(4,678)	(766)	(364)	(5,785)	(2,300)	(2,319)
Cash from operations (CFO)	25,531	(5,214)	(1,942)	21,616	31,503	43,482	66,300
Capex	(13,634)	(5,120)	(11,890)	(24,917)	(42,588)	(38,317)	(20,881)
Acquisitions & disposals net	0	0	0	(24,948)	0	0	0
Other investing activities	1,110	4,836	825	760	1,186	1,914	1,526
Cash used in investing activities (CFIA)	(12,524)	(284)	(11,065)	(49,105)	(41,401)	(36,403)	(19,354)
Net proceeds from issue of shares	0	0	10,127	48,510	0	0	0
Movements in debt	0	(3,702)	(96)	(43)	0	0	0
Other financing activities	0	0	0	0	0	0	0
Cash from financing activities (CFF)	0	(3,702)	10,031	48,467	0	0	0
Increase/(decrease) in cash and equivalents	13,007	(9,200)	(2,976)	20,978	(9,898)	7,079	46,946
Currency translation differences and other	(615)	(565)	(469)	141	0	0	0
Cash and equivalents at end of period	17,935	8,170	4,725	25,844	15,946	23,025	69,971
Net (debt) cash start of period	15,728	8,170	4,725	25,844	15,946	23,025	69,971
Movement in net (debt) cash over period	12,392	(7,558)	(3,445)	21,119	(9,898)	7,079	46,946

Source: Company accounts, Edison Investment Research

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