Davy Research

Providence Resources

Oil and gas

A fresh look at valuations: low-cost environment creates exceptional opportunity

DAVY VIEW

After an eventful year, we think that a sensible, risk weighted net present value/share valuation for Providence is 35p with core assets (discovered oil and cash) making up 20p of that. It may help to think of the Providence share price as a compilation of call options on its inventory of prospects in the Irish offshore. Given the upside potential if successful, especially the higher risk large volume plays along the Western Atlantic margin, the option premium looks cheap. The upcoming drilling campaign in 2017 provides the mechanism for this to be verified.

Valuation update

Events of the last year make a valuation review timely. Taken in the round and adjusting for the enlarged equity structure, our work indicates a risk weighted valuation of 35p per share. Barryroe phase 1 and cash make up the majority of the 20p, with the exploration element of the portfolio accounting for the balance. This is a risked point-in-time valuation; if a project is successful, the risk unwinds. Obviously, the larger the project, the bigger the impact. Another way to think about the valuation is as a series of option premiums. The analogy should not be laboured too much, but it works if the share price is seen as the option premium that – assuming success – provides a low-cost entry into a potentially much larger value situation.

Funds in place and low service costs create opportunity

The very large reduction in oil industry service costs over the past two years creates a high value window of opportunity for those oil and gas companies that have capital available and are willing to spend. This observation very much applies to Providence because, following its equity funding earlier this year, it has circa $35m available to allocate to exploration expenditure offshore Ireland. In fact, the funds in place at present – in tandem with the very low drilling costs – mean that it can now undertake exploration activity along the Irish Western margin. Such activity would have been impossible, if not unthinkable, up to relatively recently.

Managing that opportunity – 2017 will be a pivotal year

Now the challenge is to manage this opportunity. The first step was to hire the Stena IceMAX, a unit that will drill the Druid prospect. The group will obviously want to maximise the number of metres drilled in the current environment. Fortunately, the drilling unit is very efficient (twin derricks); the Porcupine lends itself to fast top hole drilling; and the group also has plenty of licence equity positions to be very flexible with respect to offering a farm-in package. In this context, we think Providence will at the very least deepen the Druid well to pursue the underlying Drombeg feature. However, the contract also allows for a second well slot. For us, the interesting question is whether the group can combine the elements in its favour – funds, efficient drilling unit and licence equity – to penetrate three targets during the summer of 2017.

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Share Price Performance

Financial Data

Providence Resources :Financial model and valuation analysis

Oil and gas Sector Review

Providence has a particularly large licence position offshore Ireland. It is also very pro-active with an involvement in five wells and 14 seismic surveys since 2004. It has particularly championed the Atlantic Margin plays, bringing in industry partners and developing new plays and targets. In June, it completed a re-financing, which extinguished all liabilities and provided a funding base to pursue drilling opportunities offshore Ireland.

This (opportunity) is timely, especially in the context of a very successful 2015 Atlantic Margin Round and the support it received from a significant number of large multinational oil and gas groups

A more detailed description of the group can be found in the investment thesis at the end of this report

The opportunity after the funding

The share funding completed in June 2016 at a price of 12p per share raised a total of $68m before costs by way of new equity. This was used to repay Melody debt and the amounts owed to Transocean (following the appeal of an earlier judgement that had largely ruled in favour of Providence and its partners). The balance of the funds was raised to drill for oil and gas in the Atlantic margin.

Table 1: Estimate of funding available for Providence exploration programme

	US$m
End-June 2016 balance sheet cash before funding	0.5
Equity placing - cash post costs	68.4
Equity open offer - cash outcome	1.7
Total	**70.6**
Repayment of debt	20
Transocean payment from appeal court	3.8
Transocean legal fees - appeal	0.2
Transocean legal fees - commercial court	1.25
Total	**25.3**
Est. 2016 capital commitments	3.5
Est. 18 months plc o/h	6
Est. net working capital cost	1
Total	**10.5**
Est. balance available for 2017	34.8

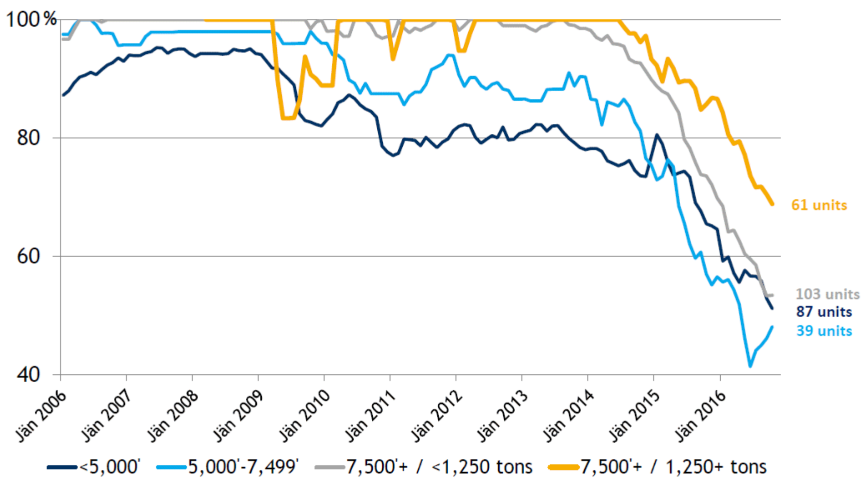
Source: Davy; company documents

The funding effectively re-set Providence. Moreover, the group now has funds in a period of exceptionally low costs for oilfield services – particularly so for drilling activity.

Exceptional low cost is a great opportunity

The severe and rapid contraction of drilling activity across the globe over the last number of years, especially in offshore areas, resulted in a collapse of offshore drilling charges and rates. This was especially the case in Northwest Europe, as evidenced by record low drilling levels in the North Sea sectors.

*Figure 1: Worldwide floater total utilization by water depth/Hookload**



* Includes data supplied by IHS-Petrodata, Inc; Copyright 2016, as of November 1st 2016

Source: Rowan Companies investor presentation

Figure 1 records the huge drop in utilisation rates by offshore drilling units over the last three years. In this market, it is not difficult to envisage equally large reductions in operating charges.

This creates an opportunity for independent oil and gas groups with cash available. Providence is a good example. We estimate that after its funding it has in the order of $35m available for investment and working capital purposes. It has disclosed that it can drill a well in the Druid prospect in the Porcupine for an estimated $35m gross. This compares to the 2013 well on the Druid prospect, which reportedly cost over $200m to drill and complete.

The current low-cost environment for deepwater rigs presents a significant opportunity to drill targets that would not be drilled in another cost environment

Creates real 'independent' drilling

Importantly, this provides Providence with the opportunity to undertake a well without having a carry or promote from a larger industry partner – which would have been the accepted route for offshore drilling prior to the cost landscape that currently exists. In a sense, Providence would not in the normal course of events be expected to be the driver and operator of a deepwater well. The fact that it will operate the Druid/Drombeg well demonstrates the opportunity offered by the low-cost environment.

The Stena IceMAX is the world's first dynamically positioned dual mast ice-class drillship. It was delivered in 2012 and has harsh environment status capable of drilling in waters up to 10,000 feet.

Newgrange: this Cretaceous target is a product of Providence and Schlumberger work in the Porcupine that integrated long offset 2D seismic and Dunquin data. It lies in 1km of water but is relatively shallow at c.400 metres below the mudline. Resource type is modelled as gas. Because of the scale of the target, the recoverable estimate resource is exceptionally large with over 13 TCF of gas estimated to be in place.

Druid: this consists of two Palaeocene fans. Seismic interpretation and inversion analysis points to a high porosity and high net to gross light oil filled sandstone reservoir. The Pmean recoverable resource is estimated at over 1bn barrels. The prospect has exceptionally good technical support.

Drombeg: this oil target is Cretaceous deepwater fan sandstone and lies at a depth of 2.75km below the mud line. It has good technical support with a prognosed Pmean of 670m barrels based on a recovery factor of 35%.

Rig booked for 2017 drilling programme

Providence has locked in the drill ship Stena IceMAX for a one-well slot in 2017. We understand the rig has been booked for a period of up two months. The day rate is $185,000 and the contract includes an option to drill a second well. If we apply the rule of thumb that the spread rate is usually twice the day rate, then the daily all-in cost for the rig should be in the region of $0.4m. Mobilisation and demobilisation charges have also become very competitive, and we suspect that this is the same for the IceMAX. In this context, a number in the region of $2-3m is quite possible.

The rig will be used to drill the Druid well in the Porcupine basin. The well (53/6-A) is still subject to regulatory procedures but is scheduled to start in June 2017. It is also quite likely that it will be deepened to drill the Drombeg prospect. It has an 80% interest in both targets. The second well option, if chosen, will likely be in the Porcupine and we suspect that it could be the giant but shallow Newgrange gas prospect.

Rig and geology favour rapid drilling progress

In order to maximise the metres drilled during the first contract period (i.e. two months duration), drilling will have to be rapid and problem free. Fortunately, there are a couple of factors that facilitate this. The IceMAX has twin derricks which make for much more efficient workflows, especially in deepwater projects with relatively shallow wells. Operational post drill reports indicate that time savings of over 20% can be achieved.

At the same time, taken in its geological context the Porcupine basin has been very quiet or passive for a considerable period (since the Palaeocene); this has allowed the build-up of layered muds during the Tertiary period. This means that the initial phase of drilling in the top hole before a riser is installed can be undertaken for a longer period, penetrating deeper into the subsurface. This phase is typically uncomplicated and quick with rapid rates of penetration.

The 2017 programme has options

The commitment to drill the Palaeocene Druid structure is locked down and firm. However, we think there are additional options available. The most obvious is to drill the deeper Cretaceous Drombeg structure. Management has stated that it is possible to design the well programme such that it can accommodate a deeper total depth even if the primary target is Druid.

Druid costs are covered – and Drombeg's should also be

If we assume a spread rate cost of $0.4m per day for a 60-day period, the gross cost of the programme will be $24.0m. Even allowing for an additional 10-15% cost for the mobilisation of the drillship, a figure of $35m looks to be capable of comfortably covering the Druid and Drombeg programmes.

Third target in 2017 season is a possibility

Assuming that the rig will stay in the Porcupine sector, it may also be possible to drill a third target. This is likely to be Newgrange, a shallow gas target in licence 6/14 in which it holds an 80% share.

If drilling is rapid during the first 60-day well slot – saving cash and preserving the optimal weather window – then it is theoretically possible that Providence will also have sufficient funding capacity left over to complete or contribute to a Newgrange well.

Pathfinder status and Schlumberger collaboration facilitate farm-out or database option

An obvious route to getting more metres drilled is to dilute the equity in its licence position by farm-out or data trade. Providence is on record that it has opened a data room to process a farm-out process of the Druid and Drombeg targets. Although Providence has funds to cover the costs of these targets (see above), this will reduce the net cost to Providence and, depending on the deal, could extend its ability to drill additional wells. It is greatly facilitated in this exercise by two important factors.

The first is that the group and its geoscientists have been a pathfinder along the Western margin of Ireland. It has put together a drilling consortium in the past that include several oil majors. As a consequence of this long-term commitment to the Irish offshore, it has a very large proprietary database ranging from specific well data to 2D and 3D seismic programmes.

A second helpful factor is that in 2015 Providence aligned itself with Schlumberger in a ‘collaboration’ project. This provided Providence with access to the latest technology and leading experienced personnel involved in the interpretation of oil and gas prospects. The results produced (by Schlumberger) very detailed mapping and target delineation outcomes for the Druid and Drombeg targets initially and then the Newgrange prospect.

The farm-out market has been very quiet in recent times, reflecting the downturn in the oil price and reduced industry investment levels. To what extent recovery of past costs and promotes can be achieved remains to be determined, but the recent OPEC deal and Providence’s advantages outlined above should allow it to maximise its position.

A farm-out/data deal raises the interesting possibility that not all of the current funding base is spent in 2017 and is instead carried forward to 2018 to contribute to a Barryroe well. This assumes that a deal to farm-out Barryroe does not conclude in sufficient time to see a second rig brought in to the Celtic Sea in 2017. The indications are that a Celtic Sea well can now be completed for around $20m – assuming current rig rates can be carried forward.

While there are limitations as to how much can be achieved with the funding available to Providence, the point is that there are choices and options available.

Spanish Point is not included in the current options for 2017. Instead, we expect a well in 2018 consequent to a separate drilling schedule.

Valuation update

Our new group valuation is shown in the following table. As indicated in an earlier comment, we think a useful way to look at the share price is as a basket of call options on various targets in the Irish sector. As progress is made on any of these targets – whether measured by the ultimate drilling gauge or just simply progress in advancing the various farm-out/deal options – the value of the call should rise as the value of the underlying asset increases.

- We use a 10% discount rate.
- Our long-term oil price is $70 per barrel.
- To tackle the inevitable dilution involved in funding drilling projects for smaller E&P groups, we estimate a final licence position.

- We assume an operational risk factor made up of discovery chance and development chance. This is clearly subjective in some cases but is used to try and factor in possible resistance to development (e.g. Kish) licence or economic justification as in the case of some smaller Celtic Sea oil accumulations (Helvic and Hook).
- We have also been quite conservative in our valuation models. These have been built-up with relatively long start-up dates (in a success case) with none of the exploration portfolio commencing before 2014 and the majority of the Atlantic Margin plays starting in 2028.
- Finally, Druid is a headline project. The data produced by Providence show an estimate of 3.2bn barrels in place with a 35% recovery factor. Our success case for Druid assumes a 15% recovery to build a more conservative bias.

Table 2: Asset valuation profile

ASSET	Gross field NPV US$m	NPV/bl $/bl	Current licence equity %	Est Final licence equity %	Operational risking %	Est. value per share (p)
Appraisal/development						
Barryroe phase 1	519	5.8	80%	32.0%	50.0%	11
Helvick	37	12.5	63%	41.3%	18.8%	0
Hook Head	223	11.2	73%	36.3%	5.0%	1
Spanish Point	241	2.5	58%	29.0%	37.5%	4
Total						16
Exploration						
Avalon	993	2.1	80%	20.0%	10.0%	3
Drombeg	605	0.8	80%	20.0%	10.0%	2
Druid	2,301	4.8	80%	20.0%	10.0%	6
Dunquin South	1,674	3.7	20%	5.0%	6.4%	1
Kish Bank	361	9.0	100%	50.0%	4.1%	1
Newgrange	361	9.0	100%	50.0%	4.1%	1
Silverback	364	1.3	100%	33.0%	10.0%	2
Total						15
Gross debt	0.00					0.00
Cash						4.7
Net cash						4.7
Total						35

Source: Davy

Our valuation was 1.21p per share before the recapitalisation of the group in June this year which was undertaken at 12p per share. The large divergence between the current valuation (35p) and the earlier estimate reflects the dilution due to the issuance of new shares at 12p per share. This (dilution) in turn reflected the distressed state of the balance sheet at the time and the unwelcome appeal court decision in early 2015. The actual underlying metrics for the various filed and prospect estimates have not changed materially, largely because we have maintained our oil price view at $70 per barrel.

Value leverage

One of the more important criteria in judging an E&P stock is the level of value leverage or the potential upside. This is substantial in Providence. The table below shows the projects in the exploration portfolio with risking removed. We have maintained our estimate of the licence dilution that we believe will happen. Even with this, many of the projects are a multiple of the current share price.

Table 3: Value leverage for exploration part of portfolio

	Current licence equity %	Final licence equity %	Unrisked for drilling and development p/share
Avalon	80%	20.0%	26.6
Drombeg	80%	20.0%	16.2
Druid*	80%	20.0%	61.6
Dunquin South	20%	5.0%	11.2
Kish Bank	100%	50.0%	24.1
Newgrange	100%	50.0%	10.3
Silverback	100%	33.0%	16.1

**Note our comment on recovery above.*

Source: Davy

Investment thesis

Providence Resources provides a direct route to an extensive and diverse licence portfolio offshore Ireland, where numerous oil and gas shows have been found in previous drilling campaigns. Its model is to identify new or by-passed plays, build a large equity position and then farm down as part of its drilling campaign. It is active in the Atlantic Margin and the Celtic Sea as well as several other basins in the Irish offshore.

A broad portfolio of drill targets reduces the single event risk

Providence has the largest acreage position offshore Ireland, reducing single event exposure. The focus on the drill bit makes for material value leverage, with drill success generating value outcomes at a multiple of current market valuations. It has also built up a portfolio of 2C oil and gas resources. This means that apart from its traditional exploration focus, it also has appraisal diversification.

Group plays pathfinder role

The group has built up its licence portfolio offshore Ireland because it (and its predecessor) has been involved in the Irish offshore for decades. The consequence of this activity is that it plays a pathfinder role in the development of the Irish offshore and has a very large database of seismic and well data. This fits into its operating model of sourcing new ideas and areas, taking substantial equity initially and then using this database and equity position to farm-out its position to the larger groups in the industry.

Active explorer – including drilling

Together with this strategy, it participates in drilling activity as extensively as it can subject to financial constraints. Since 2004, it has been involved in five wells offshore Ireland and14 seismic surveys. The wells include headline wells such as the appraisal of the Barryroe prospect in the Celtic Sea (2012) and the Exxon-led well in the Porcupine (2013).

Partly due to the data from the Dunquin well together with the results from the Eastern Canadian seaboard, the 2015 Frontier licencing round along the Atlantic Margin was a major success. This is likely to lead to a new wave of drilling activity over the next five years, with Providence expected to make a significant contribution to this.

Possible to identify participation in up to five wells; 2016 funding will kick-start drilling programme

Providence has engaged a drilling unit to enter Irish waters in 2017. The Stena IceMAX will be available for a two-month period with an option to drill a second well. The Palaeocene fan Druid prospect in the Porcupine has been slated as the initial well with a start in June 2017. However, we think it is very likely that the well will be deepened to probe the older Cretaceous Drombeg target. Pending the amount of time spent on location for this one/two well slot, it is possible that a third Porcupine well may be attempted in 2017 – likely to be the giant Newgrange gas target.

The two remaining prospects that are still required to be further appraised are the Barryroe play in the Celtic Sea and the Spanish Point gas condensate play in the northern Porcupine basin. Deals/farm-out to achieve drilling on both targets are being actively sought.

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Company profile

Providence Resources is an Irish oil and gas company with activities solely offshore Ireland. In recent years it has focused on building up the single largest licence position offshore Ireland. These licences are chiefly in the Celtic Sea and along the Atlantic Margin. In 2012 it successfully appraised and flowed oil from the Barryroe field, located in the Celtic Sea Basin. The well twinned a former discovery and logged and tested a light waxy crude at rates over 3,000 b/d. It is currently looking to farm out this project in which it has an 80% net share. The other area of particular interest is the Atlantic Margin. Two targets are of immediate interest. The Dunquin well (12% stake) was drilled in 2013 with Exxon as operator and discovered the presence of a hydrocarbon system in a large, good quality carbonate reservoir. To the North, Cairn Energy has farmed into the Spanish Point discovery and an appraisal well is expected in 2018. Providence has a 56% stake in Spanish Point and is currently in the process of farming this position down to a much lower level. As is typical of smaller E&P stocks, Providence has traditionally financed through equity. Following sales of its African and UK assets, it is now completely debt free.

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Price performance (% change)

Stock	*2011*	*2012*	*2013*	*2014*	*2015*
PROVIDENCE RESOURCES	-17.7	220.0	-66.0	-61.3	-79.6

Source: Datastream

WARNING: Past performance is not a reliable guide to future performance

Investment ratings

Providence Resources rating: Outperform Issued: 09/06/11

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