Davy Research

Providence Resources

Resource

DAVY

Now and then

Providence Resources

OUTPERFORM

Closing price:31.0c

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Job Langbroek

job.langbroek@davy.ie / +353 1 6148914

Resources Team

Job Langbroek, Caren Crowley

research@davy.ie

Share Price Performance

Financial Data

Providence Resources :Financial model and valuation analysis

Resource Sector Review

DAVY VIEW

The rush to valuation following the Barryroe well testing programme in early 2012 produced very high expectations. Three years on and following a frozen farm-out market and a funding in the middle of a bear market, our calculated group valuation now looks very different. However, with the share price also very different, good value leverage is still identifiable if the suite of projects in Providence's portfolio can be progressed.

Revisiting the valuation

Providence's funding exercise and the recent 2014 results present a good opportunity to fully review the group valuation. Since the initial Barryroe optimism, a sea change in the oil and gas market's valuation has taken place and a number of important changes have occurred in the portfolio mix. The early 2015 funding exercise at 25p per share, a fraction of the highs experienced in 2013, obviously had a significant dilutive effect on the value per share metrics. However, the general delay and investment drought also need to be reflected in the modelling of possible future cash flows. Our longer-term oil price assumption has also been lowered (now US$80/bl versus US$90/bl previously).The combined impact is significant, with our new assumptions producing a value of £1.78 per share compared to the pre-funding valuation of £7.47 at the end of last year.

Still waiting on Barryroe and Spanish Point projects to deliver

There are currently two linchpins in the group's portfolio: Barryroe and Spanish Point. Progress on either would be positive for the stock, especially Barryroe, which – for better or worse – has become synonymous with the group's fortunes. In fact, the absence of a farm-out has had a material knock-on effect on the market's valuation of Providence. In reality, there is no evidence that a farm-out is not being achieved because of the results achieved so far; rather, there seems to be reluctance on the part of industry to commit more capital, reinforced by the collapse in the oil price from September 2014 onwards. The Spanish Point project has not been drilled despite the prospect first being mentioned as a drill candidate in 2012. Nonetheless, it has been farmed out to Cairn Energy in the interim; more seismic has been shot; and it has generally been upgraded as a prospect. A farm-out of Providence's 58% stake looks to be on the cards shortly, and both the Barryroe and Spanish Point projects look candidates for drilling in 2016.

Funding secured for 2015 and look to 2016

The equity placing in the early part of the year for $28m secured funding for the next 12 months. If we assume that Spanish Point can be successfully farmed out, the other 'big ticket' items in the 2016 budget are repayment of the Melody loan and on-going working capital. The most obvious way that these expenditures can be covered is through the cost recovery element of a Barryroe farm-out. We retain our 'Outperform' rating but freely admit that it is a binary investment story.

Investment case

Providence provides access to the largest portfolio of offshore Irish oil and gas assets, several of which are at the appraisal stage

As a standalone entity, the underlying rationale to become involved in Providence is broadly unchanged. Providence provides access to the largest portfolio of offshore Irish oil and gas assets, several of which are at the appraisal stage. Moreover, the large targets along the western seaboard and the undeveloped resources in the appraisal projects provide ample value leverage relative to the current group valuation.

Our valuation to date has been based on discounted cash flow analysis of targets and prospects. We apply a number of risk discounts (exploration, completion, dilution) and other risking such that the end results resemble a modified expected monetary value (EMV), typically used in the industry to weigh up the best drill prospects.

Our latest valuation proposes a value of 178p per share for the group using the above technique. This is much lower than previous estimates but reflects a dilutive funding early this year, a lower oil price outlook, a modified staged Barryroe development and a general shift towards much later start-up dates and hence reduced net present values (NPVs), modelled for the various prospects.

Looked at as part of a sector, the investment backdrop is still not particularly supportive of oil and gas equity. The main drivers of value in the industry (price, discovery and M&A) remain subdued. Our forecasts suggest that oil prices will make a recovery later in 2015 and through to 2016.

Notwithstanding these comments, the following observations are important considerations with respect to Providence:

A deal for Barryroe would change the outlook entirely

- The equity funding completed in February this year provided a sufficiently funded space for Providence to advance the projects in the portfolio for another year and the early part of 2016.
- A deal for Barryroe would change the outlook entirely. This is a double-edged sword in that the absence of such an event is holding back the share price, but any shift in the possibility that a farm-out can be completed would likely have a very positive effect on the share price.
- The group is still the most active explorer offshore Ireland. Spanish Point is likely to be drilled in 2016, and there are several other possible drill targets in the system that will be pursued. In fact, we think Spanish Point could be farmed out sooner rather than later.
- The Irish offshore licencing round will be announced later this year. Apart from being a barometer of the level of interest in the Irish offshore industry, Providence may well be involved in its own right.

Valuation review

The valuation of Providence has always been difficult as such a valuation has to be, by necessity, based on exploration and appraisal assets. Such assets are typically risk weighted for the chance of exploration success in the first instance, but other factors also have to be taken into account. Such factors include how much equity will be left after farm-out and how and when projects are financed. When any project might commence production also plays an important role given the time factors involved.

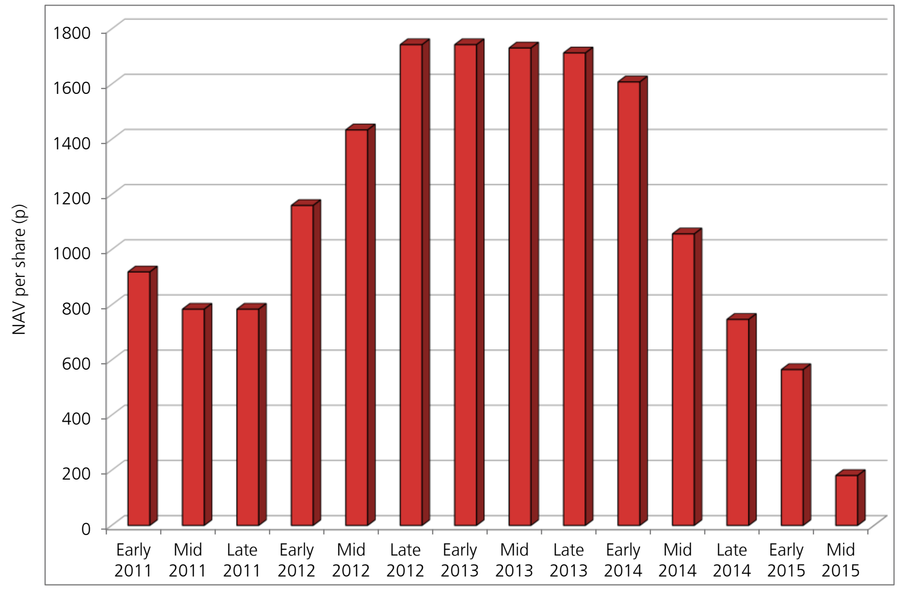
The changes in our NAV per share are a combination of adjustments to our value estimates and the number of shares that value is distributed over

In Figure 1 the share count increased by 16m in March 2011 to end the year at c.50m shares in issue. In 2012, a further 13m shares were issued to finish the year with 65m. No change took place until early 2015, when a further 75m shares were issued – bringing the share count to 140m.

Notable downward shifts in our value estimates took place in 2014, when we adjusted for a much longer production profile and lower plateau for Barryroe, thus significantly affecting values because of the impact of discounting on future cash flows. Similarly, at the start of 2015, we pushed out further the start date of the Barryroe project and also reduced the price deck for our oil forecasts.

As factors change, so will valuations. In this context, we think it is important to show how our valuation for Providence has changed since 2012. The spike in 2012 reflects a post test period when a series of reports were issued that demonstrated the commercial potential of Barryroe. This was followed by a gradual realisation in early 2014 that, due to market dynamics, a farm-out was proving very difficult to conclude and that the assumptions used to value Barryroe had to be changed to reflect this. The same period also included a realisation that the Spanish Point well would not be drilled, prompting a much slower assessment of its development potential. This is shown in the chart below, with the last data point representing our most recent analysis – the rationale for which is provided below.

Figure 1: NAV per share evolution (2012-2015)



Source: Davy

Our valuation review primarily focusses on the two headline projects as they make up the lion's share of the value in our model

Two headline projects

Our valuation review primarily focusses on the two headline projects, which comprise the lion's share of the value in our model, but also looks at the balance of the portfolio.

The review takes into account the equity funding earlier this year and also our changed long-term oil price assumption – now $80 per barrel compared to $95 per barrel at the height of the Providence valuation.

Barryroe – still work in progress

The Barryroe prospect has been the focal point of the Providence story in the last couple of years and, as a result, also becomes the core pillar of the market's estimates regarding how much the group is worth. Unfortunately, this means that the inability to conclude a farm-out of Barryroe has a direct impact on the share price because these delays are taken as a measure of Barryroe's value.

The viability (or otherwise) of Barryroe has been discussed and reviewed on numerous occasions, including the publication of the NSAI report in 2013. Providence has commissioned several large reviews that have built up models of how development could be optimised. In the early stages, a broad-brush approach was taken which was later refined to a more focussed phased development.

One of the common threads of the farm-out process is that it appears that the project has passed all the various technical assessments by parties that have looked at the Barryroe farm-in opportunity

One of the common threads of the farm-out process is that it appears that the project has passed all the various technical assessments by parties that have looked at the Barryroe farm-in opportunity. The ultimate decision not to conclude a deal seems to be a combination of pressure on companies by shareholders to reduce expansion, conservation of balance sheets, Irish offshore development history and latterly the sharp downturn in oil prices.

We believe the fact that a planned-for side-track was not completed at the time of the appraisal well is having unintended consequences

We believe the fact that a planned-for side-track was not completed at the time of the appraisal well is having unintended consequences. Strictly speaking, the actual minimum connected volume of oil demonstrated by the last well test at Barryroe is just 5m barrels. This may mean that other parties look at Barryroe as an exploration play rather than an appraisal prospect – something the intended but abandoned side-track option would have ensured did not take place.

Unfortunately, the outcome is that Barryroe is still undeveloped. Although the technical merits might well stack up, there has been a shift in emphasis regarding the project's development. The development has evolved such that it is now phased. This is sensible and makes for a lower upfront commitment. However, the reduced starting production rates and lengthening of the production profile mean that the value measured in NPV terms has also changed.

At the same time, the oil price is now lower and we have also pushed up the operating cost profile to match the experience in the North Sea in recent years (some of this is due to the small field factor which may not apply at Barryroe, but other cost increases relate to heightened maintenance and safety requirements). Together with a lower long-term oil price, this means the NPV per barrel has more than halved. If the recent funding – which more than doubled the number of shares – is taken into account, the net impact on a per share value is very significant.

Spanish Point also delayed, but increased equity should improve farm-out potential

A review of Spanish Point also leads to a marked reduction in value per barrel related to the impact of time on NPV-based calculations. This project has been slated to be drilled for several years; however, rig delay in 2014 and the exit of Chrysaor, a long-standing member of the consortium, in early 2015 have again pushed the likely well date out to 2016.

A review of Spanish Point also leads to a marked reduction in value per barrel related to the impact of time on NPV-based calculations. This project has been slated to be drilled for several years, but the unforeseen rig delay in 2014 and the sudden exit of Chrysaor, a long-standing member of the consortium, in 2015 have again pushed the likely well date out to 2016. In fact, the failure to drill this well in 2014 due to rig issues played an important role in the share price performance. It also meant that we pushed the project much further down the track when we constructed our valuation.

In the event, Chrysaor's project company for Spanish Point, CEPIL, was acquired by Providence increasing its stake in Spanish Point to 58%. While this is much larger than the 32% prior to the purchase, the farm-in arrangement between Cairn and the

Chrysaor project company still applies. This effectively means that Providence has a reduced liability for the well relative to its increased equity holding.

The exact cost to Providence depends on how the Cairn carry of 63.3% – up to a capped well cost – provides against the actual cost of the proposed well. In broad terms, we think this looks to be the amount to be paid if the CEPIL stake in the project had been distributed on pro-rata basis throughout the remaining members of the consortium (i.e. 43%) or a number lower than this if the well cost is cheaper than anticipated. In any case, the CEPIL purchase made sense in that even if the cost is close to the 43% level, post purchase Providence has a 58% equity position to attract another party into Spanish Point.

Now and then

The following table shows how the delay in Barryroe has changed the thinking regarding how the project is valued; note that the NPVs generated are subject to further risking in the equity model.

Table 1: Valuation assumptions for Barryroe and Spanish Point

	Then (late 2012)	Now (mid 2015)
Barryroe		
Resource mmbls	100	70
Capex/bl US$	15	16
Opex/bl US$	12	17.5
Production start	2017	2019
First year production b/d	37,500	12,599
Plateau production b/d	75,000	30,000
NPV/Bl US$	22.7	11.4
Spanish Point		
Resource - oil mmbls	28	28
Resource - gas BCF	415	415
Capex/boe	9.3	10.3
Opex/boe	6	10
Production start	2016	2023
First year production -oil b/d	10,000	10,000
Plateau production - oil b/d	20,000	20,000
First year production - gas mmscf/d	100	100
Plateau - gas mmscf/d	200	200
NPV/Bl US$	15.4	7.4

Source: Davy

Valuation reviews of other assets

A similar exercise for the whole of the portfolio was also completed. This looked to reflect the retrenchment in spending across the sector and also the extremely low level of drilling that has taken place offshore Ireland in recent years. The outcome was to push any potential start-up dates for the larger targets (assuming a successful discovery) further down the road. Consequently, all of the big western seaboard targets (Drombeg, Newgrange, Dunquin) will probably not see development until well into the next decade. This in turn has an impact on valuation measured in NPV terms. However, the net impact on our estimate of Providence's value is not particularly large because of the high level of risk discounting already assumed. Pushing development into the future has the effect of making a small number even smaller.

Our current valuation takes into account the changes in development expectations, delays in achieving drilling activity and the significantly increased equity base

Current valuation

Our current valuation takes into account the changes in development expectations, delays in achieving drilling activity and the significantly increased equity base. It also reflects a lower oil price scenario. While the headline impact will be from increased equity and a lower oil price, the overall shift to a slower production profile and pushing out the development options also make a significant impact as the valuation is based on discounted cash flows.

The breakout of this analysis is shown in the following table.

In Table 2, the 'All risk factors' column includes a factor for our estimate of the equity dilution involved in the final valuation

Table 2: Providence Resources valuation

Project/prospect	Equity	NPV/boe	All risk factors and project dilution estimate	Risked value per share (p)
Appraisal/development				
Barryroe phase 1	80%	11.1	32.00%	94
Dragon	100%	1.7	9.40%	2
Helvick	63%	14.6	12.40%	2
Hook Head	73%	11.8	2.50%	2
Spanish Point	58%	7.4	18.80%	36
Total				136
Exploration				
Kish Bank	50%	7.1	10.00%	7
Drombeg	80%	2	2.50%	16
Dunquin	16%	5.4	1.60%	5
Newgrange	80%	4.8	0.80%	9
Silverback*	100%	0	5.00%	0
Orpheus*	100%	0.1	5.00%	0
Pegasus*	100%	0.1	5.00%	0
Polaris (Ratlin onshore)	100%	5.2	3.30%	2
Total				40
Gross debt				-11
Cash				13
Net cash				2
				178

**decimal point valuation due to high risking*

Source: Davy

Funding has been secured for the balance of 2015 and into the first half of 2016

Balance sheet and funding

The last balance sheet available to the market is the full year to end-December 2014. Since then, there have been a number of movements in the balance sheet, under several headings, most notable of which was the equity funding in March. This resulted in an additional $28m of equity being raised. This facilitated a requirement to repay

While the cash available would provide sufficient working capital for the year, the Melody debt, which is due to be amortised by mid-June 2016, will require either a debt extension or other injection of funds such as a cost recovery mechanism through Barryroe or cash from other farm-outs

Transocean ($6m), the Melody debt payment ($4m) and deferred seismic costs ($3m) from 2014 programmes along the western margin.

Factoring an annual overhead of $5m for 2015 and interest charges on the Melody loan indicates that net debt will be in the order of c.$9.0m at the end of the year (see Table 3). This net debt position is made up of a $8.5m cash balance and a $17.3m debt facility payable to Melody in June 2016 (variances with the $20m liability are due to FX adjustments).

This illustrates that while the cash available would provide sufficient working capital for the year, the Melody debt – which is due to be amortised by mid-June 2016 – will require either a debt extension or other injection of funds such as a cost recovery mechanism through Barryroe or cash from other farm-outs.

Table 3: Projected 2015 year-end net cash after movements during the year

	US$m 2015
Cash at start of year	9.4
Debt at start of year	-21.3
Net debt at start of year	-11.9
Capital commitments	-8.9
Transocean payment	-6.0
Deferred seismic cost	-3.0
Loan repayment	-4.0
O/H	-6.0
Interest	-2.0
Net equity capital funding	28.0
Cash at year-end	8.5
Debt at year-end	-17.3
Net debt at end of year	-8.8

Source: Davy

Getting past Barryroe

This is the most important task for Providence management. The binary answer is to conclude a farm-out deal, but there are other elements of the group that might point to a future that is less focussed on Barryroe.

The portfolio approach

Providence has a wide portfolio of Irish exploration assets. This is deliberate policy and although it may cut little ice with shareholders at present, it is nonetheless a group with extensive offshore Ireland interests. If the Irish offshore is ever to deliver value to any of the stakeholders involved, Providence looks the best route to achieve this at present.

Atlantic margin position

The Atlantic margin licencing round that is currently underway helps to focus on one of the group's strengths, the extent of the licence position off the west coast and its knowledge base of the overall province. Providence has stated that it will apply for licences and will likely do so with one or more partners.

Evidence of its commitment to the western margin is the fact that the group underwrote and was involved in three seismic programmes along the western margin in the past 18 months. A 3D programme was shot over its 80%-owned Drombeg prospect and 2D was acquired over its 80%-owned Newgrange target. At the same time, the Spanish Point consortium also acquired 3D over an area to the south of the Spanish Point discovery.

Drilling programme activity

Other than the Barryroe appraisal programme, Providence is still pushing forward on drilling programmes in several areas.

Spanish Point (58%)

This is now expected to be drilled in 2016 with news expected of a farm-out in the near future. The increased equity stake (58%) should help Providence to complete the farm out. Ideally, most of the cost of the well should be covered through a combination of the old Chrysaor promote and the farm-in achieved by Providence.

Kish (50%)

The legal issue related to foreshore permitting, which delayed the original drilling programme, has been corrected by the relevant Irish state department and a new application for a foreshore licence is pending. A site survey will be carried out in the near future. The intention is to drill an exploration well.

Polaris (100%)

Formerly called the Rathlin Island prospect, attention has shifted to the near shore part of the basin and the area located to the northeast of the Ballinlea-1 well where Providence has identified the Polaris prospect. Rathlin Energy, a private Canadian company, has applied for planning permission to drill a follow-up well to its onshore Ballinlea discovery. This application was submitted in June 2013. The outcome was delayed because fracturing was included as a potential method to examine the well's commercial potential. This led to additional requests for an environmental impact assessment, which was subsequently submitted in January 2015.

Dragon (100%)

This is an appraisal project located in St George's Channel. A well has been slated for some years; however, with 100% equity, we suspect it will require external investment to progress as Providence is not likely to sole risk the prospect. There are a number of developments options involving both the Irish and UK regulatory authorities.

Dunquin South (16%)

This is the southern of two isolated carbonate platforms located in the southern Porcupine. In 2013, the Dunquin North well established the presence of a residual oil column in very good carbonate reservoir. Analysis of seismic data suggests that the southern platform has similar characteristics. Whereas the northern prospect shows clear signs of a gas chimney, the southern platform does not – suggesting that it may not be breached. However, the timing of charge and the sequence of the breaching process are not fully understood yet so further work is required that may possibly include 3D seismic acquisition.

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Price performance (% change)

Stock	*2010*	*2011*	*2012*	*2013*	*2014*
PROVIDENCE RESOURCES	-28.6	-17.7	220.0	-66.0	-61.3

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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Neutral	32	26	3	7
Underperform	14	11	0	0
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Suspended	5	4	0	0
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