Davy Research

Providence Resources

Resource

Improved investment proposition at a better price

DAVY VIEW

A mood change in the market's view of exploration and risk should not hide the portfolio progress made in the last year. We think Providence is cheap and an excellent entry into offshore Ireland.

Big step-up in Barryroe confidence over the last year

The drilling, testing and subsequent analysis of Barryroe have significantly improved the confidence level in the project. This culminated in the publication of a Competent Person's Report (CPR) by Netherland & Sewell, which indicated that a recoverable resource of 266m barrels could be recovered from the target Basel Wealden horizon. Providence has an 80% interest in this licence, which it is currently in the process of farming-out. Notwithstanding the length of time it takes to achieve this farm-out, the underlying facts will not change. A substantial resource with related upside in a stable European country is an attractive asset that should be priced accordingly. In our view, this is not being achieved by the current market.

Portfolio approach: Cairn entry into Spanish Point; Dunquin well

Although investors may like to think of the Barryroe valuation as the equivalent to a core value, Providence has always tried to follow a portfolio approach. In particular, there has been substantial validation of the Spanish Point play through the farm-in by Cairn Energy. Although a well will be a year later than hoped, it has not changed the fact that Spanish Point is essentially an appraisal well and that this target remains materially un-appreciated by the market.

The Dunquin well is also now drilling. This is a frontier exploration well that is targeting an enormous potential resource. It clearly demonstrates that the group is fully prepared to drill pathfinder wells in new basins.

Updating our valuation

The Dunquin well is likely to finish during July. At this stage the guidance is that the well is not likely to be tested regardless of the outcome. Success can come in a number of different forms; from an exploration point of view, finding a working petroleum system will be a very positive outcome.

The Barryroe farm-out is expected to be completed by end-year. The hoped-for outcome will be a full development carry and, if required, a carry into an appraisal well. Such a well might be part of the deal process with consideration contingent on additional confirmation drilling. Looking into 2014, it is quite possible that a rig is brought into the Celtic Sea to drill a number of wells. Providence could use this to drill an appraisal well.

We have updated our valuation to £18.09 per share (previously £17.33) on a full risked portfolio basis (most of the change is due to the inclusion of the Drombeg play). Barryroe makes up £9.87 of this (unchanged), the largest individual asset in our valuation.

See the end of this report for important disclosures and analyst certification

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OUTPERFORM

Closing price:595c

May 23 2013

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Share Price Performance

Financial Data

Providence Resources :Financial model and valuation analysis

Resource Sector Review

Reiterating the investment thesis

Providence has to be judged in the context of a market that is currently demanding a very steep discount for exploration projects in general and undoubtedly is also still looking for a degree of extra discount for operations offshore Ireland. However, while the market mood may have changed since the Barryroe appraisal well was drilled, the investment thesis for Providence has not.

Valuation discount is very large

We have updated our valuation to include a number of new targets and to reflect the change in timing of the discount and project start-up dates.

Our current valuation analysis on a full portfolio basis is a risked £18 per share. Barryroe is the largest element of this at just under £10 per share.

On the basis of this valuation, the group is trading at a near-70% discount to the value of the full portfolio. This compares to an average of around 30-35% of the full asset profile for headline E&P names in the FTSE 250 E&P index. If we compare the share price with our valuation of Barryroe, Providence is trading at just 50% of its value. We concede that Providence has an exploration bias and that, on a full portfolio basis, a greater discount might be expected; however, based on just Barryroe (which might be considered the equivalent of core assets), a 50% discount is excessive in our opinion. Here are a number of reasons why:

Confidence in Barryroe has improved over the past 12 months

A CPR covering the Barryroe project was produced by Netherland & Sewell Inc, published in early April.

On the back of numerous studies and data collection – culminating in the CPR published in early May – confidence in Barryroe has improved materially over the last year. The market mood, especially towards exploration projects, may have changed but so has the quality of the asset and the information and knowledge required to make informed decisions.

Validation of Spanish Point through farm-in process

There has also been good validation of the exploration/appraisal portfolio through the entry of Cairn Energy into the Spanish Point consortium.

In fact, we think Spanish Point is likely to be the Porcupine equivalent of the Barryroe project; namely, a successful appraisal well will be a catalyst to look at the area in general and form a hub for future activity. This forms a value catalyst.

Dunquin provides access to high impact and high value well

The Dunquin well is also underway at present, exposing the group to a high impact exploration play (P50 of 1.7bn barrels BOE) that, if successful, comfortably meets the description of a company maker even with an equity interest of 16%.

A drilling event does not change the valuation on its own, but it does demonstrate that the group is delivering a well programme.

Barryroe – CPR validation

The drilling of the Barryroe appraisal well and the subsequent flow testing programme are more than adequately documented at this stage, but it is worth looking at the expectations and actions that came afterwards.

With its large 80% equity position, it was no surprise that Providence elected to farm down a portion of its holding in the licence and entered into a series of 'informal' contacts with a number of companies. At the same time, a carefully guided period of announcements was made, steadily increasing the degree of study and understanding of the Barryroe play. The ultimate announcement was scheduled to be a CPR following which a formal data room was scheduled to open – assuming no farm-out was achieved through the parallel farm-out process. In the event, the timing of the CPR was delayed by three months and a data room is now officially open. Providence has guided that it hopes to have the farm-out completed by the end of the year. The unofficial process continues to run in parallel.

The shape of the deal that is being looked for is also clearer. Providence has said it will look for back costs, a carry of appraisal well costs and a carry of development capital. While it is acknowledged that the gross capital could well be in the region of $1.5bn, any such carry could be 'gated' and conditional on appraisal and analysis. Such deals are evident elsewhere (Premier/Rockhopper).

The informal process gave rise to an expectation of an early farm-out. However, given the sums involved – the capital cost component could well amount to 40% of $1.5bn for the carry component alone – it should not be surprising that a period of time is involved. In addition, conditionality will almost certainly be built into any deal. This will likely involve appraisal drilling, especially at the western margins of the structure.

The ebb and flow of events should not distract from the fundamentals as confirmed by Netherlands & Sewell, an independent auditor of reserves and resources. It has opined that on a P50 or best estimate basis, the basal Wealden contains a resource of 761m barrels of oil in place and that 35% can be recovered. This makes for a recoverable quantity of 266m barrels in just one horizon before several other target formations both above and deeper are considered.

Timing also does not change the contained resource and the other positive features of the project such as the political location, fiscal regime and high quality of the crude.

Work by us suggests that on a completely risk free basis a barrel of oil at Barryroe is worth $23 per barrel. However, our valuation is risked, which effectively reduces the value to $13 per barrel. If we assume that the current share price reflects only Barryroe, the market is now paying a value of under $7 per barrel. If anything is built in for the rest of the portfolio, then the implied value of Barryroe on a per barrel basis declines even further.

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Spanish Point – important validation

The farm-in of Cairn Energy into Spanish Point reflects the value in this project and the additional value in the surrounding acreage. In many ways, it mirrors the Barryroe project as it is based on an existing discovery that is being appraised. The target is an Upper Jurassic gas condensate, and the original well flowed at a rate of 1,800 barrels of oil equivalent per day.

The project received important validation recently with the farm-in of Cairn Energy into the Chrysaor part of the licence. Cairn elected to drill up to two wells, paying 63% to earn a 38% interest. It disclosed that it believes that this will result in it paying 55% of each well. Assuming that each well could cost up to $100m to drill, this is equivalent to a $110m spend.

Early modelling of the project indicates that a production rate of up to 72,000 boe per day is feasible assuming the drilling of up to 14 horizontal fracture stimulated wells.

An appraisal well will be drilled in 2014. This is later than expected, but its timing does not change the underlying value of the project in any meaningful sense. We value the project at £2.89 per share with a total risking of 60%.

Dunquin – finally drilling

After a long period of gestation, Dunquin is being drilled. It is an enormous target (P50 of 1.7bn BOE), and its drilling reflects the perseverance of the Providence technical team and management. It is a frontier well with a roughly 1 in 6 chance of success.

Dunquin is projected to be an isolated Cretaceous carbonate platform. Given its scale, it has the potential to make even the current estimate look conservative. It is being drilled on 2D seismic, largely because it is such a large and simple play (1.7bn barrels of oil equivalent recoverable on a P50 basis) and there is also evidence of a fluid escape feature.

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Valuation

We have updated our valuation to include the likes of Drombeg and the other gas targets in the St Georges Channel. We have not yet included Newgrange, preferring to wait the outcome of the Dunquin well (a similar target).

Table 1: Davy valuation summary (£/share)

Project/asset	Level of risking applied to project/asset*	Risked value £/share	Unrisked £/share
Exploration			
Baltimore	39.6%	0.72	1.81
Dalkey Island	13.3%	0.42	3.19
Dragon	45.0%	0.15	0.34
Drombeg	3.0%	0.65	21.81
Dunquin	6.0%	1.31	21.87
Marlin	30.0%	0.02	0.05
Nemo	30.0%	0.58	1.93
Orpheus	8.0%	0.06	0.71
Pegasus	30.0%	0.10	0.35
Ratlin Island	5.3%	0.12	2.21
Total		4.14	54.27
Appraisal/development			
Barryroe	56.0%	9.87	17.62
Helvick	35.6%	0.16	0.44
Hook Head	30.0%	0.78	2.61
Spanish Point	60.0%	2.72	4.54
Total		13.53	25.21
Net cash	100%	0.43	0.43
Total		18.09	79.91

Source: Davy

* This includes a factor for dilution of equity currently held in projects.

The values above are generated by detailed field models with estimates for taxation and a 10% discount rate applied.

Investment thesis

Providence Resources provides a direct route to the largest licence holding offshore Ireland where numerous oil and gas shows have been found in previous drilling campaigns. It has a twofold strategy: to use the advent of new technology and higher oil prices to re-access a number of former discoveries and to build up a material equity position in several very large, high-impact, high-risk targets along the Atlantic Margin. An on-going drilling programme is now actively pursuing this inventory of targets.

Successful Barryroe well kick-started major Irish drilling campaign

The Barryroe well was completed in the first quarter of 2012. The well flowed at rates of up to 4,000 boepd from one zone and 2,500 boepd from a second interval. Providence is currently attempting to farm down a portion of its 80%-held interest. The well proved that the waxy but light crude found in the Celtic Sea Basin can be successfully produced to surface with application of modern engineering methods.

Separately, the other elements of the Irish exploration programme will involve wells along the Atlantic Margin, the east coast and ultimately on Rathlin Island, located on the northeast coast.

Dunquin (Exxon-operated) and Spanish Point are the two large Atlantic Margin plays. A well is currently underway on Dunquin – a large, seismically-identified mound with the potential to hold equally giant scale levels of hydrocarbons. Spanish Point is an appraisal of a former gas condensate discovery. Cairn Energy has recently farmed in and a well is due in 2014.

Wells are also expected on the Dragon gas prospect, located in the St Georges Channel, and on Rathlin Island. These wells remain subject to rig availability but will probably take place in 2014/2015.

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.

The Barryroe success began the process of unwinding a double discount, the normal pre-drill risk discount that applies to exploration targets but also the discount applied to the Irish offshore given the mixed history of exploration/appraisal in the past.

The group is financed to complete its drilling activities during 2013.

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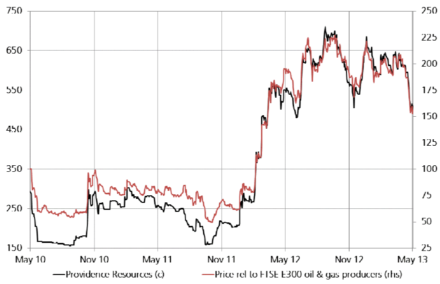
Company profile

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 but also include prospects off the east and south coasts. It has 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) is currently drilling with Exxon as operator. To the North, Cairn Energy has farmed into Spanish Point and a well is expected in 2014. Providence has a 32% stake in Spanish Point. Wells are also scheduled for the Kish Basin off the east coast and in the Rathlin trough in Northern Ireland. 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.

Share Price Performance



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

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