

23 Sep 2014

OTTO ENERGY LTD (OEL)

Galoc gonsky, cash back to shareholders

Otto Energy Ltd (OEL) has executed a Sale and Purchase Agreement (SPA) to divest all of its shares in the Galoc Production Company WLL (GPC) for US\$101.4m to Risco Energy (Risco). GPC holds a 33% W.I. and is the operator of the Galoc oil field. Risco has already paid a deposit of US\$10.14m. The proceeds from the sale will be used to pay a 6c capital return to shareholders and fund exploration activity. The transaction will require shareholder approval (expected in December). The transaction essentially transforms OEL into a well-funded explorer with key assets in Tanzania and the Philippines. We have changed our recommendation from Buy to Speculative Buy given the changing nature of OEL's business.

Increased appetite for producing assets

The appetite to acquire production assets, especially amongst buyers from Asia, is clearly growing. The Galoc transaction comes shortly after Bangchak Petroleum's bid for Nido Petroleum (NDO) and Fosun International's off-market bid for Roc Oil (ROC). The sale of Galoc may draw out other bidders in coming months either for Galoc or the whole of OEL. Other stocks with producing / development assets in ASEAN include TAP (recently started development drilling off-shore Thailand) and CUE (onshore Indonesian production).

SC55 farm out still a possibility but clock is ticking

OEL farming down of its 93.18% W.I. interest in SC55 remains a possibility. We understand two parties are still reviewing the data however with a well due to be drilled by December 23rd this year the chance of OEL achieving a farm out is diminishing. With US\$24.5m due from BHP upon completion of a well, OEL has a strong position from which to negotiate a farm-out.

Tanzania.....expect drilling in 2015

Exploration in Tanzania will remain capex light through FY15. OEL will spend approximately US\$6.5m to acquire and process more 2D data in order to work-up drill targets. We understand OEL is looking to add to the current acreage position within the East African Rift System. OEL and the JV partner, Swala Energy, expect to drill a well in 2H CY15. The Kito prospect, located in the Kilombero Basin (identified on 2D seismic) contains a P50 best estimate prospective resource net to OEL of 60MMbbl.

Valuation and recommendation

We rate the stock a Speculative Buy with a target price of 13.7c/share. The underlying value of OEL now comes from the cash, capital return and exploration assets. We estimate that existing cash plus the Galoc proceeds equal A\$118m (AUD/USD x-rate 0.89) or 9.9cps. The recent listing of Swala Energy on the Tanzanian stock exchange (SWALA.TZ) allows us to obtain a look through value of OEL's 50% stake in the Kilosa-Kilombero and Pangani assets of A\$59m (5.1cps). For our base case valuation we risk this by 25% (3.8cps). SWALA.TZ owns the other 50% of the Tanzanian assets). Our base case valuation for OEL is therefore 13.7c/share.

Share Price:	\$0.093
12mth Price Target:	\$0.137

Brief Business Description:

Oil production offshore Philippines. Prospective exploration portfolio offshore Philippines and Tanzania.

Hartleys Brief Investment Conclusion

OEL has announced the sale of the Galoc production asset. Sales proceeds will be used to pay a capital return and fund exploration.

Chairman & CEO:

Mr Rick Crabb (Non Exec Chairman)
 Mr Matthew Allen (CEO)

Top Shareholders:

Santo Holdings AG
 Molton Holdings Ltd

Company Address:

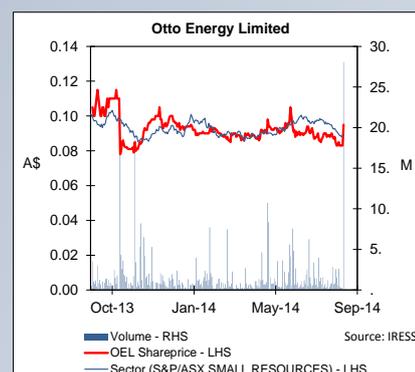
32 Delhi St
 West Perth, WA, 6005

Valuation:	\$0.137
Issued Capital:	1,152
- fully diluted	1,194
Market Cap:	\$107.1m
- fully diluted	\$111.0m
Current Debt	\$0.0m
Current Cash	\$7.8m

	FY13A	FY14F	FY15F
Prodn (mmbobe)		0.621	1.000
Op Cash Flw	\$29m	\$46m	\$39m
Free Cash Flw	-\$11m	-\$4m	\$29m
NPAT* (A\$m)	\$14m	\$35m	\$25m
EPS (\$, bas)*	1.1x	2.9x	2.1x
P/E (basic)*	8.2x	3.2x	4.5x
EV / EBIT	3.7x	2.9x	2.6x
EV / EBITDA	2.9x	2.1x	1.9x
N.D. / equity	-19%	-11%	-29%
Interest Cover	-49.9x	19.6x	3763.9x
Net Cash End	\$22.7m	\$19.1m	\$44.4m
2P Reserve (mmbbl)		3.77	
EV / 2P Reserve		\$24.67	

*normalised

Source: Hartleys Research



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 E: simon_andrew@hartleys.com.au

SUMMARY MODEL

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Analyst : Simon Andrew Phone: +61 8 9268 3020												Last updated September 23, 2014																																																																																																																								
Sources: IRESS, Company Information, Hartleys Research																																																																																																																																				

VALUATION

We rate the stock a Speculative Buy with a target price of 13.7c/share. The underlying value of OEL now comes from the cash, capital return and exploration assets. We estimate that existing cash plus the Galoc proceeds equal A\$118m (AUD/USD x-rate 0.89) or 9.9cps. The recent listing of Swala Energy on the Tanzanian stock exchange allows us to obtain a look through value of OEL's 50% stake in the Kilosa-Kilombero and Pangani assets of A\$59m (5.1cps). For our base case valuation we risk this by 25% (3.8cps risked). The locally listed entity of Swala owns the other 50% stake in the Tanzanian assets. Our base case valuation for OEL is therefore 13.7c/share.

Fig. 1: OEL (new)- Valuation Summary

Shares	m	1,193
Galoc Sales Proceeds	US\$	101
	A\$m	114
Current Cash	A\$m	4
Look through value of SWE Tanzanian Assets (SWALA.TZ)	A\$m	61
	Discount factor	25%
	Net to OEL	A\$m 46
SC55 + other Philippines exploration	A\$m	0
Base Case Valuation	A\$m	164
	cps	13.7

Source: Hartleys Research

RISKS

The key risks for OEL (like most oil & gas exploration and development companies) is making an economic discovery and obtaining the funding for ongoing exploration. Other risks include delays, key person risk, country/sovereign risk, weather, JV partner obligations, cost inflation. Investing in explorers is very risky given the exploration value of the company in essence assumes that the market will recognise a portion of potential value before the results of an exploration program are known, conscious that the ultimate chance of success is low (typically 1%-20%) and that failure is much more likely, in most cases. Other risks are earnings disappointments given the industry is volatile and earnings can disappoint due to cost overruns, project delays, cost inflation, environmental regulations, resource estimate errors and management performance and contract negotiation skills. High financial leverage (if it exists at that time) would add to the problem.

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Hartleys Recommendation Categories

Buy	Share price appreciation anticipated.
Accumulate	Share price appreciation anticipated but the risk/reward is not as attractive as a "Buy". Alternatively, for the share price to rise it may be contingent on the outcome of an uncertain or distant event. Analyst will often indicate a price level at which it may become a "Buy".
Neutral	Take no action. Upside & downside risk/reward is evenly balanced.
Reduce / Take profits	It is anticipated to be unlikely that there will be gains over the investment time horizon but there is a possibility of some price weakness over that period.
Sell	Significant price depreciation anticipated.
No Rating	No recommendation.
Speculative Buy	Share price could be volatile. While it is anticipated that, on a risk/reward basis, an investment is attractive, there is at least one identifiable risk that has a meaningful possibility of occurring, which, if it did occur, could lead to significant share price reduction. Consequently, the investment is considered high risk.

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