



Aurora Oil and Gas Ltd (“AUT”) *“USA Gas Play Offer Earnings and Wild Card Upside ”*

Background

AUT is a USA-based gas producer and explorer that has arisen from the shell of the industrial company, Tony Barlow. Key players in the stock include Peter Allchurch, with 6% of the Company. Peter was responsible for Amity Oil heading off to Turkey to successfully develop gas fields. Two other directors include Jon Stewart and Graham Dowland, who were involved in a successful oil venture in Russia when they were based in London. They own 9.6% of AUT between them.

With 88 million shares on issue, and 22.5 million options, the capital structure of AUT looks rather tight for an oil and gas junior. At the current price of 44¢, the market capitalisation is \$39m undiluted, and \$44m when the options are considered.

The USA Gas Sector is One of the Best

After operating in Turkey and Russia, the lads will find the USA a much more economical and easier to manage place in which to operate. We are seeing consistently high gas prices in the USA (it is not uncommon for producers to be paid 3-4x the gas price Australian producers get). There is the best infrastructure and availability of markets that you can imagine, and the geological productivity is very favourable. If you can get the deal flow it is about the best place to be for a junior to be. The majors have left many situations on the table.

AUT has launched its new career with the Flour Bluff Project in Texas, and it is going for a big roll of the dice with the Sugarloaf Hosston Prospect, also in Texas.

The Flour Bluff Gasfield (Net 8.75-11.7%)

Flour Bluff has been a prolific producer in times gone by, supplying about 1 TCF of gas plus condensate, from depths above 7,000 feet. Exxon was the main beneficiary until it sold out when the productivity dropped to 1 Mmcf/d. Private Texan interests purchased it and ran fracking tests on the J-Sands, at a depth of 10,000 feet. These were successful and enabled production up to 7 Mmcf/d from three wells.

AUT purchased a 12.5% working interest for US\$2.5m and then committed to its proportional share of three wells. At the time of acquisition, the field was assessed to contain 100-200 BCF of reserves, with 90 BCF of these verified by independent experts.

The first well, Webb-1, was drilled in the Western Zone. It confirmed the concept of productive gas in the J-Sands and the virginal K-Sands, which were at 11,000 feet depth (sands further down were found to be water wet). This well confirmed the presence of 100 BCF, and it is now producing at 2 Mcfd.

The second well, D-24, was drilled in the Eastern Zone to confirm 14 BCF. This is now producing from the J-Sands. Further to the East another well is currently testing shallower sands.

Development Proposal

The plan call for production of 40-50 Mcfd. This requires seven wells in the West Zone and 3-5 on the East Zone. Maximum flow rates are expected to be reached in about 20 months and be kept at that rate for three years, after which it will decline to 1 Mcfd by year 14.

Cash Flow Will be Strong

AUT's cash flow is expected to peak at US\$9m p.a. in years 5 and 6 (after royalties, taxes and all costs), based on estimates of 116 BCF of gas in reserves, and gas prices of US\$5.00/Mcf. If recent prices of US\$9.00/Mcf are averaged, this cash flow increases to US\$14m in years 5-6. That would place the shares on a prospective cash flow multiple of 2.5x. The fundamentals appear attractive enough, especially when we take the view that this project underwrites the long term future of the company.

On an asset valuation methodology based on 170 BCF, and a modest gas price of US\$3/Mcf, AUT believes the project is worth 85¢ a share.

Sugarloaf Hosston (12.5%)

An earnings story is all very well, but the juniors like AUT are not inclined to rest on their laurels if they want to continue to offer speculative appeal.

About 150 km from Flour Bluff, AUT has taken a 12.5% interest in an exciting deep play at

17,000 feet depth. The Texan partners have identified a 20,000 acres four way dip closure with potential for up to 10 TCF, though the risk weighted assessment suggests that the most likely outcome is 800 BCF – smaller, but still very significant.

Although there has been production from shallower levels a blanket of Edwards limestone overlays the target. This masked its presence until recently developed seismic processing techniques, which enable assessment of porosity in limestone, revealed the deeper target.

Drilling to 17,000 feet is no quick and easy task. It requires expensive rigs and up to 10-12,000 psi well-head equipment. It could take three months to drill, and cost US\$6m (including \$2m for completion).

The Company believes that the biggest risk with this well is the porosity. It needs to be at least 8%, and even at 8% it will need to be fraced. At 12% it could flow wonderfully.

The Numbers Could be Huge

If everything works according to the game plan, and there is 1 TCF of recoverable gas, then AUT suggests that at US\$3/Mcf it could be worth \$3.36 a share. With the shares at 44¢, it could be one for the punters.

Relevance of Valuations

There are quite a few producing oil and gas juniors that can run the numbers by you and show that they are selling at a sizable discount to the calculated value based on various assumptions on pricing and recoverability of

reserves. However, real life is often very different to a snapshot and the market generally only looks at these numbers as a relative guide.

The real reason to hold a junior, for most punters, is the opportunity to build on success and find another big winner. Basically, the punters want to gamble.

AUT certain has an exciting play at Sugarloaf. If it comes in the shareholders will be cheering all the way to the bank. However, it would be wrong to be spending the profits in anticipation. It is very rare that a prospect pans out exactly according to the plan. Usually, even when there is success, there are pluses and minuses to consider. Also, the well will take up to three months to drill, so patience is will be needed.

The cash balance of \$3m is sufficient for Flour Bluff, but we would expect to see the Company raising another \$2-3m over the next month to fund Sugarloaf and add to working capital. That might be the time to get set.

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