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RESEARCH

# Brookside Energy Ltd

## Well-positioned to ride the storm

**Share Price: A$0.005**

**ASX: BRK**
**Sector: Oil and Gas Exploration**
**8 July 2020**

Brookside Energy Ltd (ASX: BRK) is a Perth-based energy company with exposure to the most productive oil and natural gas plays (STACK, SCOOP and SWISH) in Oklahoma's Anadarko Basin. BRK adopts a real estate development approach for acquiring and developing oil and gas acreage and this has allowed it to grow in the Anadarko Basin using an asset-light model.

### Investment case

The STACK and SCOOP plays in the Anadarko Basin have remained lucrative for E&P players over the past few years, owing to their low acreage cost compared with more mature plays in the Permian Basin. Post the announcement of its maiden reserve estimates in the STACK play, BRK is now focussing on significantly scaling up its asset base with its operated interests in the SWISH play. It added two high-potential units (Rangers and Flames, totalling 1,600 acres) in the SWISH play in Q1 2020 which previously comprised the 880 acre Jewell unit. Further, in June 2020, BRK entered into a joint venture with Stonehorse Energy that should help it to expand in the SWISH play while reaping the benefits of attractive buying opportunities.

### Swift measures to tide over the current crisis

The land-and-leasing-focussed business model is expected to provide some immunity to BRK from the volatility in the oil market. Notably, the management has been prompt in implementing a number of steps, including reducing general and administration expenses, focussing on lease renewals and extensions, and harvesting cash flows from low-risk wells. We believe these timely and prudent measures will help BRK deal with the crisis in the oil market.

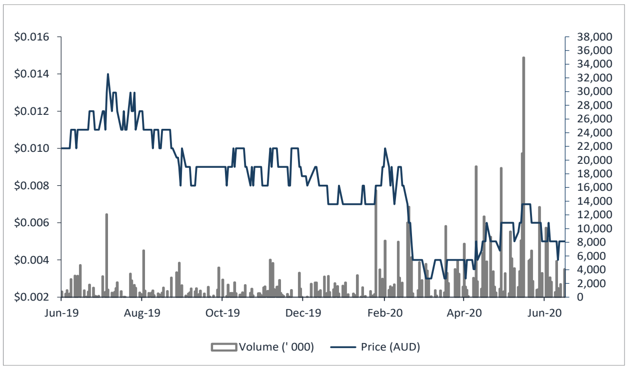
### Valuation range of A$0.019 – 0.022 per share

We recalibrate our valuation to factor in the current weakness in oil and gas prices and re-value BRK at A$0.019 per share base case and A$0.022 optimistic case using a DCF approach. We believe BRK's share price has moved lower with oil prices since early March 2020 and there is significant scope for re-rating driven by an improvement in oil price sentiment, better flow rates from existing wells and higher acreage prices.

| | |
|---|---|
| Market Cap. (A$ m) | 5.0 |
| # shares outstanding (m) | 1,001.7 |
| # share fully diluted (m) | 1,001.7 |
| Market Cap Ful. Dil. (A$m) | 5.0 |
| Free Float | 78.6% |
| 12-months high/low (A$) | 0.014 / 0.002 |
| Avg. 12M daily volume ('1000) | 2,402.5 |
| Website | brookside-energy.com.au |

*Source: Company, Pitt Street Research*

**Share price (A$) and avg. daily volume (k, r.h.s.)**




*Source: Refinitiv Eikon, Pitt Street Research*

| Valuation metrics | |
|---|---|
| DCF fair valuation range (A$) | 0.019 – 0.022 |
| WACC | 10.0% |
| Assumed terminal growth rate | 0.5% |

*Source: Pitt Street Research*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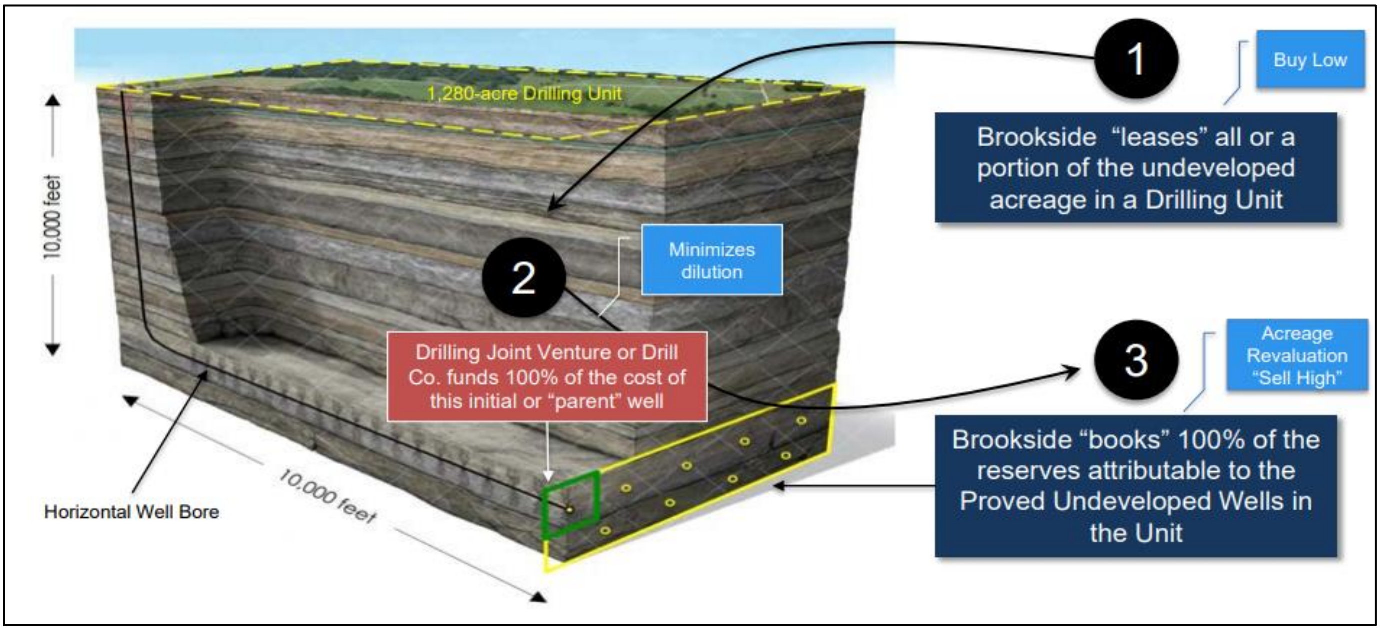
## Emerging shale oil and gas player in Anadarko Basin

*BRK adopts a real estate development approach while acquiring prospective acreage in the Anadarko Basin*

Brookside Energy Ltd (ASX: BRK), is a Perth-based company focussing on developing oil and gas plays in the Anadarko Basin[1], Oklahoma, US. BRK adopts a real estate development approach (Figure 1) by acquiring prospective acreage in the Anadarko Basin, adding value to it by consolidating leases, and proving up oil and gas reserves. Thereafter, BRK has the option of selling the revalued acreage or maintaining a producing interest. This leasing and development model has been successfully executed by BRK for oil and gas acreage and provides enormous flexibility for working capital generation and unlocking value of the acreage.

**Figure 1: BRK focuses on a buy-low, sell-high leasing model**




*Source: Company*

*BRK is gradually evolving from an acreage acquirer to an operator of wells*

BRK commenced operations in its present form in mid-2015, following the company's recapitalisation post the collapse of global oil prices in 2014. Since 2015, BRK has been progressively acquiring minority interests in oil and gas wells in the Anadarko Basin. More recently, it has started assuming operatorship of wells. BRK's US partner and manager of operations, Black Mesa, an experienced mid-continent operator, identifies the relevant opportunities and executes development in the Anadarko Basin under a commercial agreement with BRK. In April 2020, BRK increased its stake in Black Mesa from 17.2% to 28.7%, as part of simplification of the corporate structure.

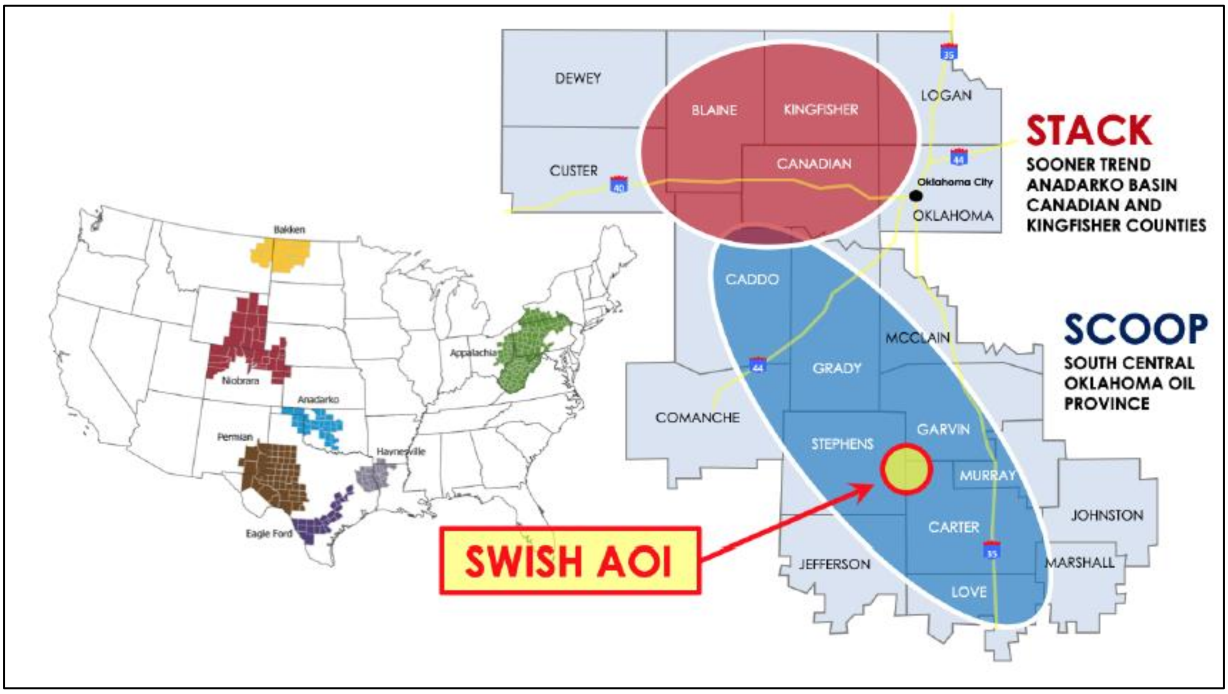
[1] It extends into south-western Kansas and south-eastern Colorado. The basin is named after the town of Anadarko, Oklahoma in Caddo County, immediately west of the seven-county Greater Oklahoma City metro area.

## What are STACK, SCOOP and SWISH plays?

'Sooner Trend, Anadarko Basin, Canadian and Kingfisher Counties' (STACK), 'South Central Oklahoma Oil Province' (SCOOP), and 'Sycamore and Woodford in the South Half' (SWISH) are the most productive oil and natural gas plays in Oklahoma's Anadarko Basin. Importantly, BRK has an exposure to all the three oil and gas plays (Figure 2).

- STACK is part of the Anadarko Basin area of Oklahoma and is a geographic referenced area, instead of a geological formation like most oil plays in the US (such as the Eagle Ford, Bakken and Granite Wash). The STACK play is rich in oil and gas formations that are stacked atop one another.
- SCOOP is another geographic referenced area that lies to the south of STACK and mostly covers the Garvin and Stephens counties. The SCOOP play is a province with plentiful of oil and liquids with one of the thickest, foremost quality resource shale reservoir in the US.
- SWISH refers to gas plays in within the southern half of the SCOOP play in south-western Oklahoma. BRK is poised to scale up its activities and asset base significantly with its operated interests in the SWISH Area of Interest (AOI).

**Figure 2: Key oil and gas plays in the Anadarko Basin**




*Source: Company*

These oil and gas plays have emerged as rivals to some of the most lucrative exploration areas in the US, including the Permian Basin in Texas and the Marcellus Appalachian Basin in the Northeast. These plays are potentially valuable for BRK's shareholders as these are relatively undeveloped as compared with other oil and gas plays in North America, and therefore acreage is available at a lower price. With drilling activity gaining momentum in the Anadarko Basin, BRK is set to unlock value from land acreage in these three plays.

## Consolidating its position in SWISH AOI

*Secured two additional SWISH AOI units in Q1 2020*

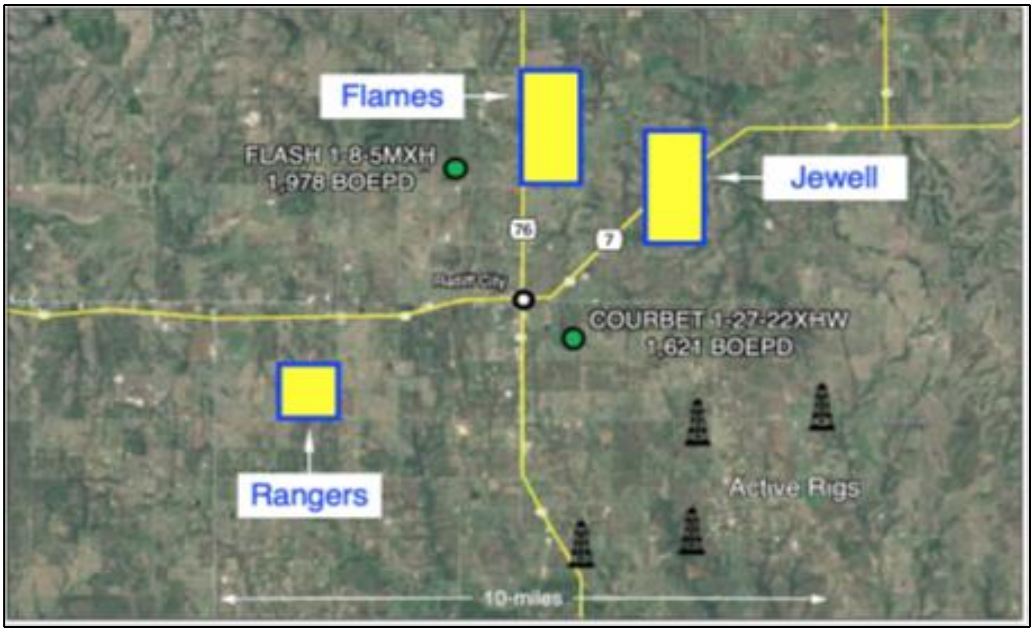
BRK has established ~2,500 working interest[2] leasehold acres within the SWISH AOI and plans to target 4,000–6,000 acres in the medium term. The company added two units – Rangers and Flames drilling spacing units (DSUs[3]) – to its SWISH AOI in Q1 2020 which previously included the Jewell DSU.

The Jewell DSU has been established as an 880-acre unit and BRK has acquired ~84% working interest in this DSU. The Rangers DSU has been pooled[4] as a 640 acre unit and the company expects to secure up to 91% working interest in this DSU (post pooling). The Flames DSU has received a spacing order[5] as a 960 acre unit and to date BRK has secured (pre-pooling) ~64% of the working interest in the unit.

Notably, these DSUs combined are more than six-times the size of the acreage position that BRK has secured in its successful pilot study in the STACK play. There are a number of high-potential wells (Figure 3) located between these three DSUs and the important ones include the Flash well (IP24[6] 1,978 barrels of oil equivalent) and Courbet well (IP24 1,621 barrels of oil equivalent).

Another encouraging development is the productivity of the new generation wells in the SWISH AOI – two of these wells (Ely, Betts) have produced >1.7 million barrels of oil equivalent cumulatively in the first 7–12 months of operation, while another two wells (Ringer Ranch, Leon) have produced >222,000 barrels of oil equivalent combined in the first 3 months of operation.

**Figure 3: DSUs and key wells in SWISH AOI**




*Source: Company*

[2] Percentage of ownership in a lease granting its owner the right to explore, drill and produce oil and gas from a tract of property. Working interest owners are obligated to pay a corresponding percentage of the cost of leasing, drilling, producing and operating a well or unit.
[3] A drilling spacing unit is the area allotted to a well where an operating oil company has acquired a majority working interest and will drill at least one well.
[4] Pooling is the combination of all or portions of multiple oil and gas leases to form a unit for the drilling of a single oil and/or gas well. Pooling arrangements are necessary to meet the minimum acreage requirement for a drilling permit under state regulations.
[5] A spacing order establishes the size of the unit, names the formations which are included within the unit, and divides the ownership of the unit into "royalty interest" and "working interest".
[6] IP or Initial Production is the rate of initial flow from a well over a 24-hour initial production rate period.

## Orion Project is another opportunity to expand in SWISH AOI

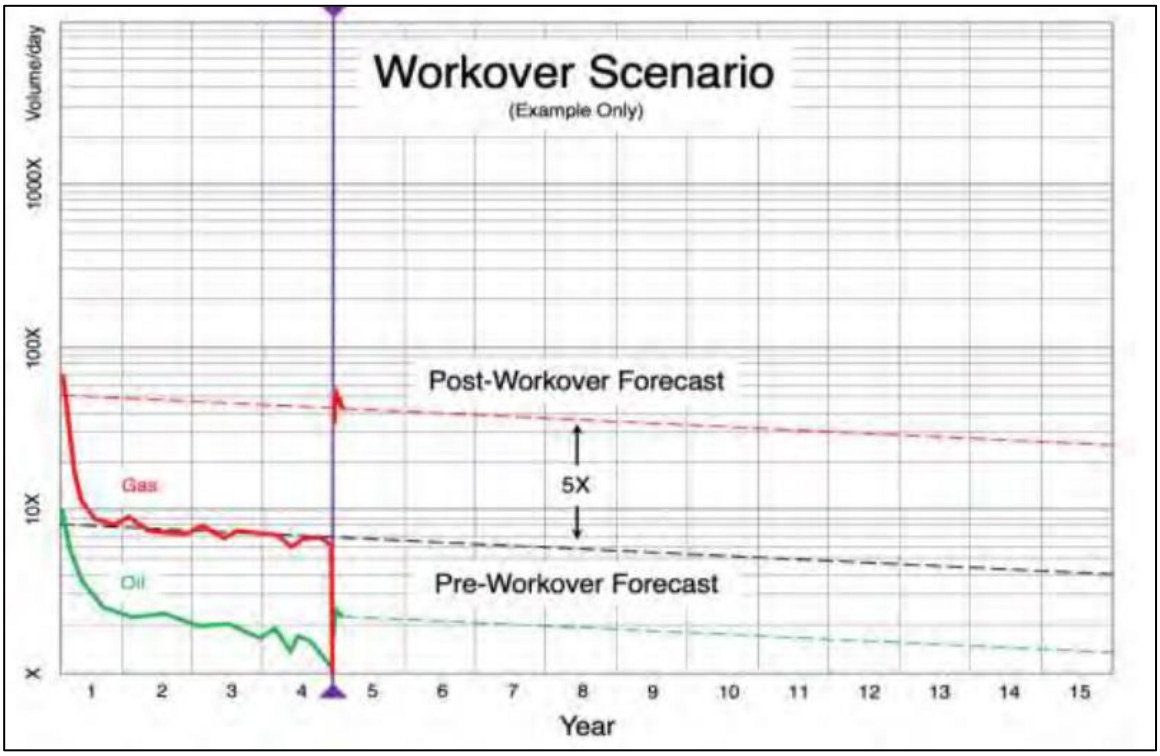
BRK announced the formation of a 50/50 joint venture (Orion Project) with Stonehorse Energy Ltd (ASX: SHE) in June 2020. The joint venture has been formed with the goal of acquiring producing oil and gas properties in the Anadarko Basin. Stonehorse, with a market cap. of A$2.4m as of 19 June 2020, holds working interests in two wells and has access to a pipeline of wellbore interests via its partner and manager of US operations, Black Mesa. Both parties have agreed to an initial combined investment of US$500,000 in the Orion Project and having a common operating partner (Black Mesa) is going to be advantageous for the joint venture.

*Orion Project will focus on unlocking value of mature wells having a long economic life*

Black Mesa will be responsible for identifying, acquiring and operating the properties on behalf of the joint venture. The initial focus area of the project will be 1,100 square kilometres spread over 12 townships but can be scaled-up easily to include other basins in Oklahoma outside of the Anadarko Basin.

The joint venture will be focussing on natural gas weighted mature production from vertical wells with long economic life and limited terminal declines. The objective is to unlock the value of such wells through low-cost, low-risk workovers[7] (Figure 4).

**Figure 4: Vertical well workover scenario for Anadarko Basin**




*Source: Company*

Through this joint venture, both companies are aiming to acquire properties at the current low point in the commodity price cycle, add value through operational execution and subsequently gain from pricing upside when the oil market rebounds. There can be additional upside if natural gas prices increase significantly during the northern hemisphere winter.

[7] Workover is the process of performing major maintenance or remedial treatments on an oil and gas well. It includes oil and gas well intervention involving invasive techniques, such as wireline, coiled tubing or snubbing.

## Navigating the oil market crisis

A severe demand-side shock caused due to the COVID-19 crisis, coupled with delay in implementing production cuts due to lack of agreement between key oil-producing nations have sent oil prices crashing to their lowest level in the past two decades. BRK's management has taken some swift and key decisions in response to the current crisis.

*Management announced a number of measures to tide over a low oil price scenario*

**First, the company has decided to immediately contain its general and administrative expenses,** starting with a reduction in Managing Director fees from A$180,000 to A$120,000 per annum. This will result in over 30% savings for the company. Black Mesa, BRK's partner, is also implementing a ~30% reduction in operating expenses by decreasing its full-time employees, utilising contractors on a need basis and reducing reliance on external support functions.

**Second, BRK is focussing on lease renewals and extension programmes for its acreage.** While the breakeven pricing for BRK's flagship Sycamore horizontal wells produces an attractive rate of return at even US$40 per barrel, the management realises that the current pricing environment does not support the development plans for wells. Thus, the company is extending leases as required to enable it to maintain a dominant position in the key DSUs so that it is able to reconvene operations swiftly when the pricing environment improves.

**Third, the company has decided to harvest some cash flow** from low-risk wells that have been drilled within its acreage position. BRK currently has an interest in a number of producing wells that are active and/or set to commence production. Notably, lease operating expenses (including fixed and variable operating costs and severances taxes) amount to ~US$7.50 per barrel of oil equivalent for this production stream, providing a solid operating margin even at the current oil spot prices.

We believe these timely and useful measures will prepare the company to tide over the financial shock and at the same time ensure that it can leverage opportunities when the market starts recovering.

## Healthy financial performance

BRK announced strong FY 2019 results underpinned by ~27% y/y growth in its portfolio in terms of acreage. It reported an EBITDA of A$5.1m and net income of A$4.1m in FY 2019 as compared with A$0.6m of operating loss and A$1.2m of net loss in FY 2018. The positive results were driven by oil and gas production revenue as well as gain on acreage sale.

BRK remains committed to using internal cash flows for drilling and completion costs and for its working capital needs to fund land and leasing progress. The cash balance of the company stood at A$841,000 as of 31 March 2020 and unused financing facilities totalled ~A$1.8m – combined, the available funding should be sufficient to cover at least three quarters of activity.

## Valuation

BRK's primarily derives its income from two streams – oil and gas production royalties and land development activities. The current market dynamics do not project a favourable road ahead for oil and gas production with some wells not feasible to operate, at least in the near future. On the other hand, we believe that the weakness in oil prices should not have a material impact on land development activities as these are also influenced by a number of other long-term factors.

We have assumed tight conditions for the oil market for 2020 and have adjusted the estimates for BRK's oil and gas production and revenues accordingly. While we have also factored in the benefit of the cost containment measures announced by the management, our valuation range has been revised downwards to reflect the near-term weakness in the oil and gas market. However, the upside potential remains intact as we believe the stock price has more than corrected itself over the last two months.

Our valuation has been revised to A1.85c in the base case and A2.21c in the optimistic (or bull) case scenario (Figure 5). In the bull case, we assume a recovery in oil prices in next couple of quarters and further cost-saving measures by the management. Figure 6 shows our sensitivity analysis applied on varying terminal growth rate and discount rate.

**Figure 5: DCF valuation for BRK**

| Valuation (AUD '000) | Base case | Bull case |
|---|---|---|
| Present value of FCF | 18,143 | 20,375 |
| Present value of Terminal FCF | 4,631 | 6,040 |
| **Enterprise Value** | **22,774** | **26,415** |
| Net debt (cash) | 4,291 | 4,291 |
| **Equity value (AUD '000)** | **18,483** | **22,124** |
| Share outstanding ('000) | 1,001,722 | 1,001,722 |
| **Implied price (A$ cents)** | **1.85** | **2.21** |
| Current price (A$ cents) | 0.50 | 0.50 |
| *Upside (%)* | *269.0%* | *341.7%* |

*Source: Pitt Street Research*

**Figure 6: DCF value in A$ cents using various WACCs**

| Sensitivity Analysis | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **WACC** | | **10.00%** | | | | | | | | |
| **Terminal Growth Rate** | | **0.50%** | **Change in WACC** | | | | | | | |
| **Implied Price (A$ cents)** | | **1.85** | *9.25%* | *9.50%* | *9.75%* | *10.00%* | *10.25%* | *10.50%* | *10.75%* | *11.00%* |
| | | *0.20%* | 1.98 | 1.93 | 1.88 | 1.83 | 1.78 | 1.74 | 1.70 | 1.66 |
| | | *0.30%* | 1.98 | 1.93 | 1.88 | 1.83 | 1.79 | 1.75 | 1.70 | 1.66 |
| | | *0.40%* | 1.99 | 1.94 | 1.89 | 1.84 | 1.79 | 1.75 | 1.71 | 1.67 |
| **Change in Terminal Growth Rate** | | *0.50%* | 2.00 | 1.94 | 1.89 | **1.85** | 1.80 | 1.75 | 1.71 | 1.67 |
| | | *0.60%* | 2.00 | 1.95 | 1.90 | 1.85 | 1.80 | 1.76 | 1.72 | 1.67 |
| | | *0.70%* | 2.01 | 1.96 | 1.90 | 1.86 | 1.81 | 1.76 | 1.72 | 1.68 |
| | | *0.80%* | 2.02 | 1.96 | 1.91 | 1.86 | 1.81 | 1.77 | 1.73 | 1.68 |

*Source: Pitt Street Research*

## Re-rating BRK

BRK is currently trading at a significant discount to its intrinsic value and we believe there are two main reasons for the undervaluation of BRK – lack of awareness about the company's business model and the negative oil price outlook. We foresee BRK being rerated by the market, mainly driven by three key factors: (1) an improvement in oil price sentiment, (2) better-than-expected flow rates from existing wells and (3) higher acreage prices in the Anadarko Basin.

## Risks

We see four main risks related to BRK's investment thesis.

- Commodity price risk: An extended period of low commodity (oil and natural gas) prices can weigh on future drilling activity in the Anadarko Basin, negatively impacting BRK's prospects.
- Execution risk: BRK's transition to becoming an operator is in a nascent stage. There is a risk associated in bringing these wells online and establishing sustainable initial production rates at the operated units.
- Geological risk: Reserve figures attributable to STACK play holdings in the Anadarko Basin are estimates, and these estimates have both an associated risk of discovery and a risk of development.
- Partnership risk: BRK's operational success will depend on the continuation of the strong relationship with Black Mesa and other key exploration partners. In a scenario where a partner decides to pull out of the strategic alliance on short notice, BRK's growth prospects maybe hampered.

Please see https://www.pittstreetresearch.com/ for our initiating coverage on BRK.

## Appendix I – Analyst Qualifications

Stuart Roberts, lead analyst on this report, has been an equities analyst since 2002.

– Stuart obtained a Master of Applied Finance and Investment from the Securities Institute of Australia in 2002. Previously, from the Securities Institute of Australia, he obtained a Certificate of Financial Markets (1994) and a Graduate Diploma in Finance and Investment (1999).

– Stuart joined Southern Cross Equities as an equities analyst in April 2001. From February 2002 to July 2013, his research speciality at Southern Cross Equities and its acquirer, Bell Potter Securities, was Healthcare and Biotechnology. During this time, he covered a variety of established healthcare companies, such as CSL, Cochlear and Resmed, as well as numerous emerging companies. Stuart was a Healthcare and Biotechnology analyst at Baillieu Holst from October 2013 to January 2015.

– After 15 months over 2015–2016 doing Investor Relations for two ASX-listed cancer drug developers, Stuart founded NDF Research in May 2016 to provide issuer-sponsored equity research on ASX-listed Life Sciences companies.

– In July 2016, with Marc Kennis, Stuart co-founded Pitt Street Research Pty Ltd, which provides issuer-sponsored research on ASX-listed companies across the entire market, including Life Sciences companies.

– Since 2018, Stuart has led Pitt Street Research's Resources Sector franchise, spearheading research on both mining and energy companies.

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