PITT STREET RESEARCH

Brookside Energy Ltd

Momentum building

Share Price: A$0.005

ASX: BRK

Sector: Oil and Gas Exploration

22 September 2020

Brookside Energy Ltd (ASX: BRK) is a Perth-based energy company with exposure to the most productive oil and natural gas plays (STACK and SCOOP) in Oklahoma's Anadarko Basin. BRK has a strategy based on three pillars focused on 1) operated drilling, 2) producing property acquisitions and 3) land & leasing. The three pillars strategy has positioned Brookside to take advantage of the oil and gas cycle at every level while minimising downside risk. This approach has allowed BRK to grow in the Anadarko Basin using an asset-light model.

Orion Project gaining momentum

In June 2020, BRK has entered a 50:50 JV with Stonehorse Energy (ASX: SHE) to exploit opportunities to acquire producing oil and gas properties within the SWISH AOI in the Anadarko Basin region. Within about two months of operations, the JV has successfully closed two acquisition opportunities, the Newberry Well and the Mitchell Well, both located within the SWISH AOI. In addition to acquiring the assets, the JV has managed to unlock their upside potential through implementing low-cost, low risk workover operations, which have resulted in increased reserves, improved net volumes, and expected cashflow levels.

BRK to grow asset base at a low point in cycle

2Q20 has seen the company experiencing some difficulty in net revenues due to the significantly lower realised oil and gas prices. To remediate and conserve cashflows, BRK has adopted some measures to optimise its operations which included cutting its operating cost base. Availability liquidity stands at approximately A$3.5M. Additionally, BRK has sought to take advantage of the low price point in the commodity cycle by pivoting towards a producing property strategy, which involves acquiring value enhancement wellbores and unlocking their upsides through low-cost operational execution such as workovers.

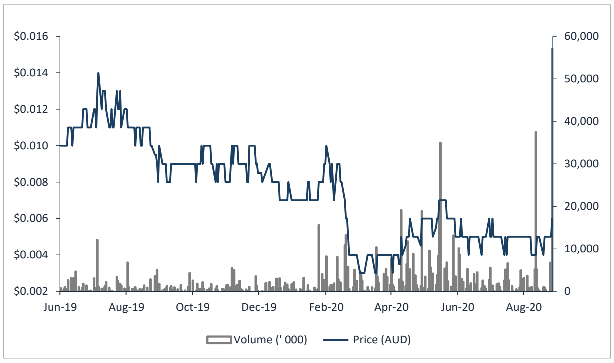
Valuation revised to A$0.015 – A$0.018 per share

We have re-worked our DCF model by incorporating the JV's acquisitions and their expected cashflows to be generated from forward gas sales. On a per share basis, however, we trim our valuation range to A$0.015 – A$0.018 (previous: A$0.019 – A$0.022) caused by the dilution of an expanded share base following the company's recent equity raisings. Key risks we see in BRK include: 1) extended period of weak commodity pricing; 2) partnership risk and 3) execution risk.

Market Cap. (A$ m)	6.4
# shares outstanding (m)	1,282.0
# share fully diluted (m)	1,854.6
Market Cap Ful. Dil. (A$m)	9.3
Free Float	69.0%
12-months high/low (A$)	0.011 / 0.002
Avg. 12M daily volume ('1000)	2,957.6
Website	brookside-energy.com.au

Source: Company, Pitt Street Research

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



Source: CommSec

Valuation metrics	
DCF fair valuation range (A$)	0.015 – 0.018
WACC	10.0%
Assumed terminal growth rate	0.5%

Source: Pitt Street Research

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Momentum building for the Orion Project

Workover done on Newberry Well increased its daily gas production by almost 7x

Following our update report released on 8 July 2020, BRK has since then made solid progress with its 50:50 joint venture with Stonehorse Energy Ltd (ASX: SHE) announced in June 2020 (Orion Project).

On 20 July 2020, the JV acquired a 43.45% interest in the Newberry Well and its associated Held by Production (HBP) acreage located within BRK's Jewell Unit in the SWISH AOI. The Newberry Well is a vertical well drilled on an 80-acre DSU in the 1980s. It was identified by Black Mesa, operator of the JV, as a suitable target that satisfied the JV's investment hurdles. Subsequent to the acquisition, a low-cost workover has been carried out by Black Mesa on the Newberry Well, with the result delivering an almost 7x increase in its daily gas production volumes and extending the producing life of the well (Figure 1).

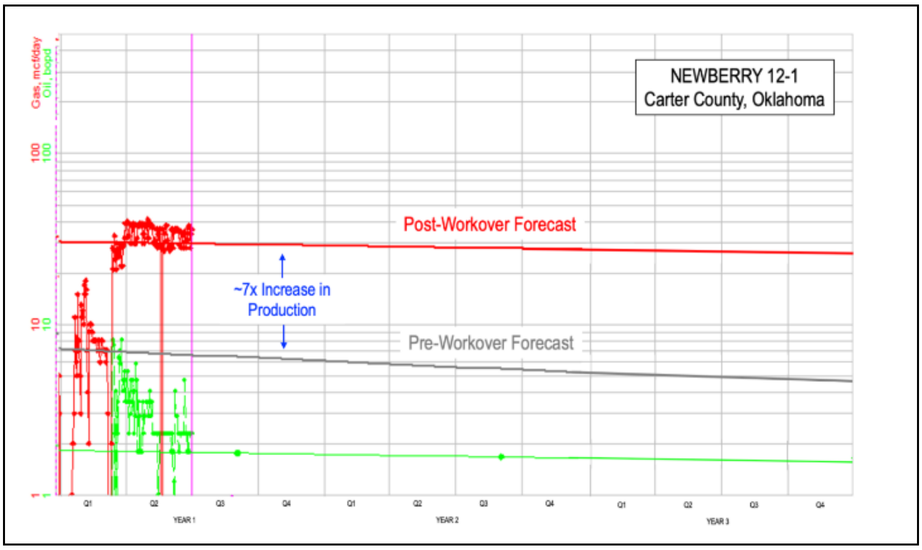
On 18 August 2020, the JV acquired the Mitchell Well also located within the SWISH AOI. Like the Newberry Well, the Mitchell Well is also a vertical well drilled on an 80-acre DSU targeting the Sycamore formation[1]. By 3 September 2020, a workover has been successfully completed with the Mitchell well shut-in ready for production awaiting installation of a gas meter.

Having now unlocked their upsides from the recent workover operations, we think these production assets will enhance future cashflows of the JV through oil and gas sales over the medium to long term, the commercial benefits of which should ultimately flow through to the BRK business.

Moreover, it is worth noting that the JV is currently taking advantage of the low point in the oil and gas commodity price cycle and building out a pipeline of potential acquisition targets within the SWISH AOI and more broadly in the southern Anadarko Basin region.

Near term, we expect the acquisition momentum will continue, which should see the JV acquiring more operated, long-life producing wellbores with large upside potential that can be unlocked through low-cost, low-risk workovers. The resultant expanded portfolio of production assets, enhanced by remedial workover activity meaning increased reserves and asset lives, should drive a substantial uplift in the JV's expected revenues and cashflows, in our view.

Figure 1: Rate/Time plot Pre and Post Workover



Source: Company

[1] One of two main producing formations in the SWISH AOI.

2Q20: Restructuring and optimisation

For the six months ending 30 June 2020, BRK reported net revenues[2] of US$0.2M (-55% HoH) and net production volumes of 24,352 BOE (-30% HoH) (Figure 2). The decline in net revenues over the period was largely attributable to the significantly lower oil and gas realised pricings impacted by the recent pullback on global economic activity and supply side tensions.

Figure 2: QoQ Production volumes and revenues

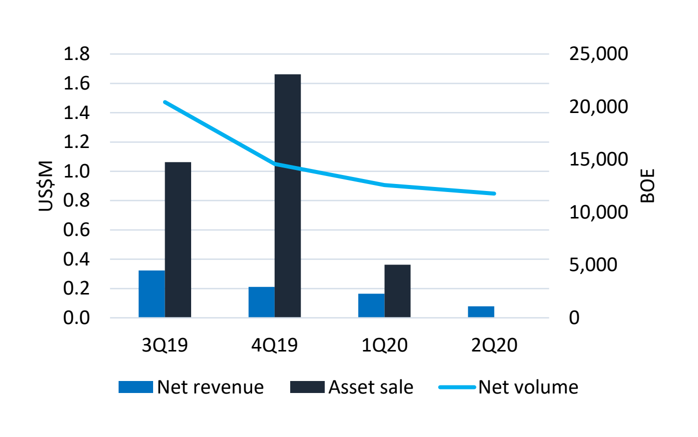
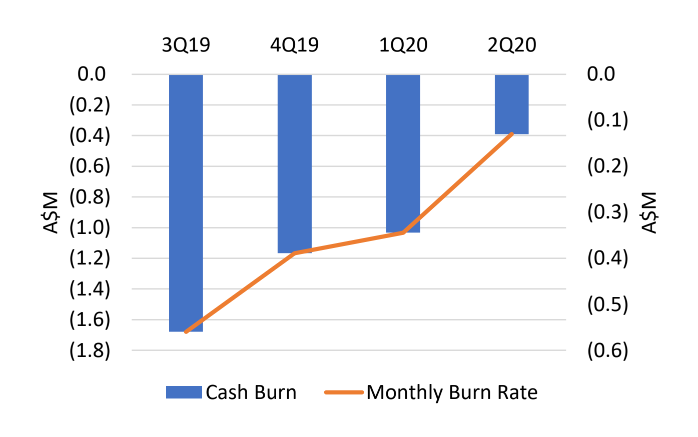


Figure 3: QoQ Cash burn levels

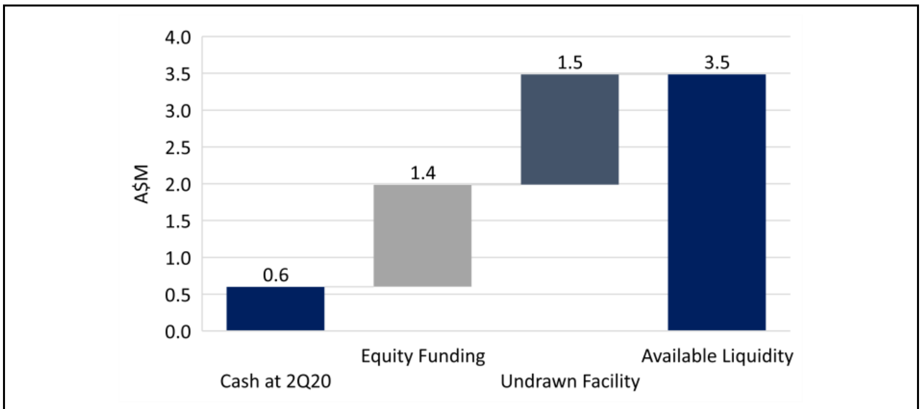


Source: Company, Pitt Street Research

To address these issues and conserve cashflows, BRK restructured its business and cut its operating cost base, reflected in its reduced quarterly burn rate (Figure 3). As of 30 June 2020, cash stood at A$0.6M and unused financing facility was at around A$1.5M[3]. Post 1H20, BRK has also successfully raised approximately A$1.4M through equity issuance. Adding altogether, BRK's current liquidity amounts to A$3.5M (Figure 4), which should last more than 26 months of cash burn based on 2Q20's burn rate.

In addition, BRK has adjusted its land and leasing strategy to preserve its core acreage position, reflected in its zero asset sales for 2Q20 (Figure 2). Moreover, BRK has sought to take advantage of the low price point in the commodity cycle by pivoting towards a producing property strategy (as outlined in the Orion Project above).

Figure 4: Cash and Liquidity



Source: Company, Pitt Street Research

[2] Net of all operating costs, severance, and ad valorem expenses.
[3] AUD/USD: 1.37.

Forecast changes and valuation

We revise our revenue modelling to incorporate the JV's recent acquisitions of the Newberry and Mitchell Wells and expected cashflows to be generated from forward gas sales. In terms of near-term gas production volumes, we utilise post workover volume of 40Mcf per day, as guided by the company. After accounting for BRK's proportional interest in the production assets, we re-ran our DCF model to include the potential added cashflows from the Newberry and Mitchell Wells, which has resulted in an uplift of approximately 3.9% in the equity value of the BRK business.

On a per share basis, however, we trim our valuation range to A$0.015 – A$0.018 (previous: A$0.019 – A$0.022) after factoring in the dilutive impact of an expanded share base as a result of the 277M new shares being issued following the company's recent equity raisings.

Our revised DCF valuation summary is shown in Figure 5 below. Figure 6 shows our sensitivity analysis on terminal growth rates and discount rates.

Figure 5: DCF valuation summary

Valuation (A$M)	Base case	Bull case
Present value of FCF	18.8	21.1
Present value of terminal FCF	4.8	6.3
Enterprise value	**23.7**	**27.4**
Net debt (cash)	4.3	4.3
Equity value (A$M)	**19.4**	**23.1**
Share outstanding (M)	1,282	1,282
Implied price (A$ cents)	**1.51**	**1.80**
Current price (A$ cents)	0.50	0.50
Upside (%)	*202.1%*	*260.6%*

Source: Pitt Street Research

Figure 6: Sensitivity analysis

Sensitivity Analysis									
WACC	**10.00%**								
Terminal Growth Rate	**0.50%**	Change in WACC							
Implied Price (A$ cents)	**1.51**	*9.25%*	*9.50%*	*9.75%*	*10.00%*	*10.25%*	*10.50%*	*10.75%*	*11.00%*
Change in Terminal Growth Rate	*0.20%*	1.61	1.57	1.53	1.50	1.46	1.43	1.40	1.36
	0.30%	1.62	1.58	1.54	1.50	1.47	1.43	1.40	1.37
	0.40%	1.62	1.58	1.54	1.51	1.47	1.44	1.40	1.37
	0.50%	1.63	1.59	1.55	**1.51**	1.47	1.44	1.41	1.37
	0.60%	1.63	1.59	1.55	1.51	1.48	1.44	1.41	1.38
	0.70%	1.64	1.60	1.56	1.52	1.48	1.45	1.41	1.38
	0.80%	1.64	1.60	1.56	1.52	1.49	1.45	1.42	1.38

Source: Pitt Street Research

Re-rating BRK

BRK currently trades at a large discount to its intrinsic value and we believe the undervaluation of BRK is due to a lack of investors awareness about the company's business model and the negative oil pricing outlook.

However, we believe BRK will be re-rated by the market upon the occurrence of the following events:

- an improved oil pricing outlook;
- further acquisitions of value enhancement producing properties;
- better-than-expected flow rates from existing wells; and
- 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 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

Cheng Ge, lead analyst on this report, is an equities research analyst at Pitt Street Research.

- Cheng obtained a B.Com in Finance and LL.B from University of New South Wales, in 2013, and has passed all three levels of the CFA Program.
- Prior to joining Pitt Street Research, he has worked for several financial services firms in Sydney, where his focus was on financial advice.
- He joined Pitt Street Research in January 2020.

Stuart Roberts 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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