Two updates and a new buy recommendation

By Brian Hoffman


Brian Hoffman

Junior oil and gas exploration and development companies are learning a basic concept in the current environment that many larger companies generally take for granted — survival.

This concept is obviously not new to juniors, although the risk is now heightened, especially for any company with a significant natural-gas focus. Juniors with strong cash flows are in the best bargaining position in terms of mergers and acquisitions — either as a target or an acquiror.

An update on two juniors I profiled earlier is provided below followed by an overview of a junior that is planning substantially growth.

Arapahoe Energy Corp. (AAO-TSX/VEN, $0.10) recently announced transactions with two Calgary-based private oil and gas exploration companies. Arapahoe is acquiring First West Petroleum Inc., whose common shares will be exchanged at one for 10.415 shares of Arapahoe. Arapahoe has also agreed to transfer its oil and gas properties in the Freemont area of Saskatchewan to Seranno Energy Ltd. for a 32.4 per cent interest in Serrano. Serrano's produces 200 BOE/d and owns 88 million barrels of possible oilsand reserves valued at $105 million.

Arapahoe is also planning to raise $10 million privately at $0.125 a share and $5.6 million from the exercise of warrants. It will use these funds to develop its Campbell and Sarcee properties as well as First West's properties. First West was producing 250 barrels of oil equivalent per day in September and had net debt of $3 million. With regard to First West's properties, Arapahoe expects another 200 BOE/d of production to start from additional wells by year-end.

My revised NAV estimate for Arapahoe is $0.39 per share based on information disclosed about First West and Serrano's financial positions and oil and natural-gas reserves. This NAV estimate reflects the impact of the two transactions, the $10 million private placement and the dilution from Arapahoe's convertible debentures and warrants.

Penn West Petroleum Ltd., a wholly-owned subsidiary of Penn West Energy Trust, has completed its $0.20-per-share cash takeover of C1 Energy Ltd. (formerly CTT-TSX, $0.20). C1 Energy was acquired at a price well below its NAV, primarily due to its cash-flow problems.

CI Energy flames out

The company's demise is almost unbelievable. The shares traded as high as $3.45 in 2005, management reported a NAV of $2.60 per share in the spring of 2006 and the estimated NAV at the time of the takeover had decreased to about $0.65 per share.

Penn West capitalized on C1 Energy's weak bargaining position. C1 Energy disclosed in its takeover-offer circular that it had approached over 110 oil and gas companies and Penn West made the highest offer. Penn West's takeover circular disclosed that it purchased almost 1.9 million shares of C1 Energy in January at $0.55 per share, so it appears Penn West contemplated a takeover at a higher price.

C1 Energy's bargaining position was so weak that it sold its 55 per cent interest in a natural-gas well in the Sarcee area of Alberta to Arapahoe and Vangold Resources Ltd. for about $200,000. Arapahoe was able to increase its working interest in this well from 19.2 per cent to 46.7 per cent for about $100,000.

The viability of that well is uncertain as water intruded through the well's casing side wall during C1 Energy's initial attempt in 2005 to complete and production-test it. Independent consultants recommended remedial completion drilling, which Arapahoe and its partners have scheduled for later in the year.

More development wells may be drilled on the Sarcee acreage if the remedial efforts are successful. Similar natural-gas wells drilled in the area by Shell Canada Ltd. have produced up to 30 billion cubic feet of natural gas per well.

Over the past three years **Grand Banks Energy Corp.** (GBE-TSX/VEN, $1.08), a junior oil and gas company based in Calgary, has grown its production of light oil and natural-gas from less than 100 barrels of oil equivalent per day to about 1,300 BOE/d — split evenly between light oil and natural gas.

Grand Banks's key operating areas are located in the Peace River Arch area of Alberta, which is primarily a natural-gas exploration region, and the Williston Basin area in southeastern Saskatchewan and southwestern Manitoba, a light-oil area. The company has an inventory of over 20,000 net acres of undeveloped land in the Williston Basin where it operates over 30 high-working interest oil wells.

Grand Banks plans to increase its production to about 4,000 to 5,000 BOE/d over the next three to four years, which would translate into annual production growth of over 30 per cent. In order to reach this level of production, Grand Banks is planning lower-risk development and exploration drilling, primarily light-oil development prospects in the Williston Basin, augmented by a mix of high-impact exploration prospects targeting deep-gas in the Peace River Arch and northeastern B.C.

During the second quarter, Grand Banks closed the sale of its oil-producing property in the Stoughton/Viewfield area of southeast Saskatchewan for net proceeds of $8.2 million. At the time of the sale, four oil wells were producing a total of about 40 BOE/d net to Grand Banks.

At June 30, Grand Banks had net debt of $8.7 million, including $2.4 million drawn on its $19-million revolving credit facility, which was increased from $10.5 million by its lender in May. Management expects to meet its working capital commitments for the balance of the year from the proceeds of the Stoughton/Viewfield property sale together with its cash flow and available credit facility.

Grand Banks's net position appears manageable, although any significant increase in debt without any notable oil or natural-gas discoveries would be a concern.

During the second quarter, cash flow was $2.1 million or $0.06 per share, net income was $0.01 per share and production averaged 725 BOE/d — 76 per cent oil. The recent increase in production to 1,300 BOE/d is primarily due to 470 BOE/d of production starting from a natural-gas discovery at Tower Creek, Alberta. During 2007, Grand Banks has focused on tying-in wells drilled in 2006, particularly the Tower Creek gas discovery, which required the construction of new production facilities.

Grand Banks reported year-end proved-plus-probable reserves of 3.8 million BOE, 62 per cent oil — up 94 per cent from the year earlier. The company reported a NAV of $1.84 per share, using the $69.1 million net present value, discounted at 10 per cent before tax, that independent engineers have attributed to Grand Banks's reserves.

GBE's president and CEO owns about 16 per cent of the outstanding shares. The shares are thinly traded and appear to have support in the $1 to $1.10 price range.

If oil prices remain strong, natural-gas prices increase over the long-term and Grand Banks successfully executes its growth strategy, its share price has the potential to increase significantly from the current level.

Brian Hoffman, CA, CPA, a freelance writer specializing in junior oil and gas companies, lives in Richmond Hill, Ont. (E-mail: bk.hoffman@rogers.com.)

INVESTOR'S DIGEST OF CANADA
NOVEMBER 9, 2007