EDISON Scale research report - Update

Deutsche Rohstoff

Oil & gas

3 September 2020

Production to increase by early 2021

Deutsche Rohstoff (DRAG) was quick to react to the COVID-19 pandemic, in cutting production from its operated Cub Creek Olander pad in mid-March 2020. This had been brought online at end 2019 and was producing c 6,000bbl/d when DRAG decided to halt production. It enabled DRAG to avoid selling oil production at historical uneconomic low oil prices and manage remaining production with its hedged portfolio. Revenues in H120 of €26.1m included €10.1m from hedging income. As oil prices are recovering from the March/April lows, management expects to restart production, beginning with Cub Creek legacy pads. This strategic flexibility is possible due to DRAG's liquidity and healthy balance sheet. Management guides to FY20e sales at the higher end of €33–37m and EBITDA of c €15–18m, mainly due to the recent recovery and stabilisation of oil prices in the US.

Production cutbacks to protect value

In H120, DRAG's average production was 5,022boed, resulting in revenues of €26.1m, of which €10.1m resulted from hedging realisations. The largest contributor to production was Cub Creek, which had increasing volumes from the Olander pad in Q120 before the production curtailments. As oil prices recover, DRAG expects to bring production online, starting with resumption of full production of the older pads from October 2020, and restarting Olander once oil prices rise.

Commodity price uncertainty leads to write-downs

In response to the impact of COVID-19 on the global economy and increasing oil price volatility, DRAG's management decided to write down c €17.2m of the company's assets to protect the balance sheet from the low oil price environment. This affected earnings, with DRAG reporting a net loss of €13.4m in H120.

Valuation: Below audited reserve values

DRAG's February 2020 independent 1P and 2P valuation of its oil and gas assets was €178.0m, including Elster Oil & Gas, Cub Creek Energy, Salt Creek Oil & Gas and Bright Rock Energy. Although c 55% of DRAG's 2020 production is hedged at a minimum price of $57.12/bbl, oil prices have significantly dropped since the CPR valuation date of the reserves. We assume the company's mining assets are valued at book value and deduct H120 net debt. This amounts to a SOTP valuation of c €104m or €20.4/share, rising to €22.1/share including 2P reserves.

Consensus estimates

Year end	Revenue (€m)	EBITDA (€m)	EPS (€)	DPS (€)	Capex (€m)	Yield (%)
12/18	109.05	97.93	2.74	0.70	(66.2)	7.7
12/19	41.20	22.70	0.06	0.10	(49.7)	1.1

Source: Deutsche Rohstoff

Price	€9.10
Market cap	€46m

Share price graph

Share details

Code	DR0
Listing	Deutsche Börse Scale
Shares in issue	5.08m
Net debt at 30 June 2020	€95.0m

Business description

Deutsche Rohstoff identifies, develops and monetises resource projects in North America, Australia and Europe. The company's focus is on the development of oil and gas opportunities in the US.

Bull

- Track record of value creation.
- Acquisition opportunities in US onshore.
- Stable liquid position in current environment.

Bear

- Diverse commodity focus for a small company.
- Disparate US peer group.
- High operational leverage if oil prices fall.

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Edison profile page

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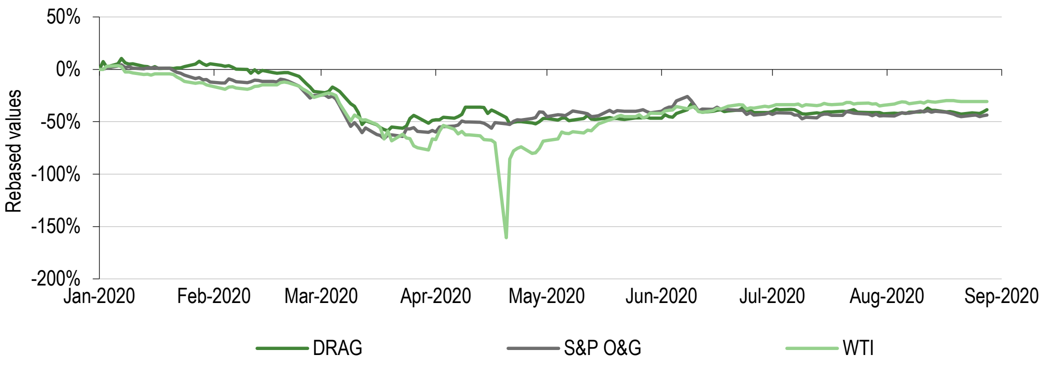
Quick response to COVID-19 protected H120 results

As for most oil and gas companies, the first half of 2020 was dominated by the impact of COVID-19 on the global economy. However, following the sharp decline in oil prices in March 2020, DRAG's management was quick to react and took several measures to contain the impact of the pandemic and safeguard the balance sheet. The company cut back oil production at Cub Creek, thereby avoiding having to sell production at historical uneconomic low prices. The positioning of DRAG's hedge portfolio also supported a controlled cutback in production, generating additional income of c €10.1m in the period. These measures resulted in average production of 5,022boed in the first half of the year. Cub Creek Energy produced rising volumes from the Olander well pad until mid-March, when management decided to cut back production, which reached 6,000bbl/d until then.

Exhibit 1: DRAG share price performance vs S&P Oil & Gas and WTI since January 2020



Source: Edison Investment Research, Refinitiv at 31 August 2020

Overall, COVID-19 posed challenges for the global economy and oil & gas sector, and a medium-term perspective that is difficult to assess. The danger of oversupply to the oil market remains, especially if demand crashes again. However, since mid-June, oil prices seem to have stabilised with supply and demand finding a new balance. WTI has been trading at c $40/bbl over the last couple of months. If oil prices recover, DRAG's management expects that production in the US should start increasing from the beginning of 2021 at the latest. A resumption of full production at Cub Creek's legacy pads is planned in the coming weeks, which is expected to increase current production by around 500bbl/d from October. The Olander pad is not expected to resume production until prices have recovered even further.

Financials

Revenue for the first six-months of the year amounted to €26.1m versus €24.2m in the same period of 2019, and EBITDA increased from €15.2m to €15.8m. Given the financial results in H120 and that oil prices have stabilised somewhat in recent months, management is now guiding to sales at the upper end of its forecast €33–37m and for EBITDA to exceed the previously guided €15m but to be within €15–18m. It bases this on an average US oil price of $40/bbl, Henry Hub gas price of $2.0/mmBtu and an FX rate of US$/€ 1.17.

Overall, DRAG has solid liquidity to weather current headwinds following the placing of the corporate bond in late 2019, which raised c €87.1m. End-H120 cash stood at c €33.8m, leaving DRAG in a healthy position to make investments and take advantage of the opportunities arising from the current environment in the oil & gas market.

Exhibit 2: Financial summary

German GAAP (€000s)	2016	2017	2018	2019	H120
INCOME STATEMENT					
Sales revenue	9,170	53,746	109,052	41,204	26,121
Growth %	383%	486%	103%	-62%	N/A
EBITDA	6,374	36,126	97,933	22,700	15,769
EBITDA Margin %	70%	67%	90%	55%	60%
EBIT	(541)	5,300	32,700	5,600	(15,550)
Net profit (after minority interests)	102	5,549	13,872	308	(13,281)
Number of shares (000s)	5,063	5,063	5,063	5,082	5,082
EPS adj. (€/share)	0.02	1.10	2.74	0.06	(2.61)
DPS (€)	0.60	0.65	0.70	0.10	
BALANCE SHEET					
Cash and cash equivalents	28,090	29,699	59,989	66,637	33,792
Total assets	193,472	213,574	224,845	278,925	221,760
Total debt	75,243	106,576	93,385	139,111	128,776
Total liability	109,146	121,901	151,007	207,424	163,554
Shareholders' equity	66,121	56,675	73,837	71,501	58,206
CASH FLOW STATEMENT					
Net cash from operating activities	2,914	37,848	68,674	34,935	
Net cash from investing activities	(38,791)	(51,625)	(28,268)	(55,234)	
Net cash from financing activities	11,516	24,735	(28,626)	35,292	
Net cash flow	(24,360)	10,958	11,780	14,993	
Bank balances (including investments)	24,634	28,368	45,646	61,281	13,877
Net debt/(cash)	47,153	76,877	33,395	72,474	94,984

Source: Deutsche Rohstoff

Valuation

Considering the independent reserve valuation presented by DRAG in February 2020, the company's market value is now below the NPV_{10} of the 1P and 2P reserves for its net oil and gas investments, plus the book value of mining assets minus net debt. Due to the nature of its investments, traditionally we have valued DRAG on an asset value basis over traditional P&L metrics such as P/E or EV/EBITDA. However, we should also take into consideration current market volatility and the downward pressure on short-tern oil and gas prices.

At the time of the independent valuation (February 2020), oil and gas prices were stable and the CPR could not have anticipated the impact of the coronavirus on global oil and gas demand, nor the extent of oil price weakness. The calculation of revenues and cash flows was based on the NYMEX forward curve at 31 December 2019 with an average WTI price of $53.11/bbl. However, EIA estimates at 11 August for FY20 and FY21 show realised WTI prices at $35.50/bbl and $45.53/bbl respectively.

We have calculated a SOTP valuation (Exhibit 3). Based on the February 2020 CPR and end-H120 balance sheet data, the SOTP valuation has slightly decreased compared to end 2019. In light of the uncertainty for oil prices for the coming years, DRAG impaired the book value of Elster and the shares of Northern Oil & Gas. These write-downs are non-cash, but reduce the company's balance sheet exposure. If oil prices remain at higher levels, there may be additional earnings potential. Net debt also increased from €72.5m at year-end 2019 to €95.0m at end June 2020.

Exhibit 3: DRAG assets and per-share value

		CPR net NPV$_{10}$ 1P		CPR net NPV$_{10}$ 2P	
Asset	**Value basis**	**Value (€m)**	**Value per share (€/share)**	**Value (€m)**	**Value per share (€/share)**
Oil & gas assets	CPR*	169.5	33.4	178.0	35.0
Mining and oil investments	H120 book value	29.1	5.7	29.1	5.7
Cash at bank	H120 book value	33.8	6.6	33.8	6.6
Debt	H120 book value	(128.8)	(25.3)	(128.8)	(25.3)
Total equity valuation		**103.7**	**20.4**	**112.2**	**22.1**
Market value**		46.2	9.1	46.2	9.1
Difference		124%	124%	143%	143%

Source: Deutsche Rohstoff, Edison Investment Research. Note: Number of shares: 5.082m; $1.10/€. *CPR dated December 2019. **Share price as at 31 August 2020.

As mentioned above, realised oil prices in 2020 have been lower than anticipated at the time of the CPR. However, management expects a pick-up in oil prices in the second half of the year as restrictions on movement around the world decrease and the global economy recovers. If oil prices remain lower for a longer period, we would observe a decrease in the value of oil & gas assets.

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