EDISON

Scale research report - Update

Deutsche Rohstoff

Oil & gas

22 May 2020

Focusing on investment opportunities

Deutsche Rohstoff (DRAG) had expected a strong increase in production in 2020 and 2021 from the Olander pad, which started at end December 2019, and the Knight wells planned for H220. However, in response to the current low oil price environment DRAG's management has adjusted its strategy and reduced costs and production. It has also shifted its strategy to focus on investment opportunities generated by the current low market, allocating up to $25m to purchase assets deemed to be undervalued in the current crisis. This strategic flexibility is possible due to DRAG's liquidity and strong balance sheet. Management guides to FY20 sales of €33–37m and EBITDA of c €15m, mainly due to significantly reduced production for the year and lower realised oil prices.

Strategy adjusted in response to COVID-19

So far, 2020 has been challenging for the oil and gas industry, with the COVID-19 global pandemic and the Russia/Saudi Arabia oil price war disrupting the market. As a result, management initiated a cost-reduction process and adjusted production. The operated Olander pad production was halted at the end of April and a reduced dividend of €0.10 is to be proposed (prior year €0.70).

Flexibility from lower costs and robust balance sheet

DRAG is in a solid liquidity position to weather the current headwinds following management actions and the raising of c €87.1m via a bond placing in late 2019. In January 2020, the bond 16/21 was called and repaid at 50% of its remaining outstanding amount. With reduced production, the company is in a position to take advantage of opportunities arising from the current environment in the oil and gas market. The company announced in April that it would invest up to $25m in oil and gold companies and take advantage of current low valuations.

Valuation: Below audited reserve values

DRAG's February 2020 independent 1P and 2P valuation of its oil and gas assets was €177.6m, including Elster Oil & Gas, Cub Creek Energy, Salt Creek Oil & Gas and Bright Rock Energy. Although DRAG has 100% of its 2020 reduced production hedged at an average price of $58/bbl, oil prices have significantly dropped since the reserves' CPR valuation date. We assume DRAG's mining assets are valued at book value, adding in end-2019 net debt. This amounts to an SOTP valuation of c €131m or €25.8/share, rising to €27.5/share including 2P reserves.

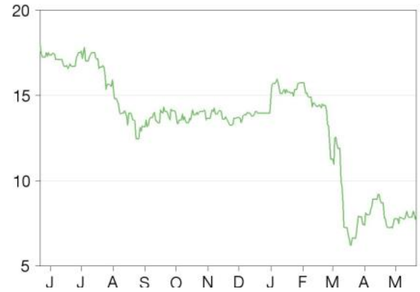
Historical financials

Year end	Revenue (€m)	EBITDA (€m)	EPS (€)	DPS (€)	Capex (€m)	Yield (%)
12/18	109.05	97.93	2.74	0.70	(66.2)	8.8
12/19	41.20	22.70	0.06	0.10	(49.7)	1.3

Source: Deutsche Rohstoff

Price	€7.96
Market cap	€40m

Share price graph



Share details

Code	DR0
Listing	Deutsche Börse Scale
Shares in issue	5.08m
Net debt at 31 March 2020	€81.2m

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

Well positioned to weather current headwinds

DRAG's business strategy involves the identification, development and monetisation of attractive resource projects in the Americas and Europe. Following a year of record revenue of €109.1m for DRAG in 2018, management estimates for 2019 were between €40–50m due to natural well declines and new investments coming online in early 2020. Realised revenue stood at €41.2m, within guidance; however, EBITDA was slightly below guidance of €25–35m, at €22.7m, justified by unexpected lower oil production from Elster Oil & Gas due to infrastructure work and pipeline capacity.

In line with company strategy, in FY19 DRAG main focus remained on its oil and gas activities within its US subsidiaries Cub Creek Energy (88.46% ownership), Elster Oil & Gas (93.00%), Salt Creek Oil & Gas (100%) and Bright Rock Energy (98.35%). At the end of 2019, the company had interests in 55 independently operated horizontal wells in the Wattenberg oil field in Colorado and 230 non-operated wells, also in the Wattenberg oil field, where it had 39 wells, with 90 wells in the Williston Basin in North Dakota and 101 wells in the Uinta Basin in Utah.

FY19 production averaged 4,501boed as the existing wells were able to stabilise production and operating costs were reduced. Drilling at the Olander well pad was completed on budget and on schedule and important foundations were laid for further development at Bright Rock and Salt Creek. However, the global COVID-19 pandemic and related economic impact alongside the lack of agreement among the OPEC+ states has led to further uncertainty for 2020. Before it can plan further wells in the US, management believes it is necessary to wait for the oil price to recover.

In Germany, Rhein Petroleum (10.00%) drilled the Steig-1 well near Weingarten/Baden-Württemberg and a significant discovery was announced. In January 2020, the majority shareholder in Rhein Petroleum, Tulip Oil, published an initial oil-in-place estimate of at least 114m barrels. Rhein Petroleum will focus on developing plans during the year to have additional wells approved for field development.

DRAG is in a solid liquid position to weather the current headwinds following the placement of the corporate bond in late 2019 raising c €87.1m and it is in a position to continue to make investments and take advantage of opportunities arising from the current environment in the oil and gas market. In April the company announced it would invest up to $25m in shares and bonds of oil companies and, to a lesser extent, gold companies and take advantage of the historically low valuations being observed in the market.

Q120 production stable compared to Q119

DRAG's net production of oil and gas in the first quarter of the year averaged 6,348boed, in line with the corresponding quarter of the previous year of 6,300boed, resulting in revenue of €16.1m, higher than Q119 at €14.7m. Production levels only started being affected in the second half of March as the company took action to limit production.

At Cub Creek, crude oil production averaged c 2,328boed, more than double the previous year due to the start of production from the Olander well pad. The Olander wells were intentionally started up more slowly than originally intended and at the beginning of March they were already producing c 5,200boed. However, due to the decision to reduce production, this was cut back to around 2,500boed by the end of March and the wells were completely shut in by the end of April. Management believes it makes economic sense to gradually ramp up production at Cub Creek with oil prices of c $35/bbl.

Response to the low oil price environment

In April 2020, DRAG announced certain measures as a reaction to the COVID-19 crisis and the current environment in the oil and gas sector:

- Adjustment of production: due to the company's liquid position and technical feasibility, management decided to reduce production of its operated oil facilities, with Cub Creek limiting oil production to 1,000–1,500bbl/d until the end of June 2020. This is around 15–25% of the originally planned production volume. DRAG is able to ramp production up in the future.
- Savings potentials are being identified and realised both in the running costs of production and in administrative costs. Management salary payments will be reduced by 25% over the next six months.
- Cub Creek has postponed the decision to develop the Knight well pad until June.
- To preserve its funds and prepare for a possible longer period of low prices, management will propose a €0.10 dividend to be paid this year (€0.70 in 2019).

The operated Olander pad production was completely halted at the end of April.

Financials

Management guidance is FY20 sales of €33–37m and EBITDA of c €15m, c 15% and 34% lower than FY19, primarily driven by significantly reduced production for the year and lower realised oil prices. Production from the Olander well pad was completely halted at the end of April, while the other well pads are producing only a minimum, which is partly necessary for regulatory reasons. DRAG is assuming an average annual oil price of $20/bbl in Q220 and $30/bbl in H220.

This approach results in an overall production that is over 50% lower than management previously assumed for 2020. Management believes it makes economic sense to use the existing flexibility and liquidity to preserve existing reserves and only produce when the oil price is expected to pick up, which management expects for 2021.

Management forecasts do not include any unscheduled depreciation. However, if the oil price remains at depressed levels permanently, there is a risk, as has been seen with other industry peers, of impairment losses on the producing oil production facilities in the US, which had a book value of €140m at 31 March 2020.

Overall, DRAG is in a solid liquid position to weather the current headwinds following the placing of the corporate bond in late 2019 raising c €87.1m. End Q120 cash was c €51.9m, leaving the company in a healthy position to make investments and take advantage of opportunities arising from the current environment in the oil and gas market.

Exhibit 1: Financial summary

German GAAP (€000s)	2016	2017	2018	2019	Q120
Income statement					
Sales revenue	9,170	53,746	109,052	41,204	16,119
Growth %	383%	486%	103%	-62%	-61%
EBITDA	6,374	36,126	97,933	22,725	9,498
EBITDA Margin %	70%	67%	90%	55%	59%
EBIT	(541)	5,300	32,700	5,630	73
Net profit (after minority interests)	102	5,549	13,872	308	774
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	0.15
DPS (€)	0.60	0.65	0.70	0.10	
Balance sheet					
Cash and cash equivalents	28,090	29,699	59,989	66,637	51,926
Total assets	193,472	213,574	224,845	278,925	268,809
Total debt	75,243	106,576	93,385	139,111	133,165
Total liability	109,146	121,901	151,007	207,424	193,983
Shareholders' equity	66,121	56,675	73,837	71,501	74,826
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	47,286
Net debt/(cash)	47,153	76,877	33,395	72,474	81,239

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 we traditionally valued DRAG on an asset value basis over traditional P&L metrics such as P/E or EV/EBITDA. However, we also have to take into consideration the current market volatility and the downward pressure on short-term oil and gas prices.

At the time of the independent report 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 or the impact of the Saudi Arabia/Russia oil price war. 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 12 May 2020 for FY20 and FY21 realised WTI prices stood at $30.10/bbl and $43.31/bbl respectively.

With the reduced production, DRAG has 100% of its 2020 production hedged at an average price of $58/bbl, which will minimise the impacts of current oil prices.

We have calculated an SOTP valuation (Exhibit 2) for DRAG. Based on the February 2020 CPR and the end 2019 balance sheet data, the SOTP valuation has slightly decreased compared to end 2018. The valuation of oil and gas assets and the mining assets book value increased, offset by an increase in net debt (from €33.4m to €72.5m), driven by the disposal of Salt Creek acreage.

Exhibit 2: 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*	168.7	33.2	177.6	34.9
Mining and oil investments	FY19 book value	34.9	6.9	34.9	6.9
Cash at bank	FY19 book value	66.6	13.1	66.6	13.1
Debt	FY19 book value	(139.1)	(27.4)	(139.1)	(27.4)
Total equity valuation		**131.1**	**25.8**	**140.0**	**27.5**
Market value**		41.6	8.2	41.6	8.2
Difference		215%	215%	237%	237%

Source: Deutsche Rohstoff, Edison Investment Research. Note: Number of shares: 5.082m; $1.10/€. *CPR dated December 2019. **Share price at 12 May 2020.

As mentioned above, realised oil prices in 2020 have been lower than were 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 will see a decrease in oil and gas asset values.

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