EDISON **Scale research report - Update**

Deutsche Rohstoff

Oil & gas

18 May 2018

Increase in production and asset monetisation

Deutsche Rohstoff's (DRAG's) multi-asset and resource strategy has been built around management's ability to identify investment opportunities, development of prospects and ultimately monetisation. In 2017 the group delivered a 497% increase in revenue, and 472% in EBITDA driven by increased production, boosted by a full year contribution from DRAG's 90% owned affiliate Salt Creek Oil & Gas. Subsequently, in April 2018 Salt Creek Oil & Gas signed a sale and purchase agreement with Northern Oil & Gas to divest most of its acreage in Williston Basin, generating a c 40% return on invested capital over 17 months. Management expects a strong increase in production over Q218 and Q318 as investment made in Elster Oil & Gas yields results.

Fast-track asset monetisation

Over a period of 17 months, DRAG successfully acquired, developed and monetised its Salt Creek acreage in North Dakota. This was purchased for a total consideration of $38.1m in December 2016 and the sale of most of the asset base was agreed in April 2018 for $59.6m, subject to normal due diligence, delivering an ROI of 1.6x. Management expects to realize a pre-tax profit on the transaction of c $12m in FY18 and will invest the cash in new projects in the US oil & gas sector.

FY17 results and FY18 outlook

In 2017, group revenue increased to €53.7m, compared to €9.2m in 2016, EBITDA increased to €36.1m from €6.4m and net profit to €7.7m from €0.1m. Management expects 2018 group revenues to increase to €75-85m and EBITDA to €65-70m. This forecast assumes WTI at $65 per barrel, a US$/€ exchange rate of 1.22, and is made on the basis that the new wells will lead to a further significant increase in production.

Valuation: At a discount to 2P value

DRAG's most recent independent 1P CPR valuation of its oil and gas assets totals €173.5m, including Elster Oil & Gas, Cub Creek Energy and the net sale proceeds for Salt Creek. Assuming the company's mining assets are valued at book value and adding in end 2017 net debt, this would amount to a SOTP valuation of c €119.9m or €23.7/share, rising to €27.8/share including 2P reserves. DRAG trades at a 13% discount to its 2P reserve value on this basis.

Consensus estimates

Year end	Revenue (€m)	EBITDA (€m)	EPS (€)	DPS (€)	Capex (€m)	Yield (%)
12/16	9.2	6.4	0.02	0.60	(38.8)	2.4
12/17	53.7	36.1	1.10	0.65	(51.6)	2.6
12/18e	82.2	69.4	4.38	0.83	(12.3)	3.4
12/19e	130.5	114.5	6.26	0.83	(87.4)	3.4

Source: DRAG, Bloomberg

Price	€24.70
Market cap	€125m

Share price graph

Share details

Code	DR0
Listing	Deutsche Börse Scale
Shares in issue	5.06m
Net debt as at 31 December 2017	€76.9m

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 US onshore.
- Technology driving increased US returns.

Bear

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

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Salt Creek monetisation and Elster development

DRAG's business strategy involves the identification, development and monetisation of attractive resource projects in North America, Australia and Europe. In 2017, group revenue increased to €53.7m from €9.2m in 2016; EBITDA increased to €36.1m from €6.4m and net profit to €7.7m from €0.1m. The company has three US assets – a 90% stake in Salt Creek Oil & Gas, 93% in Elster Oil & Gas and 88% in Cub Creek Energy. Its strategy of buy, build and monetise is in evidence with the sale, agreed in April 2018, of most of the Salt Creek assets, expected to generate a c 40% return (ROIC). The group also laid the foundation for growth in 2018 by increasing its working interest in wells on the Magpie properties through Elster Oil & Gas. It also states that 41 wells, in which it holds varying working interests, were brought into production between February and April 2018.

Salt Creek delivers c 40% ROIC

DRAG owns a 90% participation in Salt Creek Oil & Gas, founded in June 2015. In November 2016, DRAG announced the acquisition of a package of minority interests in North Dakota. The purchase price for the approximately 60 producing wells and an expected 90 future wells was $38.1m. In 2017, several wells were drilled and connected and, in October 2017, produced more than 1,000boed. In April 2018, DRAG signed a sale and purchase agreement with Northern Oil & Gas to divest most of its acreage in the Williston Basin. This includes 86 gross (8.5 net) wells producing, drilling or awaiting completion at the date of the deal, and an estimated 137 gross (8.2 net) wells of future drilling inventory.

Balance sheet strength and M&A optionality

Total consideration for the Salt Creek assets consists of $40m in cash, 6m shares of Northern Oil & Gas common stock and about $7.6m of pre-effective date capital, resulting in approximately $59.6m. The agreement requires Salt Creek to hold the stock consideration for six months and contains a mechanism for a cash settlement between $2 per share and the six-month closing price should Northern's stock not close above $2 per share for a short period of time during the six-month lock up. Salt Creek will continue to hold a small part of the acreage, with a reserve value of approximately $0.9m. Both companies expect the deal to be concluded at the beginning of June 2018, with an effective date of 1 January 2018. On completion, DRAG will have generated a c 45% return on equity over a 17-month period.

Salt Creek continues to have a financing facility with the Bank of Oklahoma to cover expenditure for the proposed wells. By the end of 2017, the facility amounted to $17.0m, of which $13.0m had already been drawn. The company expects to redeem this debt during Q218 after receipt of the sale proceeds, and we expect excess cash to be directed to repay corporate debt, fund the group's investment in Elster and be made available to support the group's acquisition strategy.

2018: Focus on US onshore production growth

Elster drilling campaign to deliver significant production growth in 2018

Following an investment of approximately $50.0m through 2017, production is expected to significantly increase from DRAG's 93% stake in Elster Oil & Gas. Q118 will benefit from the start of production from 25 wells on four well pads, with stable production reported at IP30 (30-day initial production rate) 7,493boed gross. In addition to expected production growth from Elster, Cub Creek Energy brought a further 16 wells on production in Q218. Drilling activity at Elster and Cub Creek Energy should support strong y-o-y production growth for DRAG over the rest of 2018, partly offset by the divestment of Salt Creek. Current hedged production stood at c 30% at a group level as of end Q118, with DRAG expected to benefit from the recent rise in WTI, which currently stands at $71/bbl.

DRAG's metal investments continue to benefit from a rise in underlying commodity price. They make up just 19% of our SOTP valuation, which includes them at book value.

Financials

DRAG's revenues increased significantly from 2016 to 2017. This is supported by an increase in oil and gas production that reached an annual average of 5,123boed (937boed in 2016) in conjunction with an increase in oil prices. DRAG is exposed to fluctuations in realised price across multiple commodities, with greatest leverage to oil and gas prices in the US and regional discounts to the WTI crude benchmark. Prices have been volatile, driven by commodity-specific supply/demand dynamics. WTI reached $26 per barrel in Q116 and finished 2017 at approximately $60 per barrel; current spot WTI trades at $71 per barrel.

DRAG's cash flow statement reflects the significant increase in investments made in the US oil and gas assets and the consequent increase in the net debt that financed these, through the issuance of bonds and loans from banks.

Investors should expect financial metrics to remain volatile as management continues to acquire and divest assets, and should focus on cash returns on investments achieved on such deals.

Exhibit 1: Financial summary and consensus forecasts

German GAAP (€000s)	2013	2014	2015	2016	2017	2018e	2019e
Income statement							
Sales revenue	17,762	22,870	1,899	9,170	53,746	82,200	130,450
Growth %		29%	(92%)	383%	486%	796%	59%
EBITDA	1,906	113,768	4,906	6,374	36,138	69,350	114,450
EBITDA Margin %	11%	497%	258%	70%	67%	84%	88%
EBIT	(5,432)	88,726	2,419	(541)	5,305	57,150	97,000
Net profit (after minority interests)	(7,809)	84,661	(557)	102	5,549	22,950	32,850
Number of shares (000s)	5,322	5,322	5,063	5,063	5,063	5,063	5,063
EPS adj. (€/share)	(1.47)	15.91	(0.11)	0.02	1.10	4.38	6.26
DPS (€/share)		0.50	0.55	0.60	0.65	0.83	0.83
Balance sheet – selected data							
Cash and cash equivalents	50,461	103,325	83,032	28,090	29,699		
Total assets	134,696	134,696	128,054	193,472	213,574		
Total debt	71,485	63,518	57,962	75,243	106,576		
Total liability	90,241	67,821	62,185	109,146	121,901		
Shareholders' equity	38,894	62,488	61,840	66,121	56,675		
Cash flow statement							
Net cash from operating activities	(1,768)	(18,976)	1,193	2,914	37,848		
Net cash from investing activities	(37,277)	89,588	(15,100)	(38,791)	(51,625)		
Net cash from financing activities	(47,469)	(47,469)	(14,066)	11,516	24,735		
Net cash flow	29,832	23,143	(27,972)	(24,360)	10,958		
Bank balances (including investments)	39,815	74,089	48,445	24,634	28,368		
Net debt/(cash)			(25,070)	47,153	76,877		

Source: Deutsche Rohstoff, Bloomberg

Management expects 2018 group revenues to increase to €75-85m and EBITDA to €65-70m. This forecast is made on the basis that the new wells will lead to a further significant increase in production, already evident in Q118, an average oil price assumption of $65 per barrel and a US$/€ exchange rate of 1.22. Q118 figures show that the company generated revenues of €15.6m in the quarter and an EBITDA of €10.6m. The agreed sale of the Salt Creek assets is expected to complete in Q218.

Valuation

Taking into account the agreed sale of the Salt Creek assets, the market value of DRAG is between the NPV_{10} of the 1P and 2P reserves (Ryder Scott CPR as of December 2017) for its net oil and gas investments plus book value of mining assets minus net debt. We believe asset value is an appropriate basis for valuation of DRAG over traditional P&L metrics such as P/E or EV/EBITDA due to the nature of its investments. We would expect DRAG's P&L to remain volatile due to asset acquisitions, divestments and asset impairments. Over a longer time horizon, investors may wish to consider return metrics such as ROACE, ROIC and ROE to formulate a view on management's ability to create value through its acquire, develop and divest strategy.

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 (€)**	**Value (€m)**	**Value per share (€)**
Oil and gas					
- Ryder Scott CPR**(Cub Creek and Elster)	CPR	127.8	25.2	148.9	29.4
- Salt Creek SPA (expected net proceeds)	Sales proceeds	45.7*	9.0	45.7	9.0
Mining	Book value FY17	23.3	4.6	23.3	4.6
Cash at bank	Book value FY17	29.7	5.9	29.7	5.9
Debt	Book value FY17	(106.6)	(21.0)	(106.6)	(21.0)
Total equity valuation		**119.9**	**23.7**	**141.0**	**27.8**
Market value		125.0	24.7	125.0	24.7
Delta		-4%	-4%	13%	13%

Source: Deutsche Rohstoff, Edison Investment Research. Note: US$/€ 1.19; *DRAG owns 90% of Salt Creek; **CPR dated December 2017.

Our end 2017 SOTP valuation (Exhibit 2) has decreased, mostly due to an increase in debt relative to 2016 and a lower valuation of DRAG's oil and gas assets. The increase in debt was partly to fund Salt Creek and Elster drilling campaigns, with Elster reporting first production in Q118. DRAG's total production in Q118 (491kboe) has almost doubled since Q117 (257kboe).

Since the end of 2017, the agreed sale of the Salt Creek assets reduced the SOTP valuation relative to end 2016, due to it being sold at an amount that is below the 2016 2P CPR value. However, we highlight that the deal was carried out at premium to the last published NPV_{10} of proved developing reserves, generating a strong ROI for DRAG shareholders. The other factors that have reduced the oil and gas asset valuation are the increase in the US$/€ exchange rate from 1.13 to 1.19 (approximately 5%) between CPR publications, produced barrels and assumed WTI pricing. The average NYMEX forward strip over the next 10 years, which is used to calculate NPV_{10} values, is around 5.5% lower than at the December 2016 CPR publication. A stronger than expected decline in production at Cub Creek led to a decrease in its reserve value.

If oil prices remain at current spot levels, a significant upwards revision to reserve values at end FY18 is expected. DRAG will report a profit on the sale of the majority of Salt Creek Oil & Gas in FY18.

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