SDX Energy

Capital markets day

In an enviable position in the sector

Oil & gas

At its recent capital markets day, SDX Energy reiterated 2020 production guidance and highlighted its strong cash generation, with c 90% of post-tax operating cash flows derived from fixed-price gas contracts. Management presented its 2021/22 plan of activities, targeting three wells in Egypt with potential to add 179bcf of recoverable reserves from a 233bcf exploration portfolio under assessment, and at least four exploration wells in Morocco. With increasing FCF, capital is likely to be directed to expansion of reserves but, absent this, offers the alternative option of returning capital to shareholders. Our mid-case RENAV remains in line with our last valuation at 45.0p/share.

Year-end	Revenue ($m)	PBT ($m)	Operating cash flow ($m)	Net cash ($m)	Capex ($m)	Production (kboed)
12/18	53.7	7.1	36.2	17.3	(44.8)	3.6
12/19	53.2	(12.3)	25.1	11.1	(31.3)	0.0
12/20e	42.6	10.0	29.7	16.6	(26.2)	5.8
12/21e	43.5	13.5	31.5	25.8*	(23.1)	6.4

Note: * Accounts for the wells to be drilled and connected in Morocco but does not account for the exploration wells to be drilled at South Disouq given these are contingent on final approval for the extension of the exploration licence.

Hanut resource could extend production by five years

In the recent update on its operations and financial position, SDX's focus was on its cash-generative fields and prospectivity around these assets. SDX highlighted Hanut, a prospect that lies 4.5km south-east of the South Disouq field. Like Ibn Yunus and Sobhi, Hanut is a basal KES deposit defined by high-amplitude seismic response, which is a good indicator of gas-filled sands in South Disouq. SDX estimates that Hanut has 139bcf of prospective recoverable resource and plans to drill the prospect in late Q221 or early Q321, once ministerial approval is obtained.

Excess cash provides optionality and flexibility

With a healthy balance sheet, we expect SDX to direct its FCF to exploration drilling and/or acquisitions. However, its healthy balance sheet and the nature of its business also provides the opportunity to return capital to shareholders. In this note, we test SDX's ability to distribute dividends. We estimate unrisked FCF yields post FY22 of more than 50% based on present plans. SDX has yet to establish a dividend policy, however the company has indicated that a dividend could be distributed from 2022. At the current share price and assuming 40% of FCF distribution, we estimate dividends could yield up to 20% from 2022.

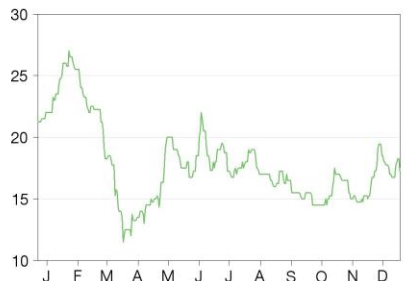
Valuation: RENAV at 45.0p/share

Our RENAV remains at 45.0p/share, as we have adjusted our short-term commodity price assumptions and updated capex in line with the 2021/22 work plan. Currently, our valuation does not account for Hanut or Warda, which could add significant upside, as SDX waits for the extension to exploration rights to be granted. The current share price appears to be heavily discounting SDX-sanctioned projects, which correspond to c 80% of our RENAV, as well as any future growth potential in Egypt and Morocco.

21 December 2020

Price	**18.0p**
Market cap	**£37m**
	US$1.27/£
Net cash ($m) at 30 September 2020	9.2
Shares in issue	205.4m
Free float	83%
Code	SDX
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	13.1	11.3	(23.3)
Rel (local)	10.6	1.2	(13.0)
52-week high/low		27.0p	11.5p

Business description

SDX Energy is a North African E&P listed in London. SDX produces oil and gas in Egypt and gas in Morocco.

Next events

LMS-2 well test	Q221
Drill Ibn Yunus-2	Q221
Drill Hanut	H221
Morocco drill campaign	H221

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Edison profile page

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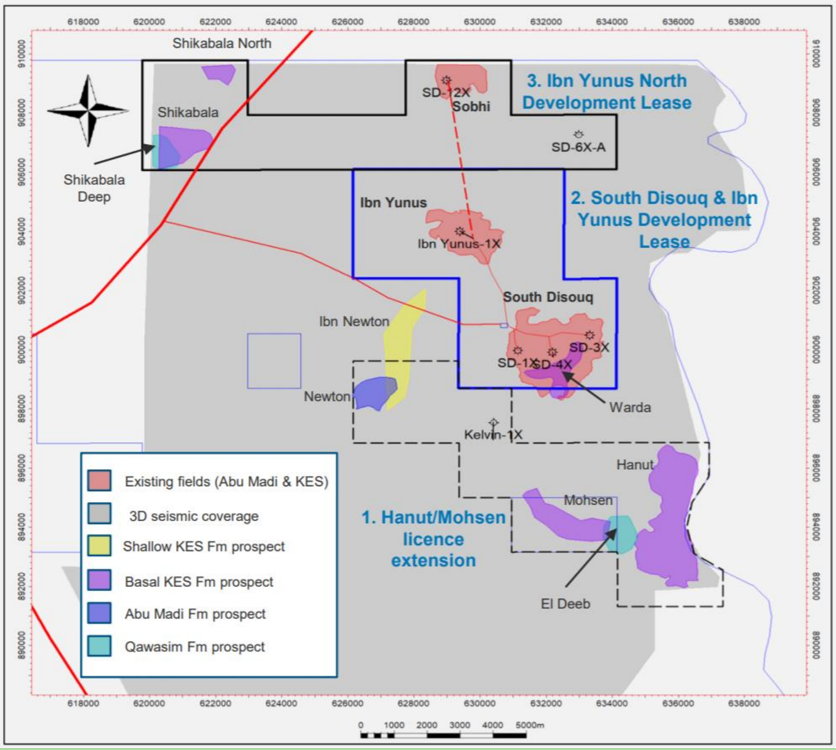
Strong production supports cash generation

At its capital markets day, SDX provided an update on its strong production, reiterating guidance for 2020 at 6,000–6,250boed (which includes North West Gemsa and South Ramadan production) and strong cash generation. The presentation focused on detailing the prospectivity around the South Disouq field in Egypt and the BMK area and the newly identified prospectivity in the Top Nappe play in Morocco.

In Egypt, the company is focusing on six primary prospects amounting to a total prospective recoverable resource of 233bcf. Hanut is the most material prospect, with a management estimated prospective recoverable resource of 139bcf, followed by Mohsen with 26bcf, El Deeb 22bcf, Warda 14bcf, Ibn Newton and Newton (a dual prospect) 16bcf, and the Shikabala cluster with 16bcf.

Exhibit 1: South Disouq exploration prospect overview



Source: SDX Energy

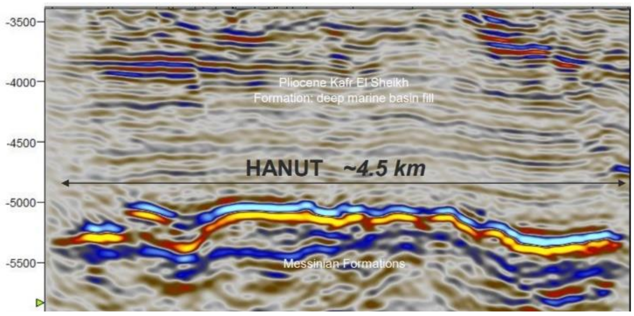
In Morocco, the successful wells at BMK-1 and OYF-2 drilled in Q120 have extended the existing production and development area to the north of Sebou. Management estimates that these wells de-risked more than 18bcf of recoverable resource in the BMK area. SDX is seeking to accelerate a four-well exploration campaign to H121 that will develop the potential of the area, and confirm the potential of the extension to the core area. There is also potential in the new Top Nappe play below SDX's core area, and the company will seek to test this play with a dual target well during the next drilling campaign. Future discoveries would allow SDX to expand the infrastructure incrementally so that future connection costs are managed sustainably.

Hanut: Potential high-impact South Disouq well

In 2021, SDX will drill one exploration well in South Disouq, on the potentially high-impact Hanut prospect, which management estimates holds 139bcf recoverable volumes. The prospect was identified after the company had reviewed the remaining prospectivity of the area, particularly in the basal Kafr El Sheikh (KES) horizon, which had been de-risked by the Ibn Yunus and Sobhi discoveries.

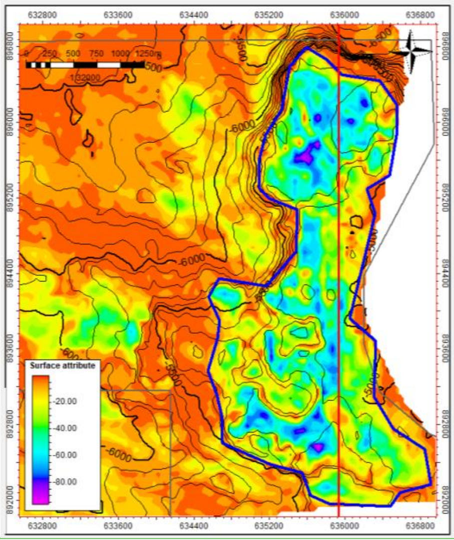
Hanut sits 4.5km to the south-east of the South Disouq field on the eastern margin of the South Disouq concession. Terms to extend the exploration period by two years for the area covering Hanut and Mohsen are required, given the exploration licence expired in 2020. The terms of the extension have been agreed between SDX and EGAS, but are pending on final ministerial and parliamentary ratification, expected in H121. SDX will operate the well and is in discussions with partner IPR (WI 45%) regarding its participation.

Exhibit 2: Seismic section with high amplitude response



Source: SDX Energy

Exhibit 3: Hanut Base KES negative amplitude extraction

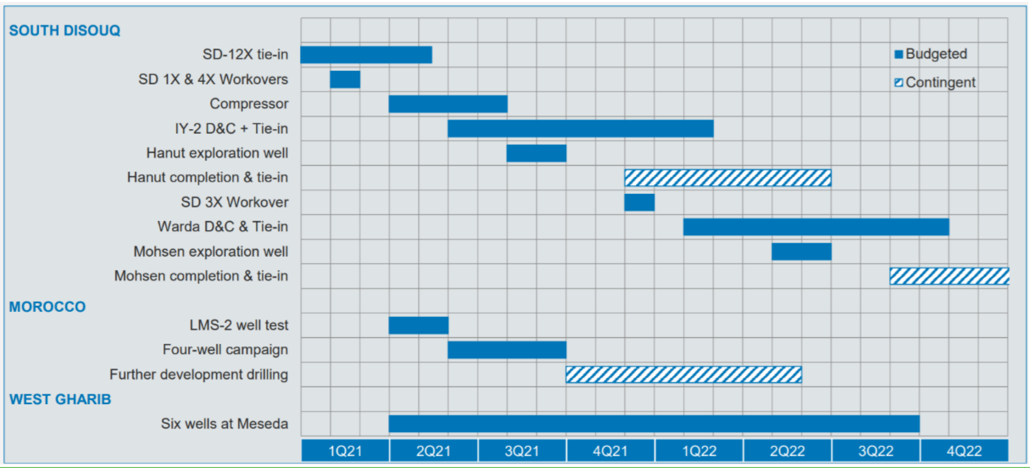


Source: SDX Energy

The Hanut prospect is a basal KES formation turbidite sand deposit, defined by a high-amplitude response (shown in bright blue in Exhibit 2) on 3D seismic, which shares the same seismic response characteristics seen in the proven basal KES gas accumulations in Ibn Yunus and SD-12X. Hanut is a stratigraphic prospect, relying on the overlying shales to provide a trap. SDX has assigned a 33% chance of success (CoS), reflecting the fact that the eastern closure is not fully imaged (cf the nearby smaller Mohsen prospect, to be drilled in 2022, which has a 51% CoS and is fully covered by 3D seismic).

In the event of success, a discovery of 139bcf would be a step change for South Disouq, given the existing dry gas 2P reserves for South Disouq and Ibn Yunus is 84bcf (based on end-2019 reserves audit). SDX plans to drill Mohsen and Warda, two further prospects similar to Ibn Yunus and SD-12X, in 2022, targeting P50 prospective recoverable resources of 26bcf and 14bcf respectively.

Exhibit 4: SDX Energy 2021–22 activities plan



Source: SDX Energy

Valuation

We value SDX using an asset-by-asset net asset value (NAV) derived from detailed discounted cash flow modelling. The core value includes production, development and contingent resources that could be developed, while exploration is valued only if wells are planned and funded in the next 12 months. We apply a 12.5% discount rate given the geographical distribution of the assets and the size of the company. We have updated our short-term commodity prices based on the latest EIA estimates. Our short-term Brent assumptions move from $41.9/bbl to $40.6/bbl in FY20 and from $49.1/bbl to $46.6.1/bbl in FY21, based on EIA forecasts published in November 2020. Our long-term price assumptions remain in line with our previous note, where we presented three scenarios with Brent in 2020 at $40/bbl in our low case scenario, $50/bbl in our mid-case scenario and $60/bbl in our high case scenario, escalated at 2.5% per year resulting in 2022 prices of $42.0/bbl, $52.5/bbl and $63.0/bbl, respectively. We continue to assume Moroccan gas prices of $10.85/mcf in 2020 inflated at 2.5%. In addition to commodity prices, key changes to our updated valuation and estimates include updated FY21 capex based on the company's proposed work programme.

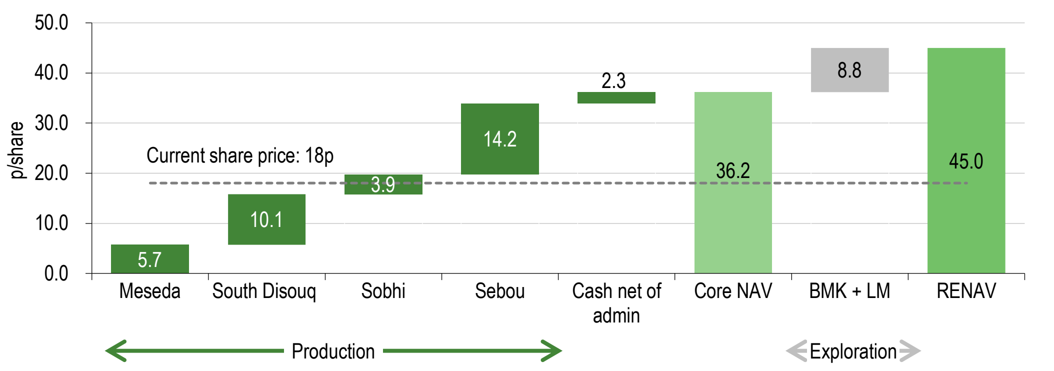
Exhibit 5: Edison updated forecasts

	New		Old		Difference	
	2020e	2021e	2020e	2021e	2020e	2021e
Production (kboed)	5.8	6.4	5.8	6.4	0%	0%
Revenue ($m)	42.6	43.5	37.9	44.0	12%	-1%
EBITDA ($m)	25.2	31.1	20.5	31.6	23%	-2%
Capex ($m)	26.2	23.1	26.2	19.7	0%	17%
Brent ($/bbl)	40.61	46.59	41.90	49.07	-3%	-5%
SD gas price ($/mcf)	2.85	2.85	2.85	2.85	0%	0%
Sebou gas price ($/mcf)	10.85	11.12	10.85	11.12	0%	0%

Source: Edison Investment Research. Note: FX US$1.27/£ based on the average of Q220 and Q320.

In Egypt, our updated valuation includes net proceeds for the disposal of North West Gemsa and South Ramadan as the company successfully disposed of the assets in July 2020 and November 2020, respectively, for a total of $2.1m. The updated valuation includes a second producer well at Ibn Yunus, to be added in Q2/Q321 to maximise recovery from the field. In Morocco, we continue to include the reserves reported at 31 December according to the FY19 annual report as well as the SAH-3 and OYF-2 wells, which were already completed as commercial discoveries during Q120. For 2020, we maintain our estimates in Morocco with a gas production level of 5.95mmscfd for the year, in line with guidance of 5.3–6.0mmscfd. Risked exploration includes the BMK-1 discovery and the potential 18bcf located in close proximity to the BMK-1 well in what the company calls the BMK area, and the LMS-2 discovery. The LMS-2 well indicates 10.6m of net gas reservoir with 30.9% porosity in the well. However, testing is required to determine its commercial potential once COVID-19 restrictions are eased, allowing SDX to bring a testing crew into the country.

Exhibit 6: SDX Energy NAV breakdown



Source: Edison Investment Research

We highlight that at this point we are not taking into consideration the 233bcf prospective resources of potential additional upside that is currently being evaluated by the company in the South Disouq area. However, as these projects develop and the exploration licence extension is granted, we will update our valuation accordingly. All in all, our mid-case risked exploration net asset value (RENAV) remains in line with our last note at 45.0p/share, with our core value standing at 36.2p/share, equivalent to 80% of our RENAV, and materially different from the current share price of 18.0p/share. Overall, our core net risked valuation remains broadly in line with our previous note at $94m, reflecting the lower near-term oil price estimates, offset by the net proceeds from South Ramadan disposal.

Exhibit 7: SDX Energy detailed valuation

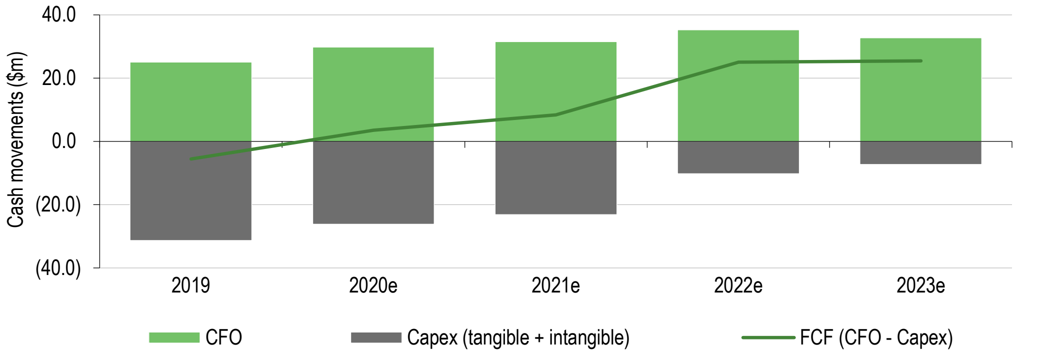
Asset	Country	Diluted WI		Recoverable reserves					Low ($40/bbl)	Mid ($50/bbl)	High ($60/bbl)
		%	CoS	Gross	Net WI	Net	NPV	Net risked value	Net risked value per share		
			%	mmboe	mmboe	mmboe	$/boe	$m	p/share	p/share	p/share
Net cash at 31 December 2019								11.1	4.3	4.3	4.3
SG&A - $NPV_{12.5}$ of three years								(9.2)	(3.5)	(3.5)	(3.5)
FY20 E&A expense								(17.6)	(6.8)	(6.8)	(6.8)
NPV of net receivable recovery								9.7	3.7	3.7	3.7
Sebou pipeline residual value (30% cost)								9.8	3.8	3.8	3.8
Egypt disposals net proceeds								2.1	0.8	0.8	0.8
Production											
Meseda Base + workovers + Rabul	Egypt	50%	90%	9.0	4.5	1.7	3.7	14.9	4.3	5.7	7.2
South Disouq + Sobhi	Egypt	70%	100%	18.7	12.1	12.1	3.0	36.4	13.9	14.0	14.1
Sebou 2P + volumes to be booked	Morocco	75%	100%	1.4	1.0	1.0	36.2	36.8	14.2	14.2	14.2
Core NAV				**29.1**	**17.6**	**14.8**	**4.2**	**94.0**	**34.6**	**36.2**	**37.7**
Exploration (known)											
BMK + LMS-2	Morocco	75%	62%	3.7	2.7	2.7	13.5	23.0	8.8	8.8	8.8
Total NAV				**32.8**	**20.4**	**17.6**		**117.0**	**43.4**	**45.0**	**46.6**

Source: Edison Investment Research. Note: Number of shares = 205.4m; FX = US$1.27/£.

Financials

We forecast year-end 2020 net cash of $16.6m and note that SDX's European Bank for Reconstruction and Development (EBRD) loan facility of $2.5m remains undrawn. Management intends to extend the tenor and re-establish the full availability of the $10m credit facility, subject to the customary satisfaction of conditions precedent in early 2021. Based on the capex projections that underpin our production forecasts and SDX's committed exploration programme, the company is fully funded for 2020 and 2021 and we forecast positive free cash flow (FCF) from 2021. We do not yet take into consideration capex for the Hanut and Mohsen wells given these are still contingent on final ministerial and parliamentary approval for the two-year extension to the South Disouq exploration area. We expect FCF in the coming years to be material, giving the company headroom for additional investments. As more than 90% of cash flows in the coming years will come from the fixed-price contracts gas businesses, we do not currently foresee the need for further equity capital, unless incremental growth capex, over and above our forecasts, is dedicated to new projects or acquisitions. Management's stated strategy is to grow the company both organically and inorganically.

Exhibit 8: Capex and cash flow forecasts



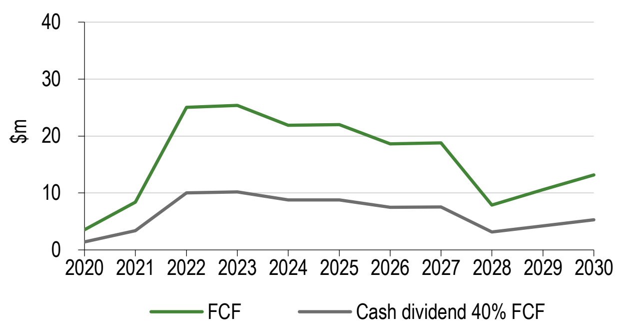
Source: SDX Energy, Edison Investment Research, Note: CFO = cash flow from operations.

South Disouq and Sebou are cash-generative assets, with low operating costs and fixed gas price contracts. Given SDX's market cap, and organic and inorganic growth opportunities, we would expect management to direct cash to extend its reserve life index – either through the drill bit or via acquisitions. Hanut, Warda and Mohsen could extend the South Disouq plateau with low investment required, given the central processing facility (CPF) is already in place. In Morocco, SDX is the only operator, other than ONHYM, that produces gas in country and is the main supplier in its area of operations, hence any discoveries around its facilities would also add value at a low investment cost. If no capital is allocated to growth opportunities, operations would cease once South Disouq had completed operations by 2030.

While we expect SDX to continue to recycle much of its FCF to grow both organically and inorganically, over time we see the potential for the company to also distribute some FCF back to shareholders as dividends. The company has not yet established a dividend policy, but based on SDX's firm exploration and development commitments (shown in Exhibit 4), including Hanut, Warda and Mohsen, we see the potential for the company to pay a dividend of c $10m pa, based on a 40% FCF payout assumption (Exhibit 10). This unrisked FCF projection and associated dividend is the equivalent of a c 20% yield at the current share price and could be payable from 2022/23.

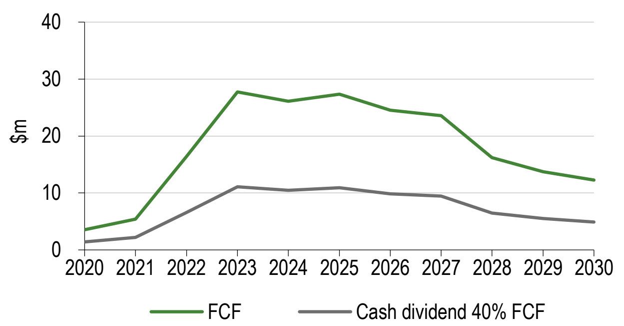
In the event the company does not drill Hanut, Warda and Mohsen (given they are still contingent on final ministerial and parliamentary approvals), the company could still pay a dividend, based on the above assumptions (Exhibit 9). Note that such dividend projections do not include additional exploration and development capex beyond the company's current plans, however with rapid monetisation of discoveries, there is clear scope for an evolving dividend policy over time.

Exhibit 9: FCF and cash dividend at 40% of FCF in a scenario where exploration rights are not granted



Source: Edison Investment Research. Note: This scenario reflects our current valuation, since SDX is still wating for exploration rights to be granted, and does not account for Hanut, Warda and Mohsen.

Exhibit 10: FCF and cash dividend at 40% of FCF under current plan of activities



Source: Edison Investment Research. Note: This scenario does not reflect our current valuation, but is in line with SDX's plan of activities and reflects the investments in Egypt once exploration rights are granted.

Exhibit 11: Financial summary

Accounts: IFRS, Yr end: December, USD: Thousands	2017A	2018A	2019A	2020E	2021E
Total revenues	39,166	53,679	53,233	42,603	43,504
Cost of sales (direct expense)	(10,254)	(11,934)	(13,900)	(8,694)	(8,536)
Gross profit	28,912	41,745	39,333	33,909	34,968
SG&A (expenses)	(8,793)	(7,270)	(6,072)	(3,932)	(4,030)
Other income/(expense)	1,820	1,025	1,161	984	764
Exceptionals and adjustments	(725)	(10,458)	(19,932)	(5,725)	(626)
EBITDA	21,214	25,042	14,490	25,236	31,075
Depreciation and amortisation	(17,824)	(17,268)	(26,295)	(15,842)	(18,706)
Reported EBIT	3,390	7,774	(11,805)	9,394	12,369
Finance income/(expense)	(129)	(542)	(511)	(552)	0
Other income/(expense)	29,558	(174)	0	1,114	1,114
Exceptionals and adjustments	0	0	0	0	0
Reported PBT	32,819	7,058	(12,316)	9,956	13,483
Income tax expense (includes exceptionals)	(4,541)	(7,021)	(5,776)	(3,371)	(951)
Fx gains (losses)	0	75	(94)	0	0
Reported net income	28,278	112	(18,186)	6,585	12,532
Shares at end of period - basic	204	205	205	205	205
Balance sheet					
Property, plant and equipment	54,445	48,680	67,895	58,217	59,090
Goodwill	0	0	0	0	0
Intangible assets	15,231	39,128	20,407	30,051	33,558
Other non-current assets	2,724	3,394	3,916	3,477	3,477
Total non-current assets	72,400	91,202	92,218	91,745	96,125
Cash and equivalents	25,844	17,345	11,054	16,578	25,752
Inventories	5,157	5,236	7,972	7,824	7,682
Trade and other receivables	37,656	24,324	21,774	17,690	15,076
Other current assets	0	0	0	0	0
Total current assets	68,657	46,905	40,800	42,091	48,509
Non-current loans and borrowings	0	0	0	0	0
Other non-current liabilities	4,506	4,572	6,698	7,521	7,521
Total non-current liabilities	4,506	4,572	6,698	7,521	7,521
Trade and other payables	19,459	14,418	25,724	23,592	21,233
Current loans and borrowings	0	0	0	0	0
Other current liabilities	2,473	3,078	2,565	1,122	1,122
Total current liabilities	21,932	17,496	28,289	24,714	22,355
Equity attributable to company	114,619	116,039	98,031	101,601	114,759
Non-controlling interest	0	0	0	0	0
Cashflow statement					
Profit before tax	32,819	7,058	(12,316)	9,956	13,483
Net finance expenses	0	0	0	0	0
Depreciation and amortisation	17,824	17,268	26,295	15,842	18,706
Share based payments	538	1,194	178	626	626
Other adjustments	(34,613)	3,224	12,718	6,043	(764)
Movements in working capital	5,412	8,584	(504)	646	397
Interest paid / received	0	0	0	0	0
Income taxes paid	(364)	(1,091)	(1,306)	(3,371)	(951)
Cash from operations (CFO)	21,616	36,237	25,065	29,742	31,497
Capex	(24,917)	(44,810)	(31,315)	(26,203)	(23,087)
Acquisitions & disposals net	(24,948)	0	0	1,000	0
Other investing activities	760	525	639	984	764
Cash used in investing activities (CFIA)	(49,105)	(44,285)	(30,676)	(24,218)	(22,323)
Net proceeds from issue of shares	48,510	114	0	0	0
Movements in debt	(43)	(197)	(1,062)	0	0
Other financing activities	0	0	0	0	0
Cash from financing activities (CFF)	48,467	(83)	(1,062)	0	0
Increase/(decrease) in cash and equivalents	20,978	(8,131)	(6,673)	5,524	9,174
Currency translation differences and other	141	(368)	382	0	0
Cash and equivalents at end of period	25,844	17,345	11,054	16,578	25,752
Net (debt) cash start of period	25,844	17,345	11,054	16,578	25,752
Movement in net (debt) cash over period	21,119	(8,499)	(6,291)	5,524	9,174

Source: SDX Energy, Edison Investment Research

EDISON

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