Research as a Service

Armour Energy Limited

Update Report

It's time to step on the gas

Energy

3 May 2023

Armour Energy Limited (ASX:AJQ) is a junior energy producer and explorer with assets across northern, southern and eastern Australia. The company is set to pursue a growth strategy with particular focus on production optimisation at Kincora to be delivered over the next 24-30 months. The success case should be readily apparent by end-2023. Importantly, we should also see a return to high-impact exploration with the drilling of the Enterprise North-1 well in the Otway Basin, over summer, subject to regulatory approvals. The success case at Enterprise North could add 150+PJ of readily commercialisable gas for the eastern markets. The company is also pursuing an early-production opportunity at its Glyde discovery in the McArthur Basin (NT). Although small, project success can unlock the gas potential of this emerging province. Armour is also undertaking a balance sheet restructure to put the company in a stronger position to work its assets at its own pace and to its own plan. We will be looking for delivery of the first-stage Kincora growth plan by end-2023 (to 10TJd) and ultimately to 20TJd in a supply constrained and rising gas price market.

Business model

Armour Energy is a junior oil and gas company holding a production base with expansion options; and an extensive exploration portfolio across three Australian states. The portfolio consists of development and exploration plays, reflecting a mix of moderate risk and early exploration stage prospects with significant, success case growth potential. The company is looking to leverage its production growth plan at Kincora, restructure its balance sheet and service a more aggressive exploration strategy, without minimal recourse to third-party financing. Dilutionary financing is always a concern for small company's although high working interests do provide options through partnering.

Marking time to gas growth

Armour is now on the path to growth with Surat Basin optimisation studies leading into prospect selection and setting the stage for the next phase in the Kincora production enhancement strategy. The completion of the capital raising and debt restructuring should provide the working capital to commit to rigs and progress approvals for drilling in perhaps both the Surat and onshore Otway basins across the end of 2023. Armour has secured a number of partnering arrangements setting up a return to the field from mid-Dec. The works at Kincora are to be the primary focus of the company's activity over the next two years and we will see the proof or otherwise of the technical programmes quite rapidly. The gas environment remains subject to stronger definition of the Federal Governments' policies and processes but overall is still supportive of new gas supply, particularly for small companies and particularly for domestic sales. The company's portfolio contains transformative oil and gas potential to be chased and exploited. Success cases should flow through to production outcomes quite rapidly.

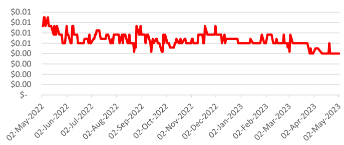
Valuation – the growth opportunity is there

Valuing pre-development phase assets is a subjective exercise, particularly considering financing timing and energy policy uncertainties. As with many small energy stocks, AJQ holds assets with transformational potential - the resource opportunity is massive. There are a number of short-medium term rerating events that can close the value gap, particularly at Kincora, Enterprise North and Glyde, which can demonstrate the intrinsic value of gas assets in a growth scenario. Forecasting gas prices in an operating environment of an increasing supply squeeze with the overhang of potentially stronger regulatory intervention remains the area of greatest uncertainty. We assign a NAV of $393mn ($0.08/share) to AJQ against a reference share price of $0.003/share. Delivering the success cases at Kincora and Enterprise North in particular, can unlock the value inherent in the 2P reserves and flow through to the remainder of the portfolio. There is a lot to potentially deliver over the next 6-12.

Share Details

ASX code	AJQ
Share price (8-Nov)	$0.003
Market capitalisation	$11M
Shares on issue	3,815M
Net Cash (as at 31-Mar)	~$16M
Free float	~40%

Share Performance (12 months)



Upside Case

- Above expectation results from Kincora gas growth programme…more gas, higher price, lower capex
- Successful drilling results at Enterprise North could deliver tangible upside and financing options
- Acceleration and commercial definition of the production opportunity at Glyde…there is a multiplier opportunity available around first northern gas

Downside Case

- Kincora programmes disappoint, downgrading the value proposition of the Surat gas plays
- Extension of gas price cap scenarios to include 'new developments' potentially negatively impacting project rates of return
- Unsuccessful drilling results at Enterprise North would cap the medium-term growth opportunities of scale

Board of Directors

Christian Lange	CEO
Nick Mather	Executive Chairman
Stephen Bizzell	Non-Executive Director
Eytan Uliel	Non-Executive Director
William Ovenden*	Non-Executive Director

**subject to confirmation of appointment to the Board*

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Marking Time To Growth

AJQ has delivered significant progress across a range of corporate initiatives, but operational performance continues at a base level running into the planned Kincora gas growth project with output targeted to reach 10TJd by end-2023 in an initial phase. Gas prices, whilst stronger under contract terms, were offset by weaker sales volumes overall.

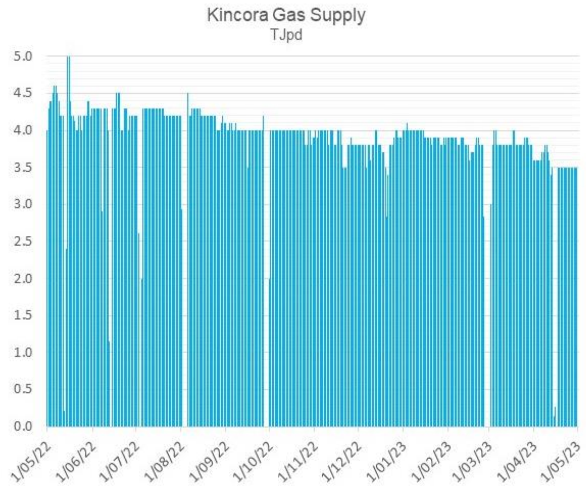
Exhibit 1: January quarter highlights and comments

Production and revenue		4QFY22	1QFY23	2QFY23	3QFY23	ΔQoQ %
Production was down QoQ on five days of unplanned shutdown, impacts from export route closures through Jan-Feb and natural decline.	**Sales (TJe)**	**457**	**403**	**433**	**392**	**(9)**
	Sales revenue ($mn)	4.1	3.3	3.5	3.1	(11)
	Debt ($mn)			**20.0**	**17.2**	
	Gas (TJ)	379	346	356	340	(4)
	Ave gas rate TJd	*4.16*	*3.76*	*3.87*	*3.78*	
	LPG (t)	473	353	660	533	(19)
	Oil (b)	1,244	1,693	2,131	860	(60)
	Condensate (b)	7,582	4,716	5,004	4,809	(4)
Continuing lift in realised commodity prices – gas up 8%, liquids up 9-15%...offset by weaker volumes.	**Gas ($/gj)**	**6.4**	**6.4**	**6.4**	**6.9**	**8**
	LPG ($/t)	663	558	848	926	9
	Oil and condensate ($/b)	**141.0**	**159.2**	**103.4**	**118.5**	15

Development, exploration and appraisal	
Two-three stimulation targets expected to be undertaken before end-2023. Work has commenced on design work for the infield stimulation campaign.	The Myall Creek-5A recompletion was successfully delivered in December with production somewhat inhibited by completions fluids. Coiled tubing works were completed through January, however, subsequent anlayses indicated the well was still being impacted by residual fluid impacts form the 2019 campaign. Well recovery is progressing but at a slower rate than anticipated. The Rednook-1 well produced across the quarter at a stabilised rate of 190mcfd. Further intervention is planned for later in this year to optimise production. *As outlined in our re-initiation report (20-Apr), the company has reset and refreshed the strategy aiming to deliver near-term production growth, develop new fields and evaluate its high-grade exploration/high leverage exploration opportunities.* *The intial phase of works is focussed on production enhancement at Kincora through a staged campaign - restoring gas flow to 6TJd through a well intervention campaign with targetted output of 10TJd by end 2023, this may include the drilling of one well before end-2023.* *A greater Field Development Plan in collaboration with SLB (formerly Schlumberger) aims to* ***optimise production*** *together with infill, exploration and appraisal drilling targeting 20TJd by end-2025.*
	Myall Creek 3D seismic reprocessing is continuing and expected to be available in July.
It's not just the Surat Basin… *Refer the RaaS ReInitiation Report for more a detailed discussion of the prospect and speculative commercial (success case) value.*	**Preparations for the drilling of the proposed Enterprise North-1 well** are under way, targeting the summer drilling window in the onshore Otway Basin. *Enterprise North is mapped as being on trend and highly correlated with the Enterprise and the Minerva gas fields. Pre-drill estimates range from 50-150PJ on a success case and development timelines in analogue discoveries like Enterprise and Speculant have demonstrated success can be monetised relatively rapidly and inexpensively.*
Refer the RaaS ReInitiation Report for more details.	The technical review of the **Glyde-1 results (McArthur Basin, NT)** has set the base for follow-up works in support of gas economics to support the conditional supply agreement into the Merlin Diamond Project**.**
Corporate.	
Capital raising and debt restructure under way.	The company is actively addressing mechanisms to strengthen the balance sheet and provide a more stable platform to finance its growth options and work the asset base. As announced on 23-March, the company is seeking to raise $32mn (before costs) through an Instituional Placement and Entitlement Offer (totalling $12mn) whilst restructuring the debt away from the current Amortising Notes (FIIG Notes) through the issue of new Armour Notes ($20mn) subject to approval at the EGM.
Cash and working capital.	The cash balance as at 31-Mar was $5.3mn. Remaining debt as reported at the end of the period was $17.2mn. Exploration, evaluation and development expenditure for the period totalled ~$1.1mn and ~$0.6mn YTD.

Source: Company data; *Analyst commentary*

Exhibit 2: 12-month production is steady – but it's now the time to deliver more



Kincora output has remained broadly steady, continuing to deliver between 3.5-4.5TJd but highlighting the inherent upside that can be captured on improving gas throughput in a plant with ullage and operating on a dominantly fixed-cost basis.

We note the potential impact that a single success (well intervention or new well) can have across the existing production base.

There is a material gas growth play to be delivered here and we will likely have the answer by end-2023 in terms of what can be delivered and at what cost.

Source: AEMO data

Valuation Is Unchanged At $393mn

We ascribe a value for AJQ of $393mn ($0.08/share post completion of the share offer) noting the closing share price of $0.003/share (1-May) represents a substantial discount to our NAV.

Exhibit 3: There is asset value that needs to translate to the bottom line

		WI	Pr	A$mn	A$/sh	
Queensland						
Kincora (base case)	Various	100%	90%	$49		Based on 2P volumes with a RaaS discretionary weighting
Kincora (growth scenario)			50%	$97		
Exploration	Various	100%		$15		
Newstead Gas Storage		100%	50%	$20		Nominal
Northern Australia	Various	100%				**McArthur Basin**
Contingent Resources	EP 171		75%	$29		Glyde Project – gas pricing is the critical unknown
Prospective Resources	Various		3%	$96		Subjective and heavily discounted – but the law of large numbers applies
Southern Australia						
Enterprise North	PEP 169	51%	40%	$90		Subjective on a pre-drill basis. Refer **Exhibit 19** for methodology. Note the discretionary RaaS weighting
Wombat-Trifon	PRL 2	15%	25%	$10		Nominal based on a look-through LKO valuation
Exploration	Various			$5		Nominal
Cooper Basin				$10		Exploration asset and we suggest low on the priority list
Other				$3		~6% shareholding in LKO
				$422	**$0.11**	
Net cash/(debt)				($25)		
Corporate				($5)		
TOTAL				**$393**		
Shares issued (mn)	3,815				$0.10	
Shares issued (mn)	**5,327**				**$0.08**	**From guidance on a post-offer basis**

Source: RaaS analysis; Risked ranges based on discretionary RaaS risk adjustments

We highlight that discounts of this magnitude are not unusual in the small-cap energy space where companies, like AJQ, are asset rich with transformational upside on small or restricted production bases. The key to closing the valuation gap is to progress commercial outcomes by working assets.

Armour's strategy is to focus on the immediate 'low-hanging' production opportunities at Kincora and Glyde to grow the production output into a strengthening commodity price environment – there is growth to be delivered.

We also add that the uncertainties associated with current political energy policies is increasing the perception of risk across the sector. Investors are in buy-the-fact mode and ultimately that is down to delivering more gas and greater cash flow.

More clarity on gas policy?

The Federal Government has released its draft gas industry Code of Conduct which ostensibly clears the way forward for smaller gas operators, although we remain somewhat cautious given the 'devil is always in the detail' with respect to what the terms and conditions translate to in practice.

Industry body APPEA has released preliminary observations regarding the proposed mandatory code of conduct suggesting that whilst the Code recognises the *"…critical need for investment in new gas supply to avoid future shortfalls in the east coast domestic market and to put downward pressure on gas prices"*, the process and practice of the operating regulations remains somewhat "uncertain" (at least in my interpretation of its commentary).

As we read it, the Code basically indicates there will be "…*automatic exemptions from price controls for small domestic-only producers"* but *"…meaningful supply investments will require further conditional exemptions"*.

With the $12/gj price cap for new gas contracts extended through to mid-2025, the exemption from price control is welcome news for AJQ (and others) but we are unclear as to **what volume of contract or supply rate constitutes meaningful supply** and given the market squeeze as modelled in AEMO/ACCC estimates perhaps gets larger over time, **is the threshold on what constitutes meaningful supply subject to change?**

We also note that the 'further exemptions' condition will be at the joint discretion of the Climate Change and Energy Minister and Resources Minister; and will need to be approved by five separate government departments and agencies.

Exemptions (as granted) may only be in effect for one year, opening the possibility that some projects *"…may need to reapply many times over the course of project operations, with no guarantee that the basis for an exemption today will be sufficient for an exemption in the future*". APPEA also indicated that *"…[c]onditional exemptions may also be varied or revoked at any time".*

We ponder if these conditions apply to projects that have expansions phases – so at start-up what is considered to be not meaningful, with growth/expansion phases, could be?

There are a number of projects that could be considered to be phased with small-scale start-up and expansions of which Carpentaria should be one.

As pointed out by APPEA *"…[l]ong-term capital investments for new gas supply cannot be made on the basis of one year of certainty"* and whilst these T&Cs may of necessity be couched in oblique/opaque terminology to cover potential loopholes, the "discretionary" nature of the process is probably the key area of concern.

A piece of good news for the industry per se, is that the draft Code likely won't be imposing a 'cost-plus' model and binding arbitration in terms of its reasonable-pricing provision. As commented though, *"…the revised approach* [may continue to represent] *significant complexity and Ministerial discretion to the operation of the gas market".* However, in the absence of a cost-plus model, just **what will be the mechanism to determine the 'reasonable price' and does that reference $12/gj as a starting point?**

APPEA conclude by commenting that *"…further clarity and refinement will be needed across a number of areas to ensure the domestic gas market is able to function effectively".*

FINANCIAL SERVICES GUIDE

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