EDISON Scale research report - Update

Deutsche Rohstoff

Oil & gas

11 May 2021

High operational leverage to provide benefit

Deutsche Rohstoff's (DRAG's) flexible business model has enabled it to rise out of the 2020 downturn with cash, including marketable securities, of €22.8m and cheaply purchased undeveloped acreage (in June 2020) offering potential for up to 100 wells. Production could increase by up to 50% during FY21 (based on the top end of management guidance) and EBITDA could almost double, based on an oil price of $60/bbl. DRAG expects to invest up to $60m in FY21 to build up additional production, including c $45m in drilling 12 horizontal wells (2.25 miles in length), which should commence production in Q421, and therefore production is expected to increase further in FY22. We are encouraged by Q1 results (reported today), which show DRAG is comfortably on track to meet its full year guidance.

Production ramping up again as oil price recovers

The key Cub Creek Olander pad was opened again in early January and is ramping up production. DRAG now expects net production of 5,700–6,300boepd from existing wells in FY21, an increase of 35% to 50% from FY20 (4,213boepd). This does not include new wells such as those expected at Bright Rock, where a possible 10 to 15 new wells could see production increase by c 75% to 700boepd during 2021 (from c 400boepd in January), or the undeveloped acreage acquired in June 2020 (potential for up to 100 wells), which could commence drilling in 2021.

EBITDA expected to almost double

Assuming the recent strong oil and Henry Hub prices persist, with WTI averaging above $60/bbl since mid-February, DRAG will benefit from its high operational leverage. Management, which is typically conservative in its guidance, expects FY21 EBITDA in a range of €42–47m, which is almost double FY20 EBITDA (€23.9m).

Valuation: Below audited reserve values

DRAG's 8 March 2021 independent 1P and 2P valuation of its oil and gas assets was $211.6m (€176.3m), including Elster Oil & Gas, Cub Creek Energy, Salt Creek Oil & Gas and Bright Rock Energy. It assumes a long-term oil price of c $55/bbl. We assume DRAG's mining assets are valued at book value and adjust for end-FY20 net debt. This amounts to a SOTP valuation for 1P reserves of c €103m or €20.3/share (45% above current share), rising to €24.2/share including 2P reserves.

Historical results for FY18–20 and company guidance for FY21–22

Year end	Revenue (€m)	EBITDA (€m)	EPS (€)	DPS (€)	Capex (€m)	Dividend yield (%)
12/19	41.2	22.7	0.1	0.1	28.7	0.7
12/20	38.7	23.9	-3.1	0.0	36.8	N/A
12/21e*	59.5	44.5	>0**	N/A***	N/A	***
12/22e*	62.5	42.5	>0**	N/A***	N/A	***

Source: Edison Investment Research, DRAG. Note: *FY21 and FY22 figures are mid points of company guidance; **DRAG expects to achieve a clearly positive group results in both FY21 and FY22; ***payment of a reliable and, if possible, increasing dividend remains a key objective.

Price	**€14.0**
Market cap	**€71m**

Share price graph

Share details

Code	DR0
Listing	Deutsche Börse Scale
Shares in issue	5.082m
Net debt at end Q121	€88.4m

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

- High operational leverage provides benefit in recent strong oil price environment.
- Cheaply acquired undeveloped acreage offering potential for up to 100 new wells.
- Stable liquid position in current environment.

Bear

- Permanently low oil price (WTI<$40/bbl) would threaten DRAG's existence.
- May be unable to raise sufficiently low-cost debt.
- Faster than expected declines in existing wells, or more than expected uneconomic wells in yet-to-be developed acreage.

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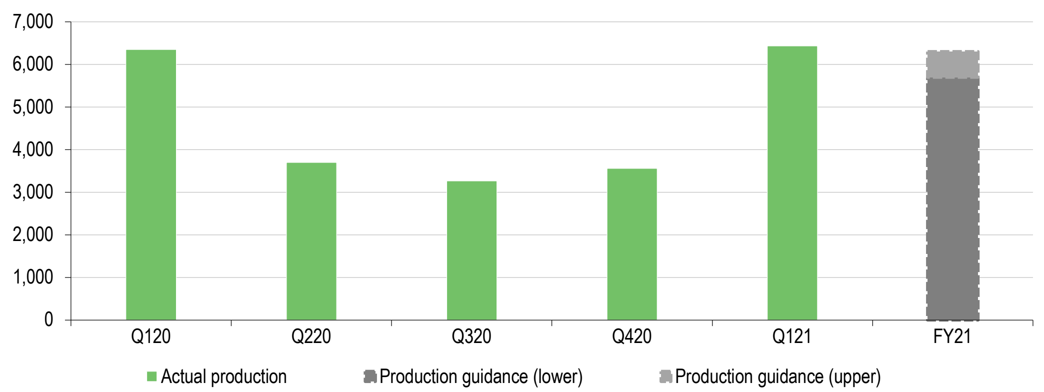
Production already back at pre-COVID-19 levels

DRAG's business strategy remains the identification, development and monetisation of attractive resource projects in North America, Australia and Europe, with a focus on the development of oil and gas deposits in the United States, where it operates through its subsidiaries Cub Creek Energy (88.46% ownership), Elster Oil & Gas (93.00%), Salt Creek Oil & Gas (100%) and Bright Rock Energy (98.35%). It is mostly active in shale basins in Colorado (c 90% of production in FY20), North Dakota, Utah and Wyoming. The company responded quickly to the COVID-19 global pandemic by reducing costs and cutting back production, particularly in Cub Creek Energy. A drilling programme to develop the Cub Creek Knight pad was postponed. Despite the challenging conditions, the company produced 4,213boepd in FY20, only 6.6% below FY19 (4,509boepd), with production in FY20 comprising 46% oil (43% in FY19).

The key Cub Creek Olander pad, which was producing c 6,000boepd prior to significant onset of the pandemic, was cut back from mid-March 2020 and completely closed in by the end of April to avoid selling oil at historically low prices. The wells remained closed for the rest of 2020 and were opened again in early January as the oil price recovered, with rates at 4,000boepd by the end of January and expected to continue to rise. The older Cub Creek drilling sites began producing again in October 2020 at around 1,000boepd, in line with expectations.

The company now expects net production of 5,700–6,300boepd from existing wells in FY21. This does not include new wells such as those expected at Bright Rock, where a possible 10 to 15 new wells could see production increase by c 75% to 700boepd during 2021 (from c 400boepd in January). In addition, Bright Rock purchased c 30,000 acres in the Powder River basin (Wyoming) at a low cost in June, which, due to the market conditions at the time, represented only the discounted value of existing production. The Powder River basin accounts for c 50% of Bright Rock's existing production (c 400boepd) and there is also significant undeveloped acreage (offering potential for up to 100 wells), which could start to be drilled as early as 2021. In total, DRAG expects to invest up to $60m in FY21 to build up additional production, including c $45m in drilling 12 horizontal wells (with 2.25 miles length), which should commence production in Q421, and therefore expects to increase production further in FY22. We are encouraged that Q121 results give production of 6,432boepd which is above the top end of the full year (FY21) guidance range, and back at pre-COVID levels (Q120: 6,348boepd).

Exhibit 1: O&G production reported in Q120 to Q420 against guidance for FY21 (boepd)



Source: Edison Investment Research, DRAG

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Financials

The company generated sales of €38.7m in FY20, within the forecast range of €37–40m and only marginally below FY19 sales (€41.2m), assisted by €12.4m hedge proceeds. EBITDA was €23.9m, 5% ahead of FY19 (€22.7m), again within the guidance range (€23–26m). Management had significantly increased guidance in November (at the nine-month results), having previously increased it in August (at H2 results), following a massive cut to initial guidance for 2020 in April.

Revenue for H220 was €12.6m, which is 26% below H219 (€17.0m). This is due to a combination of lower production, lower oil price and most of the hedge proceeds being realised in H120 (€10.2m versus €2.2m in H2). Reported EBITDA for H220 was €8.2m, which is 8% above H219 (€7.5m); however, on adjusting for one-off items, mostly within 'other operating income' (which includes profit on sale of mining shares), adjusted EBITDA for H220 was €3.8m, which was 30% below H219 (€4.4m). With oil prices (and oil and gas shares) increasing significantly since November, DRAG should start to see benefits from its high operational leverage; WTI was sub-$40/bbl at the start of November and has averaged above $60/bbl since mid-February; similarly, Henry Hub, which spent most of March 2020 to July 2020 below $1.8/mmbtu, has been mostly trading above $2.5/mmbtu since October 2020, with periods above $3/mmbtu. We note that some upside is capped as DRAG has entered hedging contracts at c $45/bbl for 45% of its 2021 production.

Management has announced the following guidance for FY21 and FY22:

- **Group sales:** FY21 in a range of €57–62m; FY22 in a range of €60–65m.
- **EBITDA:** FY21 in a range of €42–47m; FY22 in a range of €40–45m.
- **Group (net profit) result:** clearly positive in both years.

EBITDA guidance includes 'other operating income' of €7.7m, which typically includes sales of assets (fixed and/or current). This likely explains the higher EBITDA guided in FY21. We note that the company opportunistically built up a portfolio of $25m in oil and gas stocks and bond and gold stocks during market weakness in 2020; by March 2021, realised gains amounted to €8.2m (€8.5m reported in unaudited Q1 results) and there were still €3.8m of unrealised gains – gains would be recorded as 'other operating income'. The guidance above assumes WTI of $60/bbl in 2021 and 2022, a Henry Hub price of $2.5/mmbtu and an exchange rate of US$1.2/€.

DRAG's end-FY20 cash, including marketable securities, stood at €22.8m (which has already increased to €35.7m by end-Q121), having placed a corporate bond in late 2019, which raised €87.1m. We note that the other of the two corporate bonds has a maturity of 20 July 2021, with €16.7m still outstanding at end-FY20. Assuming the recent strong oil and Henry Hub prices persists, DRAG should generate considerably higher operational cash flow in FY21.

We are encouraged by DRAG's preliminary (unaudited) Q121 figures released on 10 May. Consolidated net profit was c €11.7m with sales of c €17.9m and EBITDA of c €21.3m, suggesting that DRAG is comfortably on track to meet its full year guidance. Both earnings figures were heavily influenced by 'other operating income' of €9.5m, which included €8.5m resulting from gains on sale of the equity and bond portfolio. Adjusting for 'other operating income' from the Q1 results still gives consolidated EBITDA of €11.8m, which is an increase of 42% from Q120 (adjusted EBITDA of €8.9m), and net profit of €2.1m (versus an adjusted net loss of €0.3m in Q120).

Exhibit 2: Financial summary

(€000s)	2016	2017	2018	2019	2020	Q121*
Income statement						
Sales revenue	**9,170**	**53,746**	**109,052**	**41,204**	**38,683**	**17,924**
% growth	383%	486%	103%	-62%	-6%	11%
Other operating income	10,497	1,124	19,060	4,312	7,692	9,501
EBITDA (reported)	**6,374**	**36,138**	**97,933**	**22,725**	**23,935**	**21,293**
% margin	70%	67%	90%	55%	62%	119%
EBITDA (adjusted)	**(1,923)**	**35,014**	**79,251**	**20,283**	**18,243**	**11,792**
% margin	n/m	65%	73%	49%	47%	66%
EBIT (reported)	(541)	5,306	32,691	5,630	(16,135)	14,326
Net profit (after minority interests) (reported)	**102**	**5,549**	**13,872**	**308**	**(15,509)**	**11,018**
Number of shares	5,063	5,063	5,063	5,082	5,082	5,082
EPS (reported) (€)	**0.02**	**1.10**	**2.74**	**0.06**	**(3.05)**	**2.17**
DPS (€)	0.60	0.65	0.70	0.10	0.00	0
Balance sheet						
Fixed assets	120,556	148,361	126,985	161,690	134,671	136,714
Financial assets (non-current)	21,043	22,710	22,001	36,780	35,697	34,827
Cash and cash equivalents, including marketable securities	**28,091**	**29,699**	**59,989**	**66,637**	**22,816**	**35,695**
Total assets	193,472	213,574	224,845	278,925	206,722	231,803
Total debt	**75,243**	**106,576**	**93,385**	**139,111**	**128,381**	**124,057**
Total liabilities	127,351	156,899	151,007	207,424	161,133	169,983
Shareholders' equity	66,121	56,675	73,837	71,501	45,589	61,820
Net debt	**47,152**	**76,877**	**33,395**	**72,474**	**105,566**	**88,361**
Cash flow statement						
Net cash from operating activities	**13,991**	**37,848**	**68,674**	**13,938**	**13,991**	**n/a**
Net cash from investing activities	(48,730)	(51,625)	(28,268)	(34,238)	(48,730)	n/a
Net cash from financing activities	(17,692)	24,735	(28,626)	35,292	(17,692)	n/a
Forex movement	639	(7,225)	5,136	1,004	639	n/a
Net cash flow	**(53,071)**	**18,183**	**6,644**	**13,989**	**(53,071)**	**n/a**
Cash and cash equivalents	24,634	28,368	45,646	61,281	8,210	16,236
Capex (included in net cash from investing activities)	**(36,841)**	**(51,775)**	**(66,208)**	**(28,728)**	**(36,841)**	**n/a**

Source: Edison Investment Research, DRAG. Note: *Unaudited.

Valuation

We have calculated a sum of the parts (SoTP) valuation (Exhibit 3) for DRAG, based on the following:

- An independent O&G reserves valuation (competent person's report, or CPR), dated 8 March 2021, published by the company, which valued 1P+2P reserves at \$211.6m (€176.3m). We show separate valuations for 1P and 2P reserves.
- Book value of financial assets at end-Q121 (€34.8m). This includes listed shareholdings in Almonty Industries, Hammer Metals and Northern Oil & Gas, as well as an unlisted shareholding in Rhein Petroleum.
- Book value of net debt at end-Q121 (€88.4m).

The share valuation based on 1P reserves is €20.3, which is 45% above the current share price of €14.0. Including the 2P reserves adds €3.8 per share, giving a share valuation of €24.2, which is 73% above the current share price. The CPR is based on a long-term oil price assumption of c \$55/bbl (Nymex forward price), which is the same price assumption that DRAG adopts in projects appraisals.

Exhibit 3: DRAG assets and per-share value

Asset	Value basis	Reserves (mboe)	Value (€m)	Value per share (€)
Oil & gas assets:	CPR*			
2P reserves		14.6	19.5	3.8
1P reserves		128.8	156.8	30.9
Sub-total		**143.4**	**176.3**	**34.7**
Financial assets (non-current)	Q121 book value		34.8	6.9
Cash and cash equivalents	Q121 book value		16.2	3.2
Marketable securities	Q121 book value		19.5	3.8
Less: total debt	Q121 book value		(124.1)	(24.4)
Total equity valuation: 1P+2P reserves			**122.8**	**24.2**
Excluding 2P reserves			(19.5)	(3.8)
Total equity valuation: 1P reserves			**103.3**	**20.3**
Market value**			70.6	13.9
% difference			**46%**	**46%**

Source: Edison Investment Research, DRAG. Note: Number of shares: 5.082m; $1.2/€. *CPR dated 8 March 2021. **Share price at 10 May 2021 (intra-day).

As a downside sensitivity, we note that DRAG also published a CPR, dated 31 December 2020, based on a long-term oil price assumption of c $45/bbl (Nymex forward price at that date). This report valued 1P+2P reserves at €119.5m (using $1.2/€). All else equal, this gives a share valuation based on 1P+2P reserves of €13.0, or €10.6 based on 1P reserves. We note that the oil prices have enjoyed a sustained rally since the year end, with the WTI spot price averaging above $60/bbl since mid-February.

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