

19 Jun 2013

Share Price: \$0.082
12mth price target: \$0.23

EMPIRE ENERGY GROUP LIMITED

Exploration at the Top End

Empire Energy Group Ltd ("Empire", "EEG", "Company") has secured an Exploration Agreement with the Aboriginal Native Title Claimants and the Northern Land Council for EP(A) 184.

Grant of the exploration permit is subject to relevant Northern Territory government approvals which should be received by July 2013.

2.8 million acres to explore

EP(A) 184 covers 2.8 million acres in the Northern Territory. Empire holds 100% of the permit and plans to undertake comprehensive geological field studies, including outcrop sampling and analysis of the black shale that is one of the targets for exploration in the permit. The Company will also acquire 2D seismic over the northern part of the permit, targeting the same black shale play.

The initial exploration program will be funded from cash reserves. Empire plans to drill a number of wells in 2014 and we expect the Company may seek to farmout the cost of these wells.

Industry interest in the Northern Territory

There continues to be industry interest in acreage in the Northern Territory. Most recently, Statoil and PetroFrontier amended a farmin agreement in the Southern Georgina Basin which implies a value per acre (for the first stage of exploration) of \$15 per acre.

Applying this metric to Empire's acreage results in a value of \$225m. However, we estimate an exploration value of \$2 per acre (\$29m) which is based on the EV/acre of peers in the Northern Territory.

Value underpinned by consistent production in the US

The value of Empire is underpinned by the value of its production assets in the US. Field EBITDAX for 1Q13 was US\$4.4m (group EBITDAX was US\$2.5m) on gross production of 67,567 barrels of oil and 603.9 mmcf of gas.

Cash on hand at 31 March 2013 was US\$5.7m and debt was US\$47.8m (net debt of US\$42.1m).

Speculative Buy – upside from exploration getting closer

We believe the upside in Empire's shares will come from progress made in the unconventional assets. We view this agreement as a significant step in the right direction for Empire's McArthur Basin acreage. Over the next 12 months the Company will advance the exploration and prospect potential of its acreage prior to commencing a multiple well drilling campaign. Given the size of the acreage and the results of wells on nearby acreage, we expect the Company to be successful in identifying drillable targets and, hence, future catalysts.

Although the exploration program will take some time before drilling, we believe the share price is underpinned by the value of production assets so there is little downside risk for the patient investor. We maintain our Speculative Buy with a price target of 23cps.

Brief Business Description:

Oil and gas production in the US with large unconventional upside

Hartleys Brief Investment Conclusion

Production provides a good base with upside to come from unconventional potential

Chairman & CEO:

B W McLeod (Executive Chairman)

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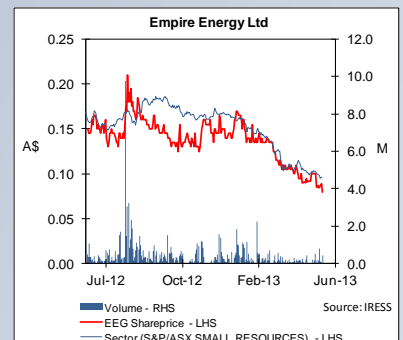
Valuation: \$0.452
Issued Capital: 304.9m
- fully diluted 304.9m
Market Cap: \$33.5m
- fully diluted \$25.0m
Net Debt (31 Mar '13): \$40.8m
EV \$74.3m

Valuation Summary	\$m	\$/share
Appalachian Basin	\$41.8	\$0.137
Mid Continental USA	\$50.7	\$0.166
US Shale	\$65.3	\$0.214
Aus Shale	\$29.0	\$0.095
Net (Debt)/Cash	-\$40.8	-\$0.134
Corporate Overheads	-\$14.2	-\$0.046
Hedge	\$6.0	\$0.020
Total	\$137.9	\$0.452

Av daily turnover \$0.1m
Yearly volume (shares) 111.0m

2P Reserve (mmboe) 11.28
EV/2P Reserve (\$/boe) \$6.59

Source: Hartleys Research



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SUMMARY MODEL

Empire Energy Ltd (EEG)					Recommendation:		Speculative Buy				
Key Market Information					Directors		Position				
Today's Date	19 Jun 2013				B W McLeod	Executive Chairman		Company Information			
Share Price	\$0.082				D H Sutton	Non-Executive Director		Level 7, Macquarie St Sydney, NSW, 2000			
52 Week High-Low	\$0.08 - \$0.21				K A Torpey	Non-Executive Director		Ph: (02) 9251 1846 Fax: (02) 9251 0244			
Market Cap (\$m)	\$33.5						www.empireenergygroup.net				
Enterprise Value (\$m)	\$74.3										
Ordinary Shares	304.9										
Fully Diluted Shares	304.9										
Profit & Loss (\$m)					Substantial Shareholders						
	12/11A	12/12A	12/13F	12/14F	Shareholder Name		Shares Interest				
Revenue from sale of product	31.3	26.7	25.0	24.5	Macquarie Group Ltd		53.7m 17.6%				
OPEX (excl amortisation)	(14.8)	(10.4)	(10.3)	(9.9)							
Overheads and other expenditure	(4.7)	(6.5)	(5.9)	(5.9)							
Total costs	(19.6)	(16.9)	(16.2)	(15.8)							
EBITDA	11.7	9.8	8.8	8.7							
Depreciation/amortisation	(4.8)	(4.6)	(4.1)	(4.3)							
EBIT	6.9	5.2	4.7	4.4							
Finance costs	(6.9)	(7.0)	(4.7)	(4.5)							
Pre-tax profit	0.0	(1.8)	(0.0)	(0.2)							
Tax expense	(1.6)	1.8	-	-							
NPAT	(1.6)	(0.0)	(0.0)	(0.2)							
Abnormal items	2.2	(1.4)	(0.0)	(0.0)							
Reported profit	0.6	(1.4)	(0.0)	(0.2)							
Balance Sheet (\$m)					Reserve/Resources		Liquids (mmbbl)				
	12/11A	12/12A	12/13F	12/14F			Gas (bcf)				
Cash	4.4	6.0	3.1	4.2	Appalachian/Central Kansas		5 42 11				
Other	11.2	9.8	6.3	6.3	Total		5 42 11				
Total Current Assets	15.6	15.8	9.4	10.4							
Producing assets	94.8	94.5	89.9	82.3							
Development assets	-	-	-	-							
Other	10.7	5.8	5.2	5.6							
Total Non Current Assets	105.5	100.3	95.1	87.9							
Total Assets	121.0	116.1	104.5	98.3							
Interest Bearing Liabilities	53.0	47.2	40.3	34.3							
Other	-5.3	-6.5	-1.8	-1.7							
Total Current Liabilities	58.4	53.7	42.1	36.1							
Interest Bearing Liabilities	0.1	0.0	0.0	0.0							
Other	13.5	13.1	13.1	13.1							
Total Non Current Liabilities	13.5	13.2	13.2	13.2							
Total Liabilities	71.9	66.8	55.3	49.2							
Net Assets	49.2	49.3	49.2	49.1							
Cashflow Statement (\$m)					Production Summary		Unit				
	12/11A	12/12A	12/13F	12/14F			12/11A 12/12A 12/13F 12/14F				
Operating cashflow	10.0	13.2	11.7	13.3	Liquids	mmbbl	0.3	0.3	0.3	0.3	
Income tax paid	(2.2)	1.1	-	-	Gas	bcf	2.4	2.4	2.2	2.1	
Interest and other	(5.6)	(1.5)	(2.3)	(2.1)	Total	mmbbl	0.3	0.4	0.4	0.4	
Operating activities	4.3	11.7	9.5	11.2							
Property, plant and equipment	(0.5)	(0.6)	(0.0)	-							
Exploration/development	(2.7)	(3.5)	(1.4)	(1.8)							
Proceeds from sale	0.0	0.9	0.2	-							
Other	(0.0)	(0.4)	(0.1)	-							
Investment activities	(3.1)	(3.6)	(1.3)	(1.8)							
Repay/draw debt	(14.3)	(8.5)	(10.6)	(8.4)							
Equity	15.2	2.1	-	-							
Other	(0.2)	(0.0)	(0.5)	-							
Financing activities	0.7	(6.5)	(11.0)	(8.4)							
Net cashflow	1.9	1.6	(2.9)	1.0							
Ratio Analysis					Price Assumptions		Unit		12/11A 12/12A 12/13F 12/14F		
Cashflow per share	cps	1.49	3.78	3.10	3.66	Oil price	US\$/bbl	85.65	84.45	85.31	86.81
Cashflow multiple	x	5.5	2.2	2.6	2.2	Gas price	A\$/GJ	6.08	5.89	5.33	5.55
Earnings per share	cps	(0.96)	(0.02)	(0.02)	(0.07)	Exchange rate	A\$/US\$	1.02	1.03	1.03	1.03
Price to earnings ratio	x	-21.5x	-1092.4x	-849.4x	-223.0x						
Dividends per share	cps	-	-	-	-						
Dividend yield	%	0.0%	0.0%	0.0%	0.0%						
Interest cover	x	3.39	3.66	3.21	3.86						
Return on equity	%	-3.2%	-0.1%	-0.1%	-0.3%						
Analyst: Peter Gray Phone: +61 8 9268 2837					Hedging		Unit		12/11A 12/12A 12/13F 12/14F		
Sources: IRESS, Company Information, Hartleys Research					Oil	mmbbl(\$ per bbl)	121 (\$90)	113 (\$90)	105 (\$90)		
					Gas	bTtu(\$ per mmbtu)	1404 (\$6.3)	1484 (\$6.1)	1408 (\$6.0)	1335 (\$5.9)	
					Sensitivity Analysis		\$/sh NPAT EPS (cps) CF/sh (cps)				
					Base case	0.452	(0.2)	(0.07)	3.66		
					Oil price +10%	0.475	0.9	0.39	3.98		
					Oil price -10%	0.429	-1.2	-0.52	3.35		
					Gas price +10%	0.463	0.2	0.10	3.78		
					Gas price -10%	0.442	-0.5	-0.24	3.54		
					OPEX +10%	0.440	-1.2	-0.57	3.31		
					OPEX -10%	0.465	0.9	0.43	4.01		
					*N.B. NPAT, EPS, CFPS forecasts are for CY2014						
					Share price valuation		\$m		\$/share		
					Appalachian Basin	41.8		0.14			
					Mid Continental USA	50.7		0.17			
					US Shale	65.3		0.21			
					Aus Shale	29.0		0.10			
					Net (Debt)/Cash	(40.8)		-0.13			
					Corporate Overheads	(14.2)		-0.05			
					Hedge	6.0		0.02			
					Total	137.9		0.45			
					Total (excluding exploration)	43.5		0.14			
							Last Earnings Estimate Changes:		18 June 2013		

KEY ASSUMPTIONS / RISKS

Our valuation methodology is based on a combination of DCF, risked value of resource potential using notional in ground valuation and conservative estimates for probability of success, and value per acre based on past transactions. This methodology results in value of 45cps.

Our price target is a discount to our valuation which considers the value of production and additional risked values of exploration assets. In EEG's case, this results in a price target of 23cps.

Fig. 1: Key assumptions and risks for valuation

Assumption	Risk of not realising assumption	Downside risk to valuation if assumption is incorrect	Comment
2P oil reserves are converted to 1P	Low	Moderate-High	We have included 1.3mmbbls of 2P reserves in our model. The development of these reserves will depend on improving recoveries, drilling more wells or working over existing wells. As such, there is no guarantee that these 2P reserves will be converted to 1P, however, we consider it likely because Empire has a great knowledge of the fields and the production history is very long.
Credit default risk	Low	High	If Empire's lender chose not to roll over the debt facility post February 2016, Empire would need to raise an estimated US\$25m either through the sale of assets, a capital raise or possibly alternative debt financing. A capital raise or an asset sale would be detrimental to the current share price.
Production risk	Low	Low-Moderate	Oil and gas production is inherently unpredictable but given the type and age of Empire's fields and the knowledge gained by Empire, we consider production risk to very low.
Long run oil price of \$90 and a long run gas price of \$5	Moderate	Moderate	Future commodity prices are influenced by many factors and are impossible to predict accurately. We base our long run commodity prices on consensus data. In addition, Empire implements a long term hedging policy.
Funding risk	Low	Low-Moderate	We do not believe that Empire has sufficient existing cash facilities (\$5.7m) or free cash flow to fund large scale development of its exploration assets. As such, it is likely that the Company will need to farmout a portion of its acreage or undertake a capital raising should it choose to develop and explore its shale acreage.
Exploration valuation risk	Low	Low-Moderate	We have estimate the value of Empire's exploration assets based on comparable metrics. No two assets are truly comparable and, as such, there is an inherent risk in a comparable valuation.

Conclusion

We believe the key risk to our valuation is exploration risk.

Source: Hartleys

HARTLEYS CORPORATE DIRECTORY

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Hartleys Recommendation Categories

Buy	Share price appreciation anticipated.
Accumulate	Share price appreciation anticipated but the risk/reward is not as attractive as a “Buy”. Alternatively, for the share price to rise it may be contingent on the outcome of an uncertain or distant event. Analyst will often indicate a price level at which it may become a “Buy”.
Neutral	Take no action. Upside & downside risk/reward is evenly balanced.
Reduce / Take profits	It is anticipated to be unlikely that there will be gains over the investment time horizon but there is a possibility of some price weakness over that period.
Sell	Significant price depreciation anticipated.
No Rating	No recommendation.
Speculative	Share price could be volatile. While it is anticipated that, on a risk/reward basis, an investment is attractive, there is at least one identifiable risk that has a meaningful possibility of occurring, which, if it did occur, could lead to significant share price reduction. Consequently, the investment is considered high risk.

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