EDISON

Northern Petroleum

Accelerating the pace of change

Corporate update

Oil & gas

Northern is embarking on a quiet revolution as it seeks to increase the pace of growth across its portfolio. New production is being targeted in Alberta to be funded from deal flow that may include disposal of the existing Netherlands production base. A farm-out of its Cygnus prospect in Italy and sale of the Netherlands assets are key catalysts for investors in 2013, while two further wells in French Guiana offer tangible exploration upside. New management is now at the helm following the recent departure of both the MD and chairman. However, we do not expect a change in direction with the die firmly cast on the new strategy.

Year end	Revenue (€m)	EBITDA* (€m)	PBT* (€m)	Debt (€m)	Net cash (€m)	Capex (€m)
12/11	24.5	14.9	7.4	0.0	29.8	(2.2)
12/12	12.4	2.3	(0.5)	0.0	22.5	(5.7)
12/13e	13.4	2.4	1.9	0.0	16.4	(6.2)
12/14e	10.0	0.9	0.3	0.0	9.1	(6.5)

Note: *PBT and EBITDA are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Alberta acquisition sets the tempo of future deals

Northern is looking to move into new developments where it can move faster than it could in its European strongholds of the Netherlands and Italy. The first of these targets is in north-west Alberta, which the company expects to develop in earnest from this coming winter subject to both early appraisal work being successful and funding being available from other asset deals such as the potential sale of its Netherlands production base. If successful, we expect Northern to seek to replicate this strategy in other locations, both in Alberta and further afield internationally.

Exploration upside on multiple fronts

Northern continues to offer investors upside via its 1.25% interest in the Guyane Maritime Permit with two further wells to be drilled in 2013 on the back of the 2011 breakthrough Zaedyus discovery. In addition, the company is looking to complete a farm-out deal in 2013 on its c 400mmbbl Cygnus property in the Southern Adriatic, while a recent acquisition in Australia could lead to shale oil exploration.

New management, but strategy shift unlikely

Northern has shaken up its board with the recent departure of both the longstanding MD, Derek Musgrove, and the chairman, Richard Latham. However, we do not expect this to prompt a change in strategy, with the new MD, Keith Bush, already an integral part of the team that is driving the accelerating business model.

Valuation: Focus will swing to exploration upside

Our core NAV of 35p is currently based on the Netherlands production base. However, should this be sold, the valuation focus will swing to exploration upside. In the near term, we expect our NAV to be at the bottom end of our upside range of 62-179p, although we expect to move this up if deals are executed as planned in 2013.

15 July 2013

Price	**31.38p**
Market cap	**£30m**
	$1.6/£, €1.15/£
Net cash (€m) at end Dec 2012	22.5
Shares in issue	95.4m
Free float	97%
Code	NOP
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(11.1)	(24.4)	(50.2)
Rel (local)	(14.7)	(26.6)	(58.3)
52-week high/low		72.5p	27.2p

Business description

Northern Petroleum is an oil and gas company that acquires low-cost exploration, production and development assets. It has exploration, appraisal and development assets in the Netherlands, Italy, French Guiana, the UK, Canada and Australia.

Next events

Netherlands sale	Q313
Potential Cygnus farm-out	Q313
Cebus results	August 2013

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Netherlands costs recovered: Sale in negotiation

Northern Petroleum's Netherlands production base is now at a stage where all development capital, plus a 30% premium, has been recovered from cash flow and the company is sharing profits with its JV partner, NAM.[1] However, the producing fields are clearly in decline with a 45% reduction in 2012 over 2011 to c 0.9mboe/d (1.6mboe/d). Part of this reduction was due to a number of shut-in periods to undertake planned maintenance and operational enhancements. However, it is also clear from ongoing seismic reprocessing work and remodelling of production that the producing reservoirs are lower in porosity and permeability than was previously thought. This has contributed to a more rapid decline in output than expected from the current production wells. While the reservoir evaluation work is still in progress, a further reduction in 2P reserves from 18mmboe to 12.2mmboe has been booked with the 2012 results, reflecting both a reduction in recoverable gas volumes and movement of certain volumes from the reserves to contingent resource category.

Having acquired its Netherlands discoveries at no cost and with all development capital now recovered (including a 30% premium), Northern was clearly at a crossroads with its Netherlands strategy: either to further invest (carrying NAM) to stabilise and grow production, or divest and redeploy capital elsewhere. At the heart of its decision to go with the latter and try to divest is recognition of a frustratingly slow pace of progress in dealing with Dutch authorities.

Northern has indicated that it has received a number of expressions of interest over the last 12 months, has held extensive negotiations with two parties and is now at the letter of intent stage with one of the parties. We understand the company expects to close this deal in Q313, although of course there can be no guarantee that this will be achieved. However, to give investors better visibility on operational progress and increase the pace of growth across its portfolio, we see this as a critical share price catalyst for investors. Furthermore, we note that Northern intends to retain future benefits in the Netherlands in select exploration acreage, at least one field development and in its shale oil potential, although we would be surprised if these were priority areas for the company in the near term given regulatory constraints and its new focused strategy.

Scale of screening exercise sets tone for new strategy

Having decided to seek faster growth opportunities, Northern embarked on a substantial screening exercise to identify suitable projects to build out its asset portfolio. €1.2m was booked in 2012 as new business costs to look at this, with three (unnamed) countries identified in particular that were studied in some depth and advanced to early negotiation stage.

Northern's criteria are to target sustainable production of 3,500boe/d and be involved in drilling three to five wells with material impact each year.

Alberta acquisition sets the tempo of future deals

The first move into new territories was announced in March 2013 with a c C$0.7m acquisition of 9,300 acres in north-west Alberta, Canada. Northern is initially targeting production of 500-1,000b/d from over one million barrels of extra oil recoverable from the original 56 million barrels of oil in place, of which 11 million barrels has been produced to date (a recovery factor of c 20%). To prove up the redevelopment concept, the company is seeking to start small-scale operations with a three- to five-well programme during the summer/autumn of 2013 around areas with all-season access.

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1 Nederlandse Aardolie Maatschappij BV (a 50/50 JV between Shell and Exxon).

Provided these small-scale operations are successful and funding is realised from deal flow, we would expect Northern to move into full-scale redevelopment of these territories during the winter of 2013/14 when there is easier field access.

Alberta is clearly a step out from previous Northern-operated activities. However, the company has engaged an incentivised local contractor to manage the development on its behalf so execution risk is thought to be low. In the fullness of time, we expect the Alberta deal to be a development model Northern is likely to want to replicate, both elsewhere in Alberta and internationally. At the heart of the strategy is a desire to have assets that can be rapidly developed, creating significantly more newsflow for investors that have been starved of operational activity historically.

High-impact exploration upside on multiple fronts

Southern Adriatic, Italy

Northern has been eyeing up the potential for deep-water turbidite fan systems in the Southern Adriatic for many years. The company already has 53mmbbls of 2P reserves booked against its Rovesti and Giove prospects in the region, although the development economics of both are unlikely to be compelling. Instead, Northern's focus has been on deeper water prospects in its FR.39.NP and FR.40.NP permits, where it is targeting fan structures similar to those in Eni's adjacent Aquila field. Following a prolonged lay-off, Eni brought the Aquila field back into production in 2011, and since this time it has provided Northern with invaluable new well data. This new data, along with 2D seismic shot in November 2011, indicates that Northern's Cygnus prospect is potentially an updip continuation of the Aquila field with a common Oil Water Contact (OWC). According to ERC Equipoise, if this were the case it would estimate high case prospective resources for Cygnus of 969mmbbls, of which 790mmbbls would be on Northern's 100% block. The mean estimate, which assumes only partial hydrocarbon fill and a separation of Aquila and Cygnus, is 446mmbbls with 401mmbbls in Northern's block. ERC Equipoise quotes a mean chance of success (exploration risk factor) for Cygnus of 12%.

Northern is clearly excited about the potential of having a de-risked a c 400-800mmbbl prospect within its 100%-owned licence area. However, the reality is that the company has neither the funds nor the appetite to drill this on a sole-risk basis. Former partner Azimuth relinquished its 15% interest in the area, although we understand this was for timing reasons rather than an indication of prospectivity. Northern is now seeking a new farm-in partner with deep-water experience and the requisite deep pockets to fund drilling in the region. We understand that discussions with suitable parties are at an advanced stage and this would clearly be a major piece of news for Northern, de-risking the play financially and technically. However, permitting remains a key concern, with environmental approvals still required before the planned 3D seismic shoot can be commissioned. Given current timing, we would not expect to see any drilling at Cygnus before 2015.

Guyane maritime permit, French Guiana

While no near-term drilling is expected in the Southern Adriatic, Northern investors still have exposure to high-impact exploration in French Guiana from two remaining wells in the current four-well programme that followed the Zaedyus discovery in 2011. Newsflow on these targets is limited with Shell as operator. However, we do know that the latest well, GM-ES-4 (Cebus), spudded on 3 May, is targeting a different fan to the three previous wells that were all drilled on the large Cingulata fan system. Each well takes approximately three to four months to drill, so we can expect results around July/August, with the final well likely to be drilling through to Q413. Meanwhile, interpretation of 3D seismic acquired during the second half of 2012 to rank prospects for follow-up drilling is ongoing. With a 1.25% interest, Northern is comfortably funded for the current drill programme.

Otway Basin, South Australia

Northern's most recent acquisition marks its entry into Australia. The company has successfully bid for a 100% five-year interest in PEL629, which represents 5,800km^2 (1.43 million acres) in the Otway Basin onshore South Australia. The target here is to explore and hopefully develop stratigraphically deep shale oil resources in the Late Jurassic to Early Cretaceous Casterton and Sawpit formations. This is not the first time Northern has looked at shale oil exploration, with some similar plays having been considered in the West Netherlands Basin. The knowledge the company built there will clearly be of value in its Australian venture, while we also note that Northern expects to retain its shale oil interests in the Netherlands even if it is successful in its sale of the conventional production and development portfolio. Northern will undertake a programme of detailed geochemical analysis and seismic reprocessing along with wireline log processing to evaluate the potential unconventional shale sequences. Depending on the success of these studies, we would expect the company to seek farm-in partners to share the cost burden for what would likely be a relatively involved drill programme to appraise these resources.

Management: Reshuffle unlikely to affect strategy

Northern has shaken up its board with the departure in July of both the longstanding MD, Derek Musgrove, and the chairman, Richard Latham, both of whom had been in their respective positions since 1999. Rex Gaisford, a non-executive director, also left the board in the same month.

However, we do not expect these changes to prompt a change in strategy. New MD Keith Bush and CFO Nick Morgan have already been an integral part of the team that has been driving the accelerating business model over 2012 and 2013 and we expect this to continue. However, we would not be surprised if further asset deals are announced as Northern continues to mine the opportunities it has screened over the last 12 months to accelerate its operating activities.

Valuation: Upside dependent on corporate activity

With so many potentially moving parts, pinning a valuation on Northern is not obvious. Our core NAV of 35p a share is largely driven by the Netherlands production and development assets (Exhibit 1) while they remain in the portfolio. This is based on the updated 2P reserves of 12.2mmboe as at end-2012, and assumes no immediate development of the remaining portfolio (assuming any decision to develop Geesbrug, Papekop and Ottoland will be delayed until a decision has been made whether to retain the assets or not). Our core NAV includes both end-2012 net cash of €22.5m ($31.3m) and four years' G&A costs discounted at 10% (an average of €4.1m pa).

Exhibit 1: Northern Petroleum core NAV valuation

Fully diluted shares	95.4	EMV	Value/share
$/£	1.60	$m	p
Dutch gas production		22.3	14.6
UK oil production		2.9	1.9
Dutch oil/gas to be developed		14.6	9.6
Net cash/(debt) end-2012		31.3	20.5
G&A (four year NPV 10)		(17.2)	(11.3)
Core NAV		**53.9**	**35.3**

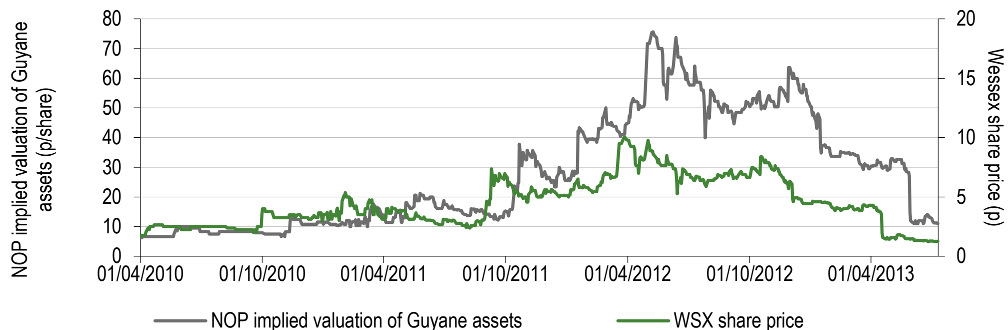
Source: Edison Investment Research

However, with the possible sale of the Netherlands business in the coming months, investors need to focus their attention on the numerous upside opportunities Northern now offers from its exploration and development portfolio. Much of this portfolio is still at an early stage of

development, so valuations are less well defined. However, in all cases there is significant scope for upside to be added.

- **Guyane Maritime**: Ascribing a value to the Guyane Maritime assets is not simple given the mixed results from the exploration programme. At the upper end of a range we could take the value inferred from the 10p/share offer tabled by Total in March 2012 for Northern's Northpet partner, Wessex Exploration, valuing the company at $115m. This would value Northern's 1.25% interest in Guyane Maritime at c 75p per share as indicated in Exhibit 2. However, with two unsuccessful follow-up wells in 2012/13, the Wessex share price has now fallen to a mere 1.5p/share, inferring a market valuation for Northern's 1.25% interest of $17m or 11p per Northern share.

Exhibit 2: Implied market valuation of NOP's Guyane Maritime interest based on WSX

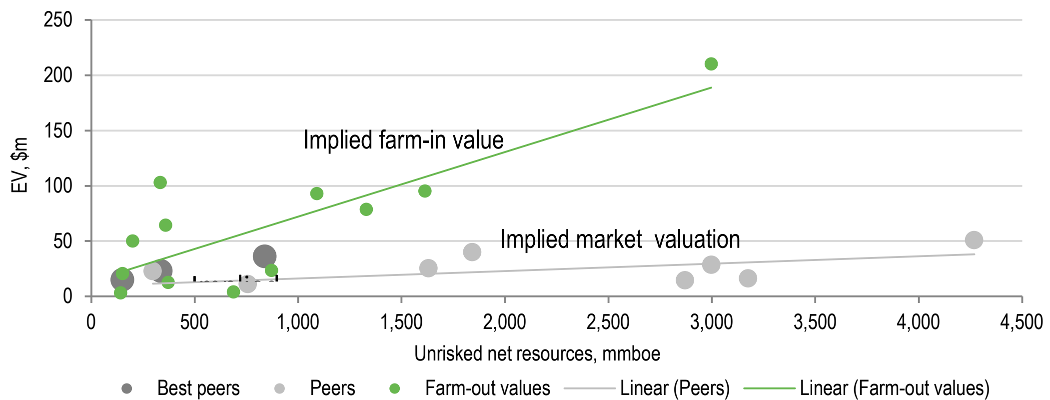


Source: Thomson Datastream, Edison Investment Research

In reality, an industry valuation probably sits somewhere between these two values, reflecting the premium being paid in the market at present for exploration farm-outs over equities (discussed later in Exhibit 3). However, in the absence of further discoveries in the Guyane Maritime block, it is difficult to justify ascribing more value to Northern's interest than is inferred from the current market valuation of Wessex.

- **Southern Adriatic**: Valuing Northern's main Italian assets will depend on if and what it can achieve from a farm-out of its Cygnus interests. We estimate the previous 15% farm-out to Azimuth for an almost full carry of $10m of seismic costs would have valued blocks FR.39.NP and FR.40.NP at $67m. However, given the potential that Cygnus is now a continuation updip of Aquila and could contain up to 800mmbbls on block, we expect any new farm-out to be on significantly more favourable terms. As an example, a two-for-one promote on a well costing $50m plus seismic back costs would value Northern's current interest at $120m. In saying this, we recognise that industry terms are rarely reflected in equity values in the current market as demonstrated in our analysis below (Exhibit 3). On the downside, we could expect the equities market to value Northern's interest at 20% of the farm-out value, with the potential for this to perhaps approach 50% if viewed favourably by the market. This suggests a valuation range for the Southern Adriatic as $13.4m on the downside (20% of the Azimuth farm-out derived value) and up to $60m if Northern successfully farms out in return for a full well carry and back costs (discounted at 50%).

Exhibit 3: Farm-out vs corporate values



Source: Edison Investment Research

- **North-west Alberta**: It is early days in Northern's programme in Canada, with the larger field development dependent on both a successful conclusion to the sale of its Netherlands assets and promising results from small-scale operations over the summer. In the event these are successful, the expectation is for Northern to redevelop a little over one million barrels of reserves. Based on PV10 economics for neighbouring developers in Alberta, we estimate the company could expect to put together a project worth c $8-13/boe at $80/bbl WTI, inferring an unrisked valuation for the Alberta programme at $8-13m. Again, we would expect investors to tend toward the lower end of this range given the uncertainties over both the pilot programme and funding.
- **Otway Basin**: It is too early to understand the shale oil prospectivity of Northern's recent acquisition in the Otway Basin, although we can use onshore Australia unconventional exploration companies as an indicator of potential value. The licence covers 1.43m acres (5,800km^2), which on a lower-range EV multiple could be worth c $3m, although this could increase to more than $30m in the fullness of time with exploration leading to production.

Exhibit 4: Onshore Australia unconventional peer group

Company	Symbol	Operations	Enterprise value US$m	Net acres m	EV/acre $
Baraka Energy	BKP:AU	S. Georgina	7	2	3.25
Beach Energy	BPT:AU	Cooper Basin	1,494	25	59.8
Buru Energy	BRU:AU	Canning Basin	408	17	24.0
Central Petroleum	CTP:AU	Amadeus/Pedirka/S. Georgina /Wiso Basins	114	41	2.8
Drillsearch	DLS:AU	Cooper/Bonaparte/Otway	578	4.9	118.0
Icon Energy	ICN:AU	Cooper Basin	77	2.1	36.8
Senex	SXY:AU	Cooper/Surat Basins	603	18	33.5

Source: Company accounts, Bloomberg. Note: EV data priced to 11 July 2013.

In summary, all four of Northern's exploration and development assets could add material value, although, with the notable exception of French Guiana, all the other work programmes are still likely to be conditional on corporate activity. While this would preclude them from our standard risked exploration NAV (RENAV), we expect investors to start to price in value for each of these projects once more tangible newsflow is forthcoming.

By adding the potential value of these projects to our previous core NAV, we suggest that a valuation range of 62p to 179p can be justified (Exhibit 5). In reality, we would expect investors to tend towards the lower end of this range in the near term. However, in keeping with the company's strategy to operate in provinces that can significantly accelerate its work activity, we expect the valuation could start to move up this range over the next six to 12 months. Clearly any news on the Netherlands disposal, Cygnus farm-out or exploration success in Guyane Maritime would have a significant impact on our valuation.

Exhibit 5: Northern Petroleum upside valuation range

	Valuation ($m)		Valuation (p/share)		Methodology
	Low	**High**	**Low**	**High**	
Core NAV	53.9	53.9	35.3	35.3	Netherlands/UK DCF valuation, net cash, G&A.
Guyane Maritime	17.0	115.0	11.1	75.4	Wessex Exploration current EV/total offer.
Southern Adriatic	13.4	60.0	8.8	39.3	Discounted Azimuth farm-out/possible farm-out for drill carry.
North-west Alberta	8.0	13.0	5.2	8.5	Typical netbacks for neighbouring Alberta conventional players.
Otway Basin	3.0	30.0	2.0	19.7	Peer group range for onshore Australia unconventional explorers.
Total potential valuation	**95.3**	**271.9**	**62.4**	**178.2**	

Source: Edison Investment Research

Financials

Due to a combination of P12 being shut in, a number of shut-ins to undertake planned maintenance and operational enhancements, and the previously discussed rapid decline of its Netherlands producing wells, revenues have dropped 49% to €12.4m. While there may be a modest improvement in 2013 due to lower maintenance, without further investment in the Netherlands production and development base, we expect the long-term trend to continue to decline.

In terms of cash burn, this will depend largely on whether Northern can secure the sale of its Netherlands production base and farm out part of its interests in the Southern Adriatic. For the purposes of clarity, we have pushed out development capex for the Netherlands assets to 2015, such that our forecasts reflect the natural decline of the portfolio. Within our capex assumptions, we assume modest expenditure for “proof of concept” production in north-west Alberta ($3m), and geochemical analysis and seismic reprocessing in the Otway Basin ($1m). However, the largest capex item is likely to be if and when Northern shoots 3D seismic in the Southern Adriatic. We have assumed this to be $8m based on a modest 3D shoot of 500-1,000km^2, although as previously mentioned we expect this to be funded via a farm-out.

Exhibit 6: Financial summary

€'000s	2010	2011	2012	2013e	2014e
Year end 31 December	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS					
Revenue	14,968	24,531	12,407	13,365	9,964
Cost of Sales	(4,892)	(5,321)	(4,282)	(6,094)	(4,666)
Gross Profit	10,076	19,210	8,125	7,271	5,298
EBITDA	4,878	14,949	2,315	2,374	875
Operating Profit (before GW and except.)	1,491	7,833	(233)	516	(718)
Intangible impairment	0	0	0	0	0
Exceptionals	0	3,108	23	0	0
Other	0	0	(132)	1,119	846
Operating Profit	1,491	10,941	(342)	1,635	127
Net Interest	(1,507)	(454)	(183)	299	218
Profit Before Tax (norm)	(16)	7,379	(548)	1,934	346
Profit Before Tax (FRS 3)	(16)	10,487	(525)	1,934	346
Tax	(1,139)	(4,256)	(1,042)	(3,455)	(2,488)
Profit After Tax (norm)	(1,155)	3,123	(1,458)	(2,639)	(2,988)
Profit After Tax (FRS 3)	(1,155)	6,231	(1,567)	(1,520)	(2,142)
Average Number of Shares Outstanding (m)	92	93	95	95	95
EPS - normalised (c)	(1.3)	3.4	(1.5)	(2.8)	(3.1)
EPS - FRS 3 (c)	(1.3)	6.7	(1.6)	(1.6)	(2.2)
Dividend per share (c)	0	0	0	0	0
Gross Margin (%)	67	78	65	54	53
EBITDA Margin (%)	33	61	19	18	9
Operating Margin (before GW and except.) (%)	10	32	(2)	4	(7)
BALANCE SHEET					
Fixed Assets	81,219	85,790	91,200	95,541	100,417
Intangible Assets	31,810	34,694	36,962	43,161	49,630
Tangible Assets	48,686	47,513	47,527	45,669	44,076
Investments	723	3,583	6,711	6,711	6,711
Current Assets	30,222	40,472	32,442	27,417	17,308
Stocks	124	70	99	50	51
Debtors	8,668	10,608	9,870	10,985	8,190
Cash	21,430	29,794	22,473	16,382	9,068
Other receivables	0	0	0	0	0
Current Liabilities	(8,065)	(8,754)	(8,754)	(9,591)	(6,500)
Creditors	(8,065)	(8,754)	(8,754)	(9,591)	(6,500)
Short term borrowings	0	0	0	0	0
Long Term Liabilities	(24,152)	(23,171)	(23,171)	(20,758)	(21,725)
Long term borrowings	0	0	0	0	0
Other long term liabilities	(24,152)	(23,171)	(23,171)	(20,758)	(21,725)
Net Assets	79,224	94,337	91,717	92,609	89,500
CASH FLOW					
Operating Cash Flow	11,637	13,059	2	1,151	2,609
Net Interest	11	23	51	0	0
Tax	(2,857)	1,913	0	(1,042)	(3,455)
Capex	(9,526)	(2,191)	(5,669)	(6,199)	(6,469)
Acquisitions/disposals	(999)	(2,609)	1,002	0	0
Financing	8,162	(1,831)	(2,707)	0	0
Dividends	0	0	0	0	0
Net Cash Flow	6,428	8,364	(7,321)	(6,091)	(7,314)
Opening net debt/(cash)	(15,002)	(21,430)	(29,794)	(22,473)	(16,382)
HP finance leases initiated	0	0	0	0	0
Loan Conversion into asset equity	0	0	0	0	(0)
Closing net debt/(cash)	(21,430)	(29,794)	(22,473)	(16,382)	(9,068)

Source: Company accounts, Edison Investment Research

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