

Warrego Energy Limited (ASX: WGO)

Overpressure halts WE-3 drilling; WE-4 drilling to start

Overview

Drilling of the WE-3 well has been halted ~300-400 m short of the main Kingia target after encountering over-pressured gas in the Carynginia Shale. The JV will now drill the WE-4 well while the WE-3 well is redesigned to manage the higher gas pressure. From a “glass half full” perspective the overpressure points to a likely larger and high productivity gas resource in the northern block; on the downside drilling is perhaps 6-7 weeks behind schedule and gas project FID is now expected in Q2 2021 rather than Q1. Our valuation is unchanged at \$0.31/sh, with upside to \$0.40 using STX’s 2C resource assessment for the JV development, and \$0.55/sh fully derisked.

Key points

Over-pressure requires well redesign: The high pressure was unexpected based on previous drilling, requiring increased mud-weights and flaring to control the well. The ~9,700 psi pressure is close to current design limits, requiring suspension until the well can be reengineered, possibly with higher rated casing and ancillaries.

Over-pressure implications: The source of the over-pressure is not fully known, however, the gas composition is similar to the Kingia formation in WE-2. This suggests WE-3 may encounter a larger and possibly higher quality gas resource in the Kingia than previously expected. The Kingia formation pressure at WE-2 was ~6,800 psia.

WE-4 to spud in two weeks: The JV will now drill WE-4, providing time to redesign and procure equipment for WE-3 without incurring further delays. WE-4 is in the same fault block as the successfully drilled WE-2 well and is not expected to encounter over-pressure problems. Drilling of WE-4 should take 90 days or less, reaching total depth in early to mid-April.

Gas project FID expected mid-year: The JV now expects a final investment decision in 1H 2021, rather than 1Q. Successful drilling and testing of WE-4 should provide confirmation of enough gas to underpin sales contracts and project finance. Results from WE-3 and WE-5 are unlikely until 2H 2021: WE-3 will require 20-30 days to reach TD once drilling recommences, but supply of higher strength casing if required will take months, suggesting WE-5 (~90 day well) will follow WE-4, before the rig returns to WE-3.

Cost implications: The additional cost from drilling delays, redesign and extra equipment is difficult to estimate, but should be manageable within existing funding capacity, assuming successful reentry of WE-3.

Share price catalysts: Near term news flow will relate to drilling progress, including penetration of the Wagina, Kingia and High Cliff reservoirs, followed by flow testing and independent reserves assessment prior to FID.

Relative valuation: WGO continues to offer cheaper entry into the WE field than STX, even allowing for STX’s operatorship and interest in other Perth Basin acreage, trading at a discount of ~50-60% to Strike on market capitalization, EV and resource metrics.

MiFID II compliance statement: Bridge Street Capital Partners have acted as Corporate Advisors to WGO and received fees from WGO for services provided.

SHARE PRICE PERFORMANCE



Closing price as of 31st Dec 2020

CAPITALIZATION	
Last price	\$0.220
52-week range	\$0.075-0.42
Capitalization	\$217m
Cash: 30 Sep*	\$11.4m
Debt: 30 Sep	\$0m
EV	\$206m
Shares	987.1m
Options/rights	18.1m
Conv Notes	-
Balance date	June
RESERVES AND PRODUCTION	
1P (18 May 20)	0.0 MMboe
2P “	0.0 MMboe
3P “	0.0 MMboe
2C “	42.7 MMboe
FY20a	0.00 MMboe
FY21e	0.00 MMboe
FY22e	0.00 MMboe
SHAREHOLDERS (%)	
Board	37
Institutions	22
Retail	41
Total	100
* excludes \$32m placement Oct 2020	
LEADERSHIP	
Chairman	Greg Columbus
MD/CEO	Dennis Donald

Disclosure: This is a commissioned research report and K1 Capital will receive a fee for preparing this report.

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2. Valuation

Table 1 Warrego valuation scenarios

Case	Description	\$A m net	\$A/share
Base	WE phased development (RISC resource assessment) ~700 bcf gas (gross) two phase development, Phase 1 \$4.5/GJ real domgas pricing (~\$3.5/GJ for STX CSBP GSA), toll processing. Phase 1 at 80 TJ/d (CSBP and additional uncontracted sales) from late 2022 (Alcoa contract from 2024) supported by Kingia 2C resources, 80% project risk (prev. 70%). Phase 1+2 at 115 TJ/d from 2026 supported by Kingia 3C resources, Phase 2 at 60% project risk factor (prev. 50%).	308 risked	0.31 risked
		390 de-risked	0.39 de-risked
B1	WE Strike 2C resource assessment Base case with ~1,187 bcf Kingia/HC 2C resources. Phase 1 as for Base (80% risk), ~200 TJ/d Phase 2 from 2026 (at 60% risk), 273 bcf Wagina 2U.	406 risked	0.40 risked
		550 de-risked	0.55 de-risked

Table 2 Base case valuation summary

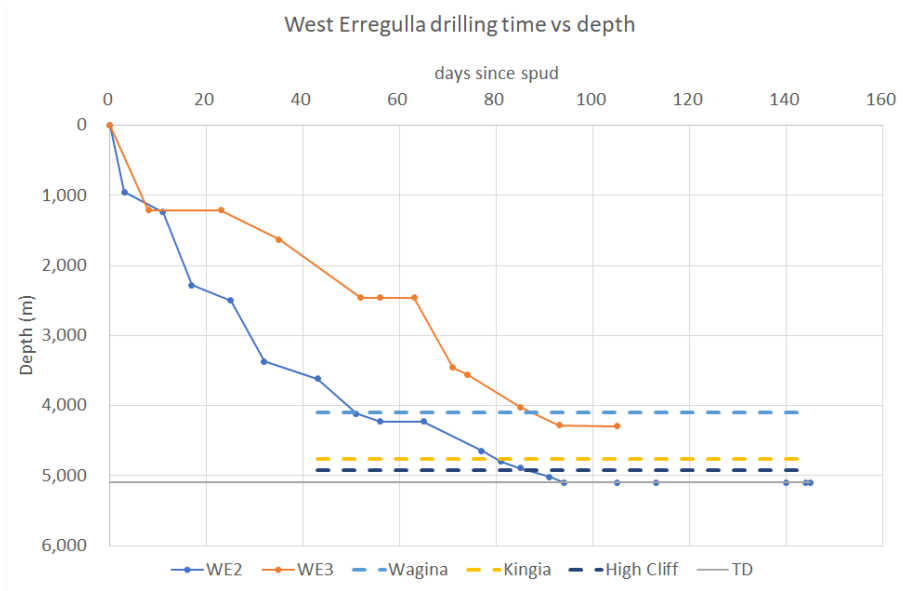
NPV @ 10.0% WACC+country factor	Net volume	NPV value	Risk factor	Risk value	Risk value	Unrisked value	Project WACC	Risk value
Valuation as of 31 Dec 2020	PJe	\$/GJ	%	M\$A	\$/sh	\$/sh	%	\$/sh
Projects (DCF model valuation)	341.0			207	0.21	0.29		
WE - tolling (Phase 1)	189.7	0.97	80	144	0.14	0.18	10.0	
WE - tolling (Phase 2+)	151.3	0.69	60	63	0.06	0.11	10.0	
Lochend Cardium tight oil	0.0	2.38	20	0	0.00	0.00	10.0	
Exploration / Appraisal	671.0			92	0.09	0.93		
EP 469 discovered gas	37.6	-	2	-	-	-		
West Erregulla - Dongara	32.9	0.83	30	8	0.01	0.03		
West Erregulla - Wagina	12.0	0.83	50	5	0.00	0.01		
West Erregulla - Kingia	41.3	0.83	50	17	0.02	0.03		
West Erregulla - High Cliff	37.6	0.83	50	16	0.02	0.03		
EP 469 Jurassic oil	57.5	2.10	8	10	0.01	0.12		
STP-EPA-0127	-	-	-	0	0.00	0.00		
Tesorillo (Spain) conv. gas	452.1	1.55	5	35	0.04	0.71		
El Romeral	-	-	-	1	0.00	0.00		
Other (corporate, cash, debt, etc)				9	0.01	0.03		
Corporate costs				-30	-0.03	-0.03		
Hedging & Investments				-	-	-		
Franking credits (@ 0 %)				0	0.00	0.02		
Cash				40	0.04	0.04		
Additional Equity				1	0.00	0.00		
Debt				-	-	-		
Minorities / Other				-1	-0.00	-0.00		
Equity Valuation @ base case	-			308	0.310	1.25	0.31	
Equity Valuation @ spot prices	@ \$US52/bbl real Brent & 0.77 f			-	-	-	0.00	
Mkt Cap @ current share price	(and undiluted share count)			217	0.220			
Total shareholder return (%)					n/a			
Number of shares (undiluted)	000,000			987.1	@ valuation date			
Number of shares (diluted)	000,000			995.2	for fully funded development			

Notes: 0.77 USD: AUD spot and 0.70 USD: AUD long term exchange rate. West Erregulla development based on RISC resource assessment.

3. Drilling progress

We estimate WE-3 is ~6-7 weeks behind schedule.

Figure 1 WE2 and WE-3 time-depth comparison (as of 4th January 2021)

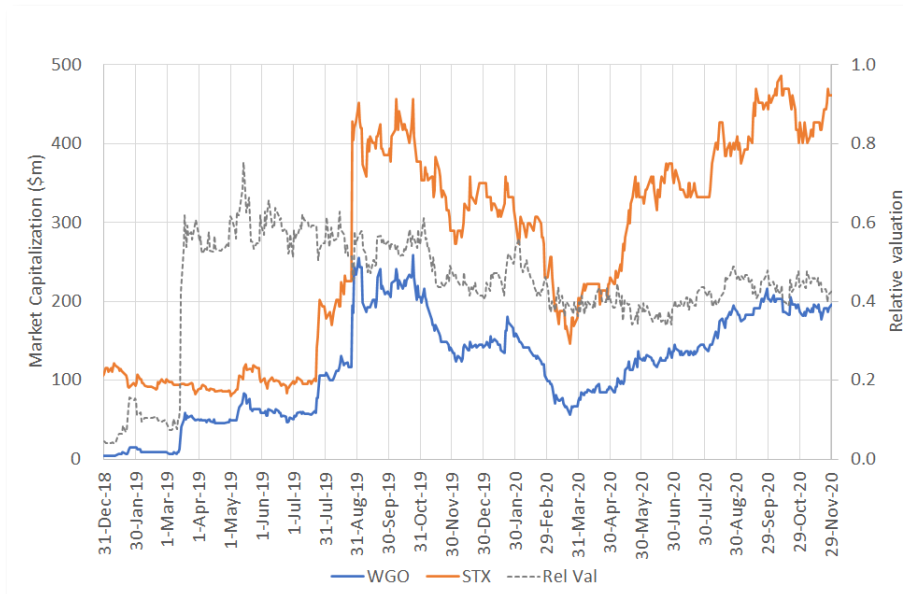


Source: K1 Capital analysis based on company announcements.

4. Relative valuation

The market continues to value Warrego at a discount of ~50-60% to Strike in market capitalization terms, as shown in Figure 2 below, despite both companies having a 50% share in the same principal asset (West Erregulla).

Figure 2 Relative market capitalization of Warrego and Strike



Source: K1 Capital analysis of ASX data. Closing price data to 31st December 2020.

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1.1 Appendix 1

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