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Davy Research

June 9, 2011

Equity Report: Company update

Providence Resources

Price: 280c (246p)

Value through the drill bit: major push to commercialise offshore Ireland will start with late summer drilling of Barryroe well

Rating: OUTPERFORM *Issued 09/06/11*

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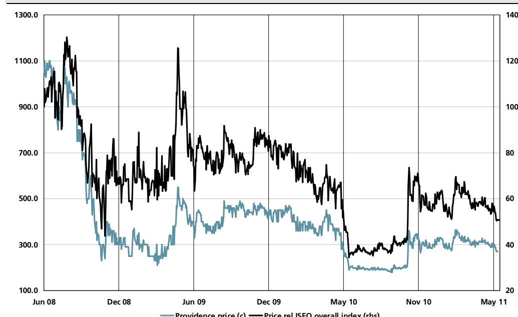
Share Price Performance



Company data	
Reuters/Bloomberg/Xetra	PRR.L/PVR.L/PZQA
Sector	Oil & Gas Exploration
Shares (m)	49.8m
Daily No. Shares Traded (m)	0.04
Free Float (%)	80%
52 Week High/Low	150p/330p

Capital Structure	
Mkt. Cap (£m)	£124m
Net Debt/(Cash) (£m)	£55m
Deferred consideration/debt-related	n/a
Pref Shares/Non Eq Min	n/a
Minority interests	n/a
E.V. (£m)	£179m

Rig secured for start of six-basin drilling programme offshore Ireland

- The announcement that a rig has been secured to drill offshore Ireland this year is a milestone for Providence and heralds the start of a major new phase of exploration and development activity for the group.
- Contrary to popular perception, oil and gas have been found offshore Ireland on numerous occasions. The lack of success in the past is due to an inability to convert discovery to commercial enterprise.
- However, high oil prices and technological advances now offer an opportunity to revisit a number of these earlier discoveries. This is Providence's intention.
- But Providence will also drill several very high-impact wells, especially along the western margin.

Portfolio approach reduces single event drilling risk

- The drilling campaign will kick off with the Barryroe well, a 'relatively' low-risk undertaking, in Q3 2011.
- Our risked group valuation is 919p per share, significantly higher than the current share price. However, we see the market demand for a much higher risk weighting shrinking if Barryroe is a success. Furthermore, a complete revision of the target inventory is likely to take place.
- Cash flow allied to a $65m (gross) funding earlier this year means that this drilling programme is financed.

Stock could materially outperform

- Providence offers two things: a means to invest in the Irish offshore and some very simple, yet large, upside plays that have barely begun to be reflected in the share price.

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Investment case

Providence Resources has been operating for a considerable period of time, most of it as an explorer offshore Ireland. Although it attempted some international diversification over recent years, it has returned to its roots over the last year with a new focus on the drill bit, especially offshore Ireland.

Leverage

By concentrating on the drill bit, exploration companies create value leverage. This is because drilling outcomes can result in very fast and large shifts in valuation.

Normally pre-drill, the market will only pay for a 'risked' valuation of the various drilling prospects. However, in the case of Providence, the market price is not even close to our risked pre-drill NAV per share (919p).

- **The value leverage argument is especially strong in the case of Providence. In fact, it is the strongest investment case for the stock.**

This means the value leverage argument is especially strong in the case of Providence. In fact, it is the strongest investment case for the stock.

Table 1: Valuation summary (p)*

	Risked	*Unrisked*
Production assets	97	97
Net (Debt)/cash	(29)	(29)
Appraisal/Development portfolio	512	1,136
Exploration portfolio	339	3,574
Total	919	4,778

*oil price of $85 per barrel, gas price 50p per therm
Source: Davy

Why Providence trades at such a substantial discount probably reflects the potted history of exploration success offshore Ireland in general and of Providence specifically. However, that is just part of the story. Our group valuation adjusts for this risk. Unrisked, the various projects have the potential to create multiples of our risked valuation.

In effect, Providence is risked twice over: firstly due to its status as a play offshore Ireland and secondly because investors will only pay a risked value for prospects before they are drilled.

Barryroe and Spanish Point – possible game changers

- **Barryroe has been identified since the 1970s. However, the advent of new technology as well as higher oil and gas prices has completely changed the economics of exploiting this deposit.**

The above also explains why Barryroe, an unconventional oil play, is so important. With success at Barryroe, there will be a gradual realisation that other parts of the portfolio offshore Ireland can also deliver. This is especially true of the Spanish Point gas condensate discovery, where a well is to be drilled in 2012.

This should result in a rapid unwinding of the 'Irish' discount. At this stage, the normal risk reward dynamic for exploration companies should apply, which is particularly strong in the case of Providence.

Diversification

Providence's activity schedule ensures steady newsflow over the next two to three years. Some of the wells will be rank frontier exploration, while others are appraisal. Together, they make for a broad spread of risk profile that should allow trading for all tastes.

Probably the most important element of this entire programme is that no one well will break the investment case; individually, however, any one well could make it.

Activity schedule

This is a key part of the Providence story and will ensure that investor interest remains keen. The news that a rig has been secured to drill the Barryroe target is a very important development. We see this well starting in late summer following a three 3D seismic programme that will be completed during Q2.

Table 2: Drilling schedule – guided 2011 to 2013

Well	*Current interest*	*Timing*	*Risked value and (adjusted for final equity positions) (p per share)*	*Unrisked value (p) per share*
Barryroe	50%	Sep-11	113	287
Hook Head	73%	Nov-11	98	326
Singleton	99%	2011	Development	97
Dalkey Island	50%	Q4 2011/Q1 2012	43	321
Spanish Point	32%	2012	287	478
Dunquin	16%	2012	160	2665
Rathlin Island	100%	2012	8	248
Baxter's Copse	50%	2012	3.5	13
Dragon	50%	2012	8	14
Nemo	60%	2013	38	63

Source: Davy

Final push for offshore Ireland

A new focus

In recent years, Providence attempted to diversify its portfolio by becoming involved in projects with a production or near production bias in the Gulf of Mexico and also offshore Nigeria.

However, the advent of surging oil prices based on strong underlying demand for oil has put exploration back at the forefront of the industry. The argument for Providence to return to its traditional exploration focus was also strengthened by a collapse in US gas prices (due to the advent of shale gas) and uncertainty of gas markets for the Aje Nigerian development. Against this background, Providence used its local knowledge and widespread licence position along the offshore margins of Ireland to put together an extensive exploration portfolio of drilling targets.

Providence's licences offshore Ireland

Celtic Sea

- Standard Exploration Licence 2/07 - 72.5% and operator
- Standard Exploration Licence 08/01 - 50% and operator
- Standard Exploration Licence 10/01 - 50% and operator

St George's Channel

- Exploration Licence 1/07 - 100% and operator

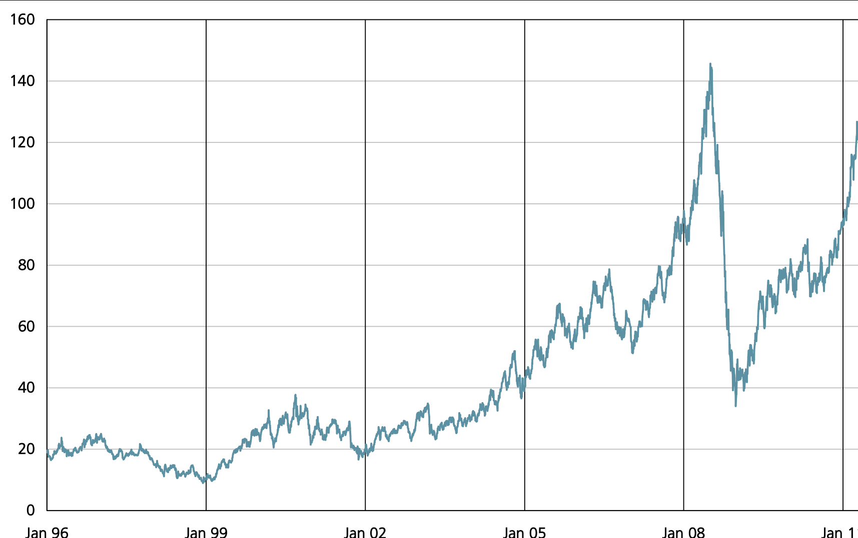
West Of Ireland

- Frontier Exploration Licence 2/04 - 32% and operator
- Frontier Exploration Licence 4/08 - 32% and operator
- Frontier Exploration Licence 3/04 - 16%
- Licence option 08/2 - 50% and operator

What has changed offshore Ireland?

Exploration offshore Ireland has had mixed results. Several important discoveries have been made, as a consequence of which one field (Kinsale Head) is nearing the end of its life in the Celtic Sea and another (Corrib, albeit struggling due to planning delays) is about to start along the western margin.

Figure 1: Brent oil (US$ per barrel)



Source: Datastream

Nevertheless, some 160 wells have not delivered a commercial oil discovery yet, even if several substantial pools of oil have been found. This is particularly true of the Celtic Sea and has given rise to a perception that no commercially viable projects are present. However, a number of factors have changed over the past two decades, all of which make a material difference.

- The current oil price regime is very different to what it was even ten years ago.
- Technology has advanced significantly, allowing more complicated and smaller projects to proceed.
- Infrastructure (pipelines) are now installed throughout Ireland, and there are interconnectors to the United Kingdom.
- There is an attractive fiscal regime in place – tax take of 25-40%.

Providence's portfolio

- A suite of 'unconventional' (light and waxy, heavy) oil plays in the Celtic Sea
- A deepwater, high-impact west coast Atlantic Margin play

Providence's portfolio

It is best to think of Providence's portfolio as having two distinct characteristics:

- a suite of 'unconventional' (light and waxy, heavy) oil plays in the Celtic Sea;
- a deepwater, very high-impact west coast Atlantic Margin play.

There are other projects that have material potential (the Dalkey Island prospect in the Irish Sea), but these exceptions tend to 'prove the rule'.

This combination of price, technology, infrastructure and fiscal terms has changed the risk and return profile offshore Ireland completely. Providence is looking to exploit this new reality.

Unconventional oils

- **The main complication with waxy crude is that the oil can be very viscous when it moves beyond the reservoir and temperatures drops**

Unconventional oils cover the broad gamut of heavy to waxy oils, sometimes involving a combination of all or parts of these characteristics. The overriding challenge is to overcome operational issues that have an impact of the commercial outcome. Each case is different. For instance, heavy gravity oil sometimes – but not always – involves higher viscosity. In the same way, waxy (highly viscous) oils can be very light and sweet. Detail counts too, with each case having its own set of specific characteristics such as location, refining capacity, abnormal reservoir temperature or chemical composition.

The key is that each project has its own set of characteristics to which a response is required. This means that technological capability is important, which makes the partnership arrangement paramount.

A heavy oilfield is likely to have spatial variations in API and viscosity, reflecting its genesis through the normal processes (bio- degeneration and evaporation). This means that best practice dictates that its commercial 'kick off' will have to take into account well performance and proof that well productivity is maximised.

This involves a number of steps – 3D seismic, extended well test and then reservoir observation to maximise output. At this stage, a well programme can be designed and will usually encompass a deviated well. Similarly, a waxy oilfield such at Barryroe, while probably more heterogeneous, will also require a period of testing to see how oil recovery can be maximised.

- **An unconventional oil development requires a different skill set and time frame to 'conventional oils' and underlines the importance of having the right partners**

The conclusion is that an unconventional oil development requires a different skill set and time frame to 'conventional oils' and underlines the importance of having the right partners.

The UK experience

The UK sector has a considerable resource of what can be loosely called 'unconventional oils'. Much of this has been a viable target since the early 1990s, and several large well-known fields such as Alba and Gryphon and latterly Captain have been developed successfully and very profitably. More recently, Xcite Energy has focussed its efforts on developing the Bentley Field in the North Sea.

The Bentley project

- **Xcite Energy is a UK/Canadian dual listed company developing the Bentley Field in the North Sea. It has a 100% stake in Block 9/3b and is listed on AIM and the TSE Venture exchange.**

Xcite Energy is advancing plans to put the Bentley Field (160m barrels recoverable P50 basis) on first stage production at the end of this year or early 2012. Full field development is likely around 2014.

The project received a major fillip at the end of 2010 when a new well successfully demonstrated that commercial flow rates could be achieved from the field. The Xcite guidance is careful not to overpromise on commerciality, and this is instructive of how we think we should consider heavy oil projects. It probably points to how the Barryroe and Baltimore projects will evolve.

Providence's involvement with unconventional oilfields offshore Ireland

Providence is a Celtic Sea veteran with operations that go as far back as the early 1980s. Through its predecessor company Atlantic Resources, it participated in the Helvick oil discovery on Block 49/9 and is also familiar with the various kinds of oil and gassy plays in the more western end of the basin. These include several prospects now included in its inventory of activities. Two of these in particular, Barryroe and Baltimore, stand out. The former is due to be drilled later this year and has a potentially transforming impact on the group.

Barryroe (50%)

List of wells with recovered oil in licence option 08/1 (Barryroe)

- 48/24-1 in 1974 flowing 1,300 bopd
- 48/28-1 in 1974 flowing 1,527 bopd
- 48/24-3 in 1990 flowing 1,619 bopd

This package of Early Cretaceous oil-bearing reservoirs is located in the southwest of the Celtic Sea underneath the Seven Heads gas field. It was first discovered in 1974 by Esso Exploration (part of ExxonMobil) when it drilled two wells, both of which flowed oil and gas to surface. It was subsequently appraised by Marathon in 1990 with well 48/24-3, which flowed 1,619 barrels of oil per day (bopd) with surface restrictions.

So far, four wells have been drilled into the Middle and Lower Wealden at this location, three of which have flowed waxy but relatively light oil to surface. The advent of improved technology, North Sea precedents and higher oil prices now make this a much more viable proposition. In addition, Providence has signed a memorandum of agreement (MOA) with Shell to agree an off-take agreement for the Barryroe oils with Shell providing a price mechanism for any future production.

3D seismic survey

- **The Polarcus Samur, a new seismic vessel commissioned by Polarcus, will begin shooting seismic in June of this year. The shoot is expected to take 10 to 15 days.**

A major factor in the development of Barryroe will be the acquisition of a new state-of-the-art 3D seismic survey scheduled for the early part of the summer. This should make a major contribution to well planning and overall risk reduction.

The Early Cretaceous Wealden sand reservoirs offshore Ireland are characterised by variation both laterally and vertically related to their genesis. Faulting, which leads to compartmentalisation, is also a feature of these reservoirs.

The 3D survey should allow the company to optimally position wells. This is because it will provide information that will enable the avoidance of faulting but also position the well to hit the thickest reservoir sections.

Competent persons report

- **The licence option consists of two parts. One part relates to all resources below 4,000 feet and the other to all resources below surface.**

RPS Energy has published a Competent Persons Report (CPR) on the Barryroe oil discovery. This placed a P50 (median expectation) of 58.6m barrels recoverable from the upper and lower Wealden sands. A conservative recovery factor of 16% was applied, which seems reasonable given that unconventional reservoirs can deliver up to 30% (recovery) with modern technology. Details of the field's physical characteristics

illustrate the complexities of unconventional oilfields. The report details a wax content of between 12% and 22% for Barryroe but at the same time reports a low density of 40º API.

While there is evidence that at reservoir temperatures and pressures oil will flow very easily due to low in-situ viscosity, problems could arise if the oil cools as it rises up the well bore during production. To address this issue, a development option will require the heating of flow lines, and it is also likely that an Electrical Submersible Pump (ESP) will be used in tandem with chemicals to reduce the viscosity as the temperature drops.

Capital and operating costs

The added complexity and processes involved push up operating costs considerably higher than that normally experienced.

- We see such costs being close to $20 per barrel for Barryroe with finding and development costs almost $15 per barrel.
- This makes for a breakeven cost, including invested capital, of around $35 per barrel.

Baltimore (60%)/Nemo (54%)

The Baltimore heavy oil accumulation was discovered by Bula Oil in 1992. However, the well, which was originally targeting gas resources, intersected a heavy oil accumulation instead. A decision was taken to plug and abandon the well because the heavy low 11º API oil encountered was believed to be non-commercial. A more recent study (based on released Bula maps) suggests a potential STOIIP (stock tank oil initially in place) of up to 300m barrels of oil (mmbo). Notwithstanding the nature of the oil, reservoir porosity and permeability are excellent – all of which are positive factors when a decision has to be taken to proceed with future development.

Similarly, the Nemo heavy oil deposit, which is located under the Early Cretaceous Ardmore gas discovery, is believed to contain up to 230m barrels of oil in place. The 1974 discovery well flowed both oil (16º API) and gas.

In 2010, Providence farmed out interests in both Baltimore and Nemo to Nautical Petroleum, a UK-based company that specialises in heavy oil projects.

- **Nautical can earn up to 65% by electing to drill an appraisal well by the end of 2011**

Nautical is funding desk-top commercial reviews for both Baltimore and Nemo and can earn up to 65% by electing to drill an appraisal well on Nemo by the end of 2011.

Hook Head (72.5%) and Helvick (62.5%)

Both these targets fall into the 'nearly commercial' category, albeit for different reasons.

Hook Head

Four wells have drilled into Hook Head reservoirs, all of which have logged hydrocarbons. In particular, the first and third of these wells hit over 100 feet of net hydrocarbon-bearing sands. Although earlier estimates suggested that up to 70m barrels might be recoverable from three separate fault blocks, results from the fourth well downgraded this estimate to circa 20m barrels. The lower Cretaceous reservoirs are likely to be waxy, albeit oil density is reasonable at 30º API.

We expect that a re-entry of the third well (50/11-3) will take place this year followed by a short side track into the main zone. A series of tests will ensue, allowing a final commerciality decision to be made.

Helvick

The Helvick field was discovered in 1982 by Gulf. The discovery well flowed light oil at significant rates of up to c.10,000 bopd from upper Jurassic sandstones. However, subsequent wells were disappointing as the reservoir proved to be much more limited in extent than hoped for. After five wells, the most up-to-date estimate for a recoverable resource is now 3m barrels. While such an amount of oil has attraction on a purely notional numeric value, it still carries single event risk. However, as part of a cluster development in the more widely developed Celtic Sea scenario, it could and will be very profitable in the current oil price regime.

Irish Atlantic Margin plays

The second element of Providence's portfolio is located along the deepwater frontier Atlantic Margin, offshore the west coast of Ireland. The licences held by the group include a low-risk appraisal project called Spanish Point and a very high-risk, high-impact exploration play called Dunquin. Both will be drilled in the coming two years.

Spanish Point (32% equity)

- **The second phase of FEL has been entered into, a stage that includes a well commitment**

The over-pressured Upper Jurassic Spanish Point gas condensate discovery is located in the Main Porcupine Basin. Providence operates the project on behalf of its partners, Chrysaor (60%) and Sosina (8%). The project is located c.200 km offshore the west coast and is in c.400 metre water depth. The group committed to the Irish government to drill a well in early 2011 and is planning to carry out operations during the summer of 2012.

- **The reservoirs display reasonable porosity, especially the uppermost A sand, but diagenetic alteration has reduced the reservoir permeability – hence the requirement to use fracture stimulation/horizontal wells to improve production rates**

The Spanish Point discovery was made in 1981 and flowed at a rate of 1,800 barrels of oil equivalent per day from one (A Sand) of four logged hydrocarbon-bearing intervals within a gross 1,400 feet gas/condensate column. The other three sands (B, C, D) demonstrated lower permeability than the uppermost sand.

Previously, this discovery did not attract investment due to its location, lack of infrastructure and perceived lack of a viable domestic Irish gas market. This has now changed with gas pricing similar to the UK, pipeline infrastructure onshore Ireland and technology offering development solutions that were not available heretofore.

Chrysaor

- **Chrysaor is owned by a combination of its management team, Barclays Natural Resource Investments (a subsidiary of Barclays) and a fund managed by Natural Gas Partners**
- **After its initial 30% farm-in, Chrysaor elected to increase its stake to 60% of the well by committing to 60% of the well cost and capping Providence/Sosina's cost exposure**

Providence's partners include Chrysaor, a private UK company specialising in fallow oil and gas discoveries. Chrysaor is currently operating the development of the deepwater Solan oilfield in the West of Shetlands with Premier Oil as partner. Chrysaor farmed into the licence in 2008 for a 30% stake by committing to a 300 sq km 3D seismic survey that was completed in 2009.

Competent persons report

A CPR has been completed by Synergy covering the Spanish Point discovery area (FEL 2/04 and the adjacent licence FEL 4/08).

Best case recoverable estimates are for 2P resources at Spanish Point of nearly 100m barrels of oil equivalent (mmboe) with an upside 3P case of 200 mmboe. The base case is made up of 415bn cubic feet (bcf) of gas and 26m barrels of recoverable condensate.

As part of its pre-development analysis, Chrysaor has modelled an initial production rate of c.70,000 barrels of oil equivalent per day (boepd) has been modelled for Spanish Point assuming completion strategies involving fracture stimulation and/or horizontal matrix producers.

Capital and operating costs

Capital costs have been modelled in the CPR to be in the region of $900m or just over $9.0 per boe on a 2P basis. Peak production output is modelled as having the potential to reach up to 250m (standard cubic feet of gas per day (scfg/d) and a liquid fraction of 30,000 bopd (together 70,000 boepd).

- **An initial production rate of c. 70,000 boepd has been modelled for Spanish Point assuming completion strategies involving fracture stimulation and/or horizontal matrix producers which, in concert, should improve flow rates. The development concept involves a shallow water fixed platform tied into a deepwater manifold located over the field proper. The field development concept calls for the drilling of 7-14 wells with condensate and gas exported via pipelines to shore in the Shannon Estuary.**

This resource is expected to meet economic criteria at reserve levels above 150 bcf of recoverable gas and production rates in excess of 15m scfg/d.

We feel that the risk is low for the upcoming well, which is essentially an appraisal well. Rather, the primary risk is whether the well can demonstrate appropriate production rates to allow suitable economic returns. Consequently, the appraisal well will answer several questions regarding the quality of reservoir and the number of wells required for development. The most important of these is if a fraccing programme will improve permeability and consequently flow rates.

Davy model

Our model assumes an all-in capital expenditure per barrel of $10 and a unit operating cost profile of around $7 per barrel. There is obvious further upside potential should the 3P number of 200 mmboe recoverable be realised.

Additional leads and prospects

The Spanish Point area also contains a number of further leads and prospects. Providence and its co-venture partners licensed the adjoining FEL 4/08 as part of the 2008 Licensing Round and identified a number of further leads and prospects. The group has secured a 3D seismic vessel for a c.200 sq km programme over this adjoining acreage during summer 2011.

The group also commissioned a CPR over this area, which indicated up to an additional 550m 3P boe recoverable in the area licensed around the Spanish Point discovery. This audit included the Burren oil discovery, which is a tested Barremian oil bearing sandstone play which has potential for up to c.66m boe recoverable.

Dunquin (16%)

- **The Dunquin target is held through FEL 3/04, which covers five blocks in the southern Porcupine**

The Dunquin licence is operated by ExxonMobil (40%) with partners ENI (40%) and Sosina Exploration (4%). In 2009, ExxonMobil elected to move to the next phase of the licence, which includes a well commitment. In 2010, a site survey was completed over the agreed exploration well location.

While Providence's stake is relatively small at 16%, the target size is substantial and the cost of drilling is very large, with some estimates suggesting costs of c.$150m per well. The smaller stake therefore makes good sense to us as it still provides plenty of upside but minimises cost. Through its farm-in deal with ExxonMobil, Providence has a promoted carry.

- Dunquin is believed to be a late Jurassic to early Cretaceous carbonate build-up situated on a major intra-basinal ridge system covering an area of c.700 km^{2}, analogous to giant producing fields in the Gulf of Mexico and the Middle East

The Dunquin prospect is potentially a giant gas/oil field and is interpreted to comprise two discrete carbonate mounds. The P50 (mid-case) recoverable resource potential for the two build-ups is c.8.4 trillion standard cubic feet (tscf) and around 300 mmbo (about five times the size of Kinsale Head on a boe basis). The upside or P10 number is 18.6 tscf and 662 mmbo recoverable. Importantly, resource estimates have been attributed to only the carbonate mounds with nothing ascribed to the ridge itself.

The feature is very obvious in seismic section, and several strong geological arguments can be made that it represents a build-up of a very large carbonate mound. This provides a reservoir framework. Gas chimney effects on seismic also suggest the existence of hydrocarbons, the presence of which is reinforced by indications of thermogenic hydrocarbons in sea floor bed cores around the proposed well location.

However, the potential at Dunquin will only be realised through the drilling of an exploration well. The scale, risk and cost (upwards to $150m) involved mean that ExxonMobil is very much the ideal partner. Under the timeframe of the well commitment provided by ExxonMobil to the government, this well must be drilled by 2013 at the latest.

Other targets/projects

There are a number of other targets in the general Irish western offshore area that are at various stags of maturity and delineation. To some extent, how they evolve will follow on from the current well programmes. Success at Spanish Point will likely cause a major push to increase the drilling activity along the Irish Atlantic margin. The same argument applies to the outcome of the Dunquin well.

- The development of one or both of these targets (Spanish Point/Dunquin) will lead to the setting up of additional infrastructure along the western seaboard that will present lower hurdle rates for the next generation of adjacent targets

The development of one or both of these targets will lead to the setting up of additional infrastructure, both offshore facilities and services, along the western seaboard that will present lower hurdle rates for the next generation of adjacent targets.

Other areas

Rathlin Basin (100%)

Providence was awarded an exploration licence over Rathlin Island, offshore Northern Ireland, in Q1 2011. The licence covers part of the Rathlin Trough, where a recent well on the shallower onshore section is reported to have recovered oil to surface during testing. Providence has identified a number of prospective leads based on available 2D seismic data and intends to work these up into a drillable prospect inventory over the coming months. Although the basin is frontier acreage, it is encouraging to see oil being found in the first exploration well drilled in the basin.

Dalkey Island Prospect (50%)

Providence has identified the Lower Triassic Dalkey Island Prospect, offshore Dublin, as a significant undrilled oil exploration prospect with an in-place prospective resource potential in the order of 870 mbo in

place. Reservoir quality is very high in the Kish Basin; if oil is demonstrated to be present, the recovery factor to be applied to this oil is expected to be better than average.

Providence operates the prospect on behalf of its partner, Star Energy Group (a wholly-owned subsidiary of PETRONAS).

Similar aged oil productive reservoirs have been discovered in the Liverpool Bay area of the East Irish Sea Basin, offshore UK. The company has begun discussions with rig operators to source a suitable unit for the drilling of a well in 2011/2012. Given its location in shallow water (25m) and close proximity to shore (around 10 km), this prospect should be cheap to drill.

Although the potential prospective resources are significant, even a very minor oil or gas discovery could be developed at this location.

Dragon Gas Field (100%, Irish licence area)

Providence's Standard Exploration Licence (SEL) 1/07 in the St George's Channel Basin contains the mapped extension of the UK Dragon gas discovery (70 bcf recoverable) into Irish waters as well as the deeper Orpheus and Pegasus exploration prospects.

In November 2010, the company signed a ten-month option agreement with Star Energy Group (Star), which provides for Star to acquire a non-operated 50% interest in the Dragon licence in return for carrying out a number of sub-surface studies on the Dragon gas discovery. Should Star subsequently exercise this option, it will participate in the drilling of the planned appraisal/development well on the Dragon discovery. The company currently plans to drill this well in the summer of 2012.

Onshore UK

- **Singleton produces from the Great Oolite Group. The carbonate reservoir is quite substantial with over 100m barrels initially in place. However, relatively low and variable porosity means that recoverable reserves are low compared to the in-place numbers.**

Providence has a 99.125% stake in the Singleton oil field, which is located in the Weald Basin in southeast England and produces from Middle Jurassic carbonate reservoirs. The field started production in 1989 with output peaking in 1996 at 1,000 bopd. Production is currently running at around 650 bopd.

The oil is trucked and gas is currently flared. Operating cost is in the order of $15 per barrel.

The field is currently the subject of an investment programme by Providence to increase output to 1,500 boepd over the next two years. It plans to achieve this through a combination of the following:

– improving existing production capability through acid stimulation and multilaterals;
– facilities upgrading and de-bottlenecking – gas management;
– accessing new reserves through new wells.

The company is planning to fracture stimulate up to two wells in 2011 in addition to drilling the extended reach X12 well, which will access

- **The update of reserves and resources at Singleton was completed by Collarini & Associates**

reserves in the far southwest of the field. This latter well is particularly important.

The work undertaken in 2010 (the X11 well and the X8v dual lateral) resulted in a recent reserve audit increasing 2P reserves to 7.7 mmbo recoverable. This compares to 5.2m barrels previously.

A scheme to convert some of the associated gas to power (GTW) output has been agreed and planning permission has been received to pursue this project, which is expected to be online within a year.

Singleton is an important part of the group's financial structure as it provides a core of cash flow based on output.

- **The group has an average target of 750 bopd of production for 2011 and 1,500 bopd for production in 2012**

Financial review

Production

Following the sale of its Gulf of Mexico assets this year, for the foreseeable future, the primary source of production and hence cash flow for Providence will arise through its near-100% equity stake in the Singleton field, onshore UK.

The group has set an output target of 1,500 bopd. This compares to current production of 650 bopd. This growth in production will come from various initiatives, including new wells and improved output through acid stimulation.

Table 3: Production and revenue summary for Singleton (US$m)

	2011	*2012*
Production b/d	750	1,500
Average hedge price (est.) US$/bl	75	75
Market price (US$/bl)	110	85
Avg. price achieved (US$/bl)	91	82
Revenue	25.0	45.1
Costs	(4.9)	(9.3)
EBITDA contribution	20.1	35.8

Source: Davy

Cash flow and expenditures

Not surprisingly, the high level of activity that Providence will undertake in the next two years requires considerable investment.

- **Based on the forecast final equity held in each drilling project for the group in 2011, we estimate that Providence will require capital of $54m to meet its drilling and investment requirements. This falls marginally to $49.5m in 2012.**

Based on the forecast final equity held in each drilling project for the group in 2011, we estimate that Providence will require capital of $54m to meet its drilling and investment requirements. This falls marginally to $49.5m in 2012. However, there is likely to be some degree of additional equity reduction in one or two of the drilling consortiums through farm-outs. For instance, the capital required in 2011 includes a €10m estimated cost for a 100% gross stake in a Rathlin Island well. We would not expect this to be Providence's final equity position, which is likely to be considerably lower with a commensurate reduction in cost. Additional farm-outs cannot be ruled out across the portfolio.

The early 2011 equity funding of $65.7m (gross) provides the lion's share of this commitment, with the balance coming from cash flow produced by its UK oil production at Singleton.

Group net debt was $104m at the start of the year. Adjusting for the recent $65m gross equity financing, asset sales and operating cash flow from production, we believe a net inflow of circa $20m for the year is possible.

- **In April 2011, Providence sold its Gulf of Mexico operations for a consideration of $15m in cash and $7m in deferred payment**

However, in 2012, expenditures of just under $50m – even if offset by a EBITDA contribution of $35.8m from oil sales – will result in a net cash outflow of $31m in the year. The end result will leave the group's net debt largely unchanged over a two-year period. This assumes neither further asset sales as a consequence of drilling activities nor the sale of its Aje interest offshore Nigeria.

Table 4: Summarised net debt and cash flow movement (US$m)

2011		
BNP Paribas loan year end 2010 adjusted for $15m GOM sale		(48.6)
Convertible debt year end 2010		(54.60)
Cash year end 2010		15.00
Net debt year end 2010		(88.2)
2011 capex	(54.00)	
2011 operating cash flow	20.1	
Feb 2011 funding (net of costs)	60.0	
Admin and finance costs	(16.00)	
Net inflow/(outflow)	10.1	
Projected year end net debt 2011		(78.5)
2012		
2012 capex	(49.5)	
2012 operating cash flow	35.8	
Admin and finance costs	(17.00)	
Net inflow/(outflow)	(30.9)	
Projected year end net debt 2012		(109.0)

Source: Davy

Capital structure

While equity has played the primary role in financing the group in the past (similar to most E&P stocks), both regular and convertible debt has also been raised in recent years. The presence of producing assets in the US (formerly) and onshore UK has formed the core of security provided for the standard debt packages secured by the group. Initially, a Macquarie loan facility was put in place by Providence. This was subsequently refinanced with a $100m senior secured reducing borrowing base facility provided by BNP Paribas.

Debt

The $64m in senior debt held by Providence at the last balance sheet date has now been reduced to $48.9m following the sale of the Gulf of Mexico assets. This BNP Paribas facility is secured on the Singleton assets and matures in September 2014.

In July 2008, Providence issued a €42m convertible bond, which is due for redemption in mid-2012. The coupon is 12%.

Re-financing and asset sales

Providence recently divested its interest in the Gulf of Mexico for an immediate cash consideration of $15m. A further $7m will become payable on certain reserves criteria being met. At the same, time it is quite possible that the group's 5% stake in the Aje field might be sold.

- **At one stage, we thought the Aje stake would be a useful window to the regional prospectivity because it would allow the new entrant full access to data. However, this first mover advantage no longer applies given the discoveries made offshore the West African transform margin and the licence positioning that has taken place.**

It should be possible to re-finance the convertible bond, especially given the generous 12% coupon. The sale of Aje is more difficult to predict. While it may be an attractive asset in its own right, the actual stake is probably too small for a major oil company but with a price too rich for a small company. For now, we assume that a transaction range of between $20m and $50m is the most likely outcome. Our own modelling suggests a value of $30-35m. The sale of Aje is further complicated in that part of the bond conditions is such that if a sale of Aje is achieved, proceeds from this sale must be used to redeem the bond.

Share structure

In early 2010, the group consolidated its capital base by a factor of 100. There are 49.8m shares in issue.

Major shareholders

- O'Reilly family (20%)
- JP Morgan (9.1%)
- Henderson (5.0%)
- Blackrock (4.2%)

The last significant equity raise was in February 2010, when 16.1m new shares were placed at 255p per share.

There are 4.8m outstanding options and 9.2m warrants. The company has four major shareholders with an interest over 3% (see side note).

Valuation

Our valuation for Providence is shown in Table 5.

- The methodology used generates a value for every field based on estimated operating and capital assumptions.
- Our models assume a long-term oil price of $85 per barrel and a gas price of 50p per therm.
- Each field/asset is modelled, cash flows discounted to present value and risked.
- As well as our take on exploration risk, the final value includes an element that tries to take into account the ultimate equity position following farm-out. As a general rule, we assume that the final equity position in most of the prospects and targets is probably going to be around one third (the obvious exception being the Dunquin target on the Atlantic margin).
- The assumptions show that while Providence is involved in some very large and high-impact projects, the risked valuation is often less than some of the smaller but lower-risk plays. This is as it should be and is to be expected.
- We provide a risked and unrisked valuation. The unrisked is the best possible outcome on the reserve/resource estimates made at this juncture. It does not include any licence equity dilution. While we concede that this is unlikely, in a success case any dilution of equity would not be undertaken without significant value realisation.

The Davy risking process

The valuation that this analysis generates is investor-focused in that it seeks to look at the end value that is to be expected. It not only adjusts for exploration risk but also risks each project for development delay/problems etc. We mostly use an 80% risk weighting for development as standard.

However, we also work in a factor to reflect the fact that smaller companies will not proceed with full positions in drilling consortia, especially if they are exceptionally large for the scale of the company. Consequently, investors need to adjust the gross prospectivity implied by a large early equity position in a licence or prospect.

- **On our suite of assumptions and risking, the risked value for Providence is 919p per share and the full unrisked value per share is 4,778p**

The following table demonstrates that, on our suite of assumptions and risking, the risked value for Providence is 919p per share and the full unrisked value per share is 4,778p. The risked value is some three times the current market price, while the unrisked value is over 15 times the current market price. We feel that these numbers clearly demonstrate the 'value leverage' angle in the stock.

Table 5: Valuation summary

Field/project	*Current licence equity*	*Current drilling plans*	*Project NPV/boe (US$)*	*NPV (US$m gross)*	*NPV (£m net to Providence)*	*Unrisked £/share*	*Unrisked (p/share)*	*Factor applied to account for success and development risk*	*Subsequent factor applied to account for Davy estimate of final equity position*	*Risked value/share (p)*
Exploration										
Aje	5%	0	4.6	712	22	0.4	44	59.4%	100%	26
Baltimore	60%	0	2.5	163	61	1.2	122	60.0%	66%	48
Baxters Copse	50%	2013	4.2	21	7	0.1	13	40.0%	66%	3.5
Dalkey Island	50%	2011	12.8	513	160	3.2	320	13.3%	100%	43
Dragon	50%	2013	2.7	34	11	0.2	21	60.0%	66%	8
Dunquin	16%	2012	7.8	13,324	1,332	26.6	2,665	12.0%	50%	160
Marlin	60%	2013	2.0	20	7	0.1	15	60.0%	50%	4
Nemo	54%	2013	3.6	184	63	1.3	125	60.0%	50%	38
Rathlin Island	100%	2012	7.9	198	124	2.5	248	9.6%	30%	8
Total							3,574			339
Appraisal/ development										
Barryroe	50%	2011	15.8	473	148	3.0	287	60.0%	66%	113
Helvick	63%	2013	19.3	58	23	0.5	45	45.0%	66%	13
Hook Head	73%	2011	18.0	360	163	3.3	326	60.0%	50%	98
Spanish Point	32%	2012	12.3	1,195	239	4.8	478	60.0%	100%	287
Total							1,136			512
Producing										
Singleton	99%	2011	10.1	78	48	1.0	97	100.0%	100%	97
Net debt										
BNP debt			-49							
Convertible			-54.6							
Cash			80.7							
Net cash			-22.9				-29		100%	-29
Total							4,778			919

Source: Davy

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Neutral	25	29	8	22
Underperform	8	9	0	0
Under Review	3	3	2	5
Suspended	0	0	0	0
Restricted	0	0	0	0

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