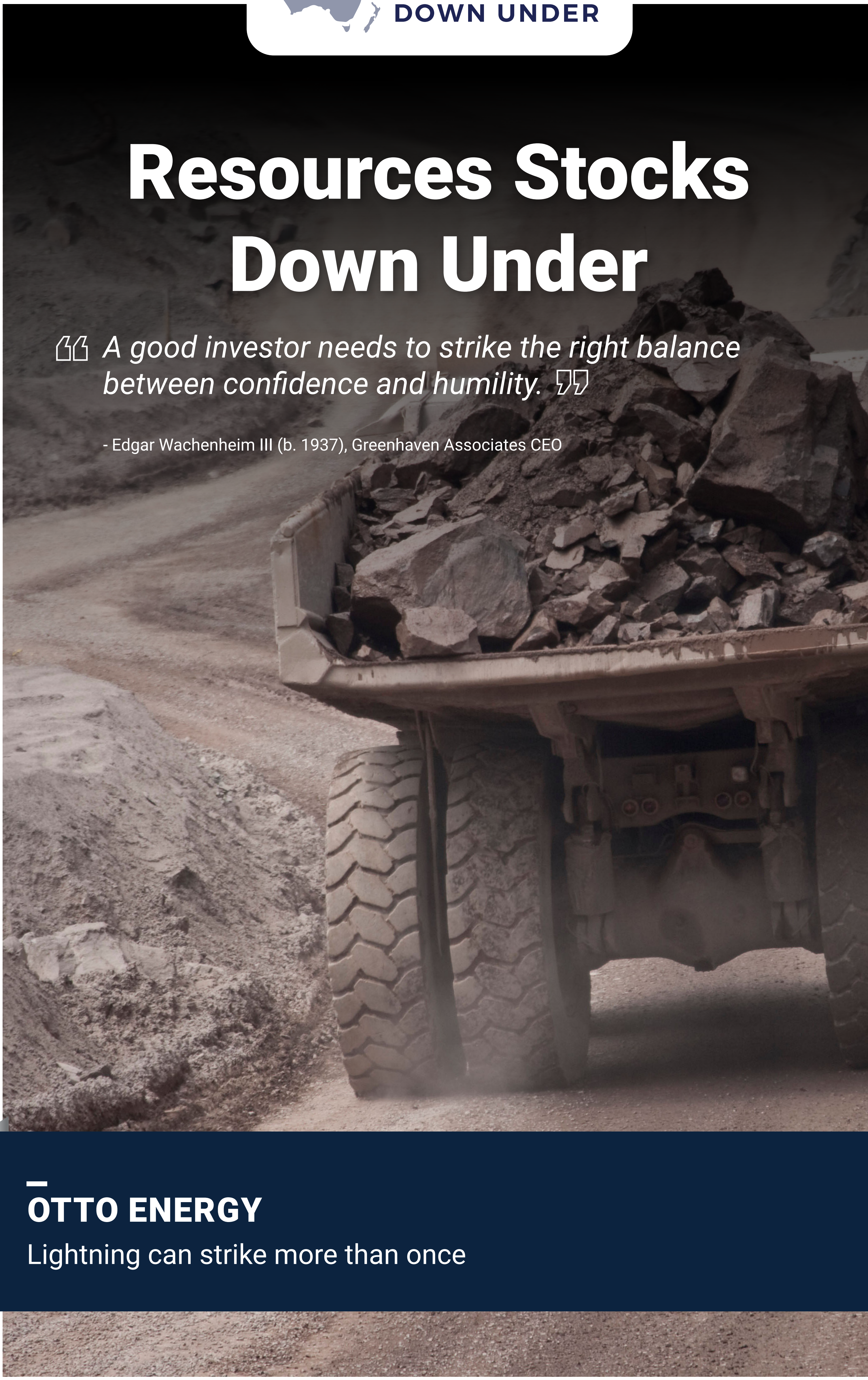
STOCKS DOWN UNDER

15 DEC 2022



Resources Stocks Down Under

A good investor needs to strike the right balance between confidence and humility.

- Edgar Wachenheim III (b. 1937), Greenhaven Associates CEO

OTTO ENERGY

Lightning can strike more than once

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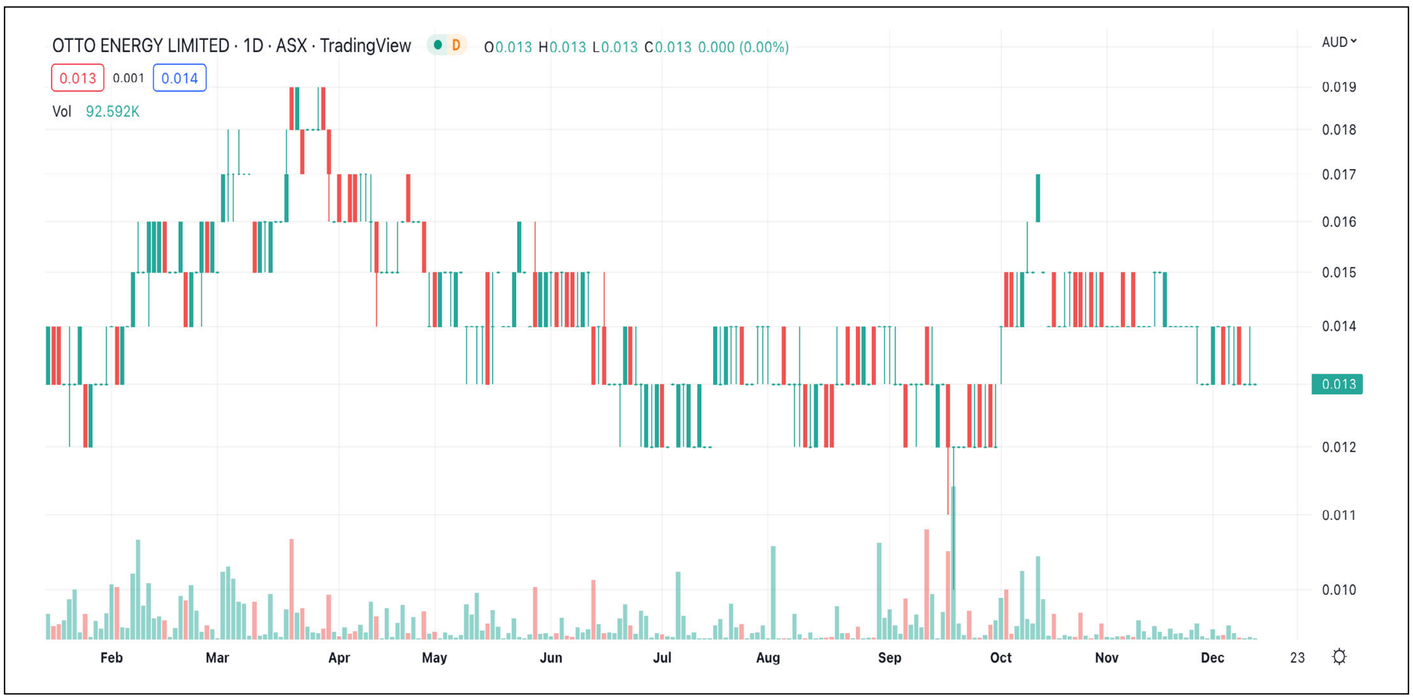
Stocks Down Under rating: ★★★★

ASX: OEL
Market cap: A$81.4M

52-week range: A$0.010 / A$0.019
Share price: A$0.013

It's hard to believe that an oil and gas company could be this inexpensive. The Houston-based Otto Energy, with interests in a number of producing fields in the Gulf of Mexico, enjoyed US$40.6m in revenue in FY22 and US$30.2m in EBITDAX (that is EBITDA with exploration expense added back). But right now the Enterprise Value of the stock is just US$23m. That's right. With Otto Energy you get your money back with less than one year's earnings.

Share price chart



Source: Tradingview

It has changed, but the market is acting as if it has not

In April 2018 Otto Energy had just made the transition from explorer to producer. The company owned half of a Gulf of Mexico oil field in shallow waters offshore Louisiana, called South Marsh Island 71, and with the first three wells from this field having just gone on stream, you could get Otto Energy stock for around 5 cents a share.

Now fast forward to November 2022. Otto Energy has interests in four other producing fields alongside SM71. Its share of oil and gas from the fields in the September 2022 quarter came to 2,511 barrels of oil equivalent per day (boe/d), which earned it US$13.9m in revenue just that quarter. And yet Otto Energy is currently trading at only 1.3 cents per share.

A great portfolio

Welcome to the new world of oil and gas, where, in spite of high prices for the commodities, ASX investors are often reluctant to properly price the stocks of emerging producers. We think that will change, however, as companies build up a track record of growing production and as investors realise that 'peak oil' is still a couple of decades away.

Apart from its valuation, the first thing to like about Otto Energy is the portfolio of assets that the company has built over the last few years. Take the aforementioned SM71 as a good example. This 12 sq km oil lease, to the south of Marsh Island in offshore Iberia Parish Lousiana, had been an oil producer between 1995 and 2010. Byron Energy (ASX: BYE) bought this lease when the Bureau of Ocean Energy Management, a US Federal agency that manages the Outer Continental Shelf, offered it for sale in 2012. Otto farmed in to the lease in late 2015 and was therefore a player when the Byron #1 well found oil in April 2016. This was the field that started producing in March 2018.

Four years later, and SM71, with two more wells and with Otto Energy holding a juicy 40.6% Net Revenue Interest (NRI), is the second most active lease on the entire Gulf of Mexico shelf.

Lightning strikes

SM71 wasn't the only piece of good fortune to have happened to Otto in recent years. Also noteworthy was the Green #1 well that tested the onshore Lightning prospect in Matagorda County, Texas, to the southwest in Houston. That discovery well of February 2019, which was operated by Hilcorp, the largest privately-owned oil and natural gas producer in the United States, remains the largest onshore discovery in Texas of the last ten years. Otto Energy retains a 28.2% NRI.

Another thing to like about Otto Energy is the discipline with which management has gone about building the company in recent years. All of the fields in which it has invested are operated by others, but Otto only invests in the Gulf of Mexico and, therefore, has virtually no sovereign risk. It only invests where there is a quick tie-in to markets for any oil or gas produced. And it only invests where the Internal Rates of Return on successful projects can come in north of 75% and Return on Average Capital Employed can come in at more than 20%.

A lot of new wells

The result today is a small company, with 2P Reserves on a Net Revenue Interest basis of only 5.8 million barrels of oil equivalent. This small company, however, can grow up fast, because the suite of fields in which it is invested can produce at low cost, isn't experiencing the kind of production declines you see from fields on their last legs and, importantly, those fields don't require much capital to keep going. We predict there will be more where that came from in the years ahead because the company is evaluating potential new investments all the time and, as of October 2022, Otto is debt-free, unhedged and therefore enjoying the current high prices for oil and gas.

The September 2022 quarterly report from Otto shows you how busy this company's portfolio is getting. The new offshore Mosquito Bay West field (NRI 21.4%) in Terrebonne Parish, Louisiana, started production from its first well on 18 August. The first well in the nearby in Oyster Bayou South field (NRI 22.7%) started producing around 12 September.

And later that month it was the Vick #1 well's turn in the onshore Eaves Field (NRI 7.7%), in Lavaca County, Texas. Meanwhile out in the Green Canyon area, 140 miles offshore in the central Gulf of Mexico, a well in the Green Canyon 21 field (NRI 13.3%) was being recompleted where first production is now expected early in calendar 2023.

West Texas Intermediate may have peaked at US$115 back in June, while US natural gas hit its high in August at US$9.70 per mmbtu, but we remain optimistic about the prospects of emerging producers, like Otto Energy. The market is undervaluing the high cash flows continuing to come Otto's way and not putting any premium on the management team that has positioned this company for growth. For investors who have the risk appetite, this one is four stars.

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