16 October 2017

SDX ENERGY INC

OIL & GAS

SDX.L

53.5p

Market Cap: £108.4m

SHARE PRICE (p)

12m high/low	67.4p/22p

Source: LSE Data

KEY INFORMATION

Enterprise value	£87.1m
Index/market	AIM
Next news	Q3 earnings - October 2017
Gearing	N/A
Interest cover	N/A

SDX ENERGY IS A RESEARCH CLIENT OF PROGRESSIVE

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Funding to further growth

SDX Energy has recently announced that it has raised US$10 million through an oversubscribed share placing. Placing funds will be used to accelerate activity with the money earmarked for two exploration wells in Egypt and two further development wells in Morocco. The two exploration wells in Egypt will be targeting an additional 150 BCF in the South Disouq licence following the company's success at its SD-1X exploration well. The company has also decided to add a further two development wells to its seven well programme in Morocco which should help prove up additional reserves and allow it to boost production.

- **Egypt**. In the South Disouq licence, where SDX is the operator with a 55% working interest, the company enjoyed success with its initial SD-1X exploration well which proved to be a significant gas discovery. Management is now looking at a further four well programme in Q1 2018. This will encompass two development wells to help bring the SD-1X discovery on stream and two exploration wells targeting combined additional, prospective resources of 150 BCF of gas.
- **Morocco**. In Morocco, the company has now started a nine well programme, seven of which are development wells in, and around, the producing Sebou licence where the company is operator with a 75% working interest. This programme is designed to prove up additional reserves to allow management to increase production through the existing infrastructure at a very low cost. A recently announced successful first well provides encouraging signs for this development programme. Two exploration wells will also be drilled in the Lalla Mimouna licence to ascertain the potential of this area.
- **Balance Sheet.** This placing raised gross proceeds of US$10 million which will further strengthen the balance sheet which at the end of June 2017 had net cash of US$27 million. The money raised will meet the costs of the proposed additional four wells planned which are expected to cost approximately US$2.5 million each.
- **Valuation.** Our reduced FY 2017E revenue and profit assumptions reflect, respectively, deferral of some production in Egypt into 2018 and the enhanced drilling programme. Using the industry standard valuation of a discounted cash flow analysis, we are reducing our valuation on SDX to 79p/share from 83p/share. This is predominantly due to the increased number of shares and the strength of Sterling relative to the US dollar more than offsetting the stronger balance sheet. Investors should be aware of the increased potential reserve upside with this higher level of activity. Investors should view any valuation in the context of their own assessments of the relevant risks.

FYE DEC	2015	2016	2017E	2018E	2019E
Revenues (US$ m)	11.4	12.9	42.1	78.5	79.6
Op. profits (US$ m)	(7.1)	(26.5)	15.4	42.1	53.3
Net income (US$ m)	10.1	(28.0)	14.4	38.9	50.6
EPS (¢/share)	19.5	(35.0)	7.7	19.0	24.7
Dividend (p/share)	0	0	0	0	0
Cash flow (US$ m)	(5.2)	(2.0)	23.5	44.7	54.5
Net cash (US$ m)	8.2	4.3	21.2	37.7	80.2

Source: Company Information and Progressive Equity Research estimates

Activity increases

SDX Energy announced on 15 September that it has raised US$10 million through an oversubscribed share placing. Placing funds will be used to accelerate an already busy drilling programme. Management is looking at adding a further four wells to a nine well programme with the addition of two exploration wells in Egypt and two further development wells in Morocco. The two exploration wells in Egypt will be targeting additional prospects totalling 150 BCF in the South Disouq licence following the company's success at its SD-1X exploration well. The company has also decided to add a further two development wells to its seven well programme in Morocco which should help prove up additional reserves and allow it to boost production.

Egypt. In the South Disouq licence, where SDX is the operator with a 55% working interest, the company enjoyed success in May with its initial exploration well – SD-1X - which proved to be a significant gas discovery. Management is now looking at a four well programme in Q1 2018. This will encompass two development wells to help bring the SD-1X discovery on stream and two exploration prospects which could contain combined prospective resources of 150 BCF of gas. The development wells could also add additional resources to the SD-1X discovery. (See page 4)

Morocco. In Morocco, the company has now started a nine well programme, seven of which are development wells in, and around, the producing Sebou licence and the adjacent Gharb Centre licence where the company is operator with a 75% working interest. This programme is designed to test additional fault blocks which will prove up additional reserves to allow the management to increase the supply of gas to new customers at low cost through the existing infrastructure. The first well in this programme, KSR-14, would appear to be successful with initial results exceeding pre-drill expectation and back up management's view. Two exploration wells will also be drilled in the Lalla Mimouna licence to ascertain the potential of this area. (See page 7).

Valuation. On the back of this placing, we are using the typical industry valuation methodology for the company's assets. This industry standard valuation is derived through a discounted cash flow analysis. The underlying value of the assets is unchanged in US dollar terms although we are reducing the per share value of these assets to reflect the increased number of shares and also the strength of Sterling against the US Dollar (which has increased to a GBP/USD rate of 1.35 against the previous rate we used of GBP/USD of 1.25. This has seen the core valuation of the producing assets decline to 48.3 p/share down from 57.1 p/share. We have also adjusted the valuation of the SD-1X discovery to reflect a lower level of reserves and lower risking after the drilling of the well. On top of this we are adjusting the cash to reflect the proceeds of the placing and utilisation of its large receivable position in Egypt. Overall this has led to a reduction in the industry standard asset value declining from 83 p/share to approximately 79 p/share. However, against this, the increased drill programme offers the ability to allow shareholders to enjoy a larger potential lift in reserves assuming a modicum of success in the drilling programme. (See Pages 9 & 10).

Financials. This placing raised a gross consideration of US$10 million which will further strengthen the balance sheet which at the end of June 2017 had net cash of US$27 million. The money raised will meet the costs of the additional four wells planned which are expected to cost approximately US$2.5 million each. On the profit and loss account we are reducing our forecasts. Most of this is due to increased drilling which if not successful will have to be written off through the profit & loss account. Additionally our 2017 forecast also reflects lower than forecast production from Egypt. 2017 net income is reduced to US$14.4 million from US$34.8 million. This forecast is liable to significant fluctuations dependent of success with the drill bit. Investors should, though, remember that the main driver of value comes through asset valuation rather than headline profitability. (See page 12).

SWOT Analysis

Strengths

One of the major strengths of the company is that it has low cost/high margin production in Egypt and Morocco. In a period of weak oil prices, this has allowed the company to continue to generate cash flow when many other players are suffering. The other main strength is its strong balance sheet. We estimate that the cash position after the placing is approximately US$ 33 million. This is more than sufficient to carry the company through this 13 well programme.

Weaknesses

The big weakness for the company is through the maturity of its producing assets. In Egypt, the North West Gemsa and Meseda licences are mature although management is trying to mitigate the decline in these licences. In Morocco, the existing production wells are also in decline. This decline in the mature Egyptian asset base should be offset by SD-1X development when this comes on stream whilst the drilling programme in Morocco is expected to prove up additional resources which can be easily marketed and hence ramp up production.

Opportunities

The strong balance sheet gives the company the potential to make accretive acquisitions. At a time when many smaller players are under significant financial strain, we believe that SDX could find relative bargains. This has been shown with the acquisition of the producing Circle assets at the start of the year.

Threats

Perhaps the largest threat to the business (as with all E & P companies) comes from the operating environment – especially the oil price. Weakness in the oil price will lead to lower than expected cash flows from its producing assets. That said, the proposed SD-1X development together with its existing Moroccan production will provide the company with additional fixed price gas volumes therefore mitigating the risks from oil price weakness. The other potential threat is due to much of its operations being based in Egypt where there have been some socio-economic problems over the last few years. This threat would appear to be receding on the back of the free floating the Egyptian currency and the government's desire to pay its receivables backlog by the end of the year. SDX, though, does not have a significant receivables risk with the government as it can take payment in Egyptian Pounds (EGP) as well as US Dollars (USD).

Egypt

With its desire to become a North African focused E & P company, the initial focus of SDX's operations was in Egypt. Management was eager to focus on this country given that it contained three significant world class hydrocarbon basins. Not only are there significant hydrocarbons, the onshore operating arenas have proven to be relatively low cost. Historically, this has proved a relatively difficult region to operate in given the low domestic price for gas and the economic problems suffered in the country leading to problems for contractors getting paid. However, things are improving. The domestic gas price is improving with the country running out of gas and looking to make up the shortfall with the importing of increasing levels of high cost LNG. This has allowed the price of domestic gas to gradually improve. The economic situation is also improving. As part of the agreement for an IMF bail out, there has been the removal of currency controls. With loans from the IMF, the government has pledged to clear the receivables balance to contractors by the end of 2017.

SDX Energy has three core assets within Egypt. It has 50% working interest in both the Meseda and North West Gemsa licences which are low cost oil production licences. These are mature assets and the company is working hard to alleviate the decline in these licences. In North West Gemsa, the company has a workover programme which is expected to maintain gross production at approximately 5,000 boe/day. In the Meseda concession, management has installed a new liquids treatment facility and is replacing downhole ESPs (Electric Submersible Pumps) with the aim of increasing production up to approximately 8,000 boe/day. There is some further upside in the Meseda area with the company announcing on 5 October that it had made an oil discovery the Rabul-2 well which has dramatically increased the heavy oil pay seen in the Rabul-1 discovery. The well found 101.5 feet if net heavy oil pay across the Yusr and Bakr sands and compared to the 14.5 feet of net pay in the Yusr sands in the Rabul-1. The well will now be tested to determine potential flowrates and volumes in this discovery. This should allow the company to further alleviate the natural decline in this field. However, the outlook for the company has now changed dramatically by the significant gas discovery in the South Disouq licence.

South Disouq

SDX is the operator of this licence with a 55% working interest. The licence is located in the onshore Nile delta region of Egypt and the SD-1X discovery would appear to confirm that it is situated at the southern end of the prolific Abu Madi Baltim trend where over 6 TCF of gas has been discovered to date. Management felt that pre-drill the largest risk associated with this licence was whether the source and associated migration path of the gas in the Abu Madi Baltim trend extended into the South Disouq licence. The success at the SD-1X exploration well has now mitigated much of this risk and opened up the play within the block.

SD-1X

The company finished drilling and testing the SD-1X well in May 2017 and confirmed a significant gas discovery. The reservoir in this four way dip closure came in very much on prognosis and flowed at a stabilised rate of 25.8 mmcf/day of dry gas. Gaffney Cline and Associates (GCA), SDX's independent reserve auditor, has analysed the data from this well and estimated that there are 2C resources of 47 BCF of gas and 2.3 mmbbl of condensate. We believe that this could prove to be conservative since GCA have based this reserve estimate on a "gas down to" basis. Given that the gas/water contact has not been found there could be significant additional reserves within the flanks of this discovery. The initial discovery well was drilled towards the crest of the structure.

Given that this discovery is close to a gas trunk line, it would appear to be commercial and management is looking at moving this ahead to development with first production hoped to be as early as Q1 2018. However, this timing is dependent on getting a field development plan approved by the authorities and agreeing a gas price with them that will enable SDX and its partner to generate an acceptable return on their investment. To further this development it is envisaged that two development wells will be drilled into the structure. These will add to the productive capacity of the field. As these wells will be drilled further towards the flanks of this field, there is the potential of deepening the "gas down to" level which could allow an increase in the recoverable reserves. The first development well is expected to be spudded by the year end.

Assuming that the two further development wells come in as prognosed, these wells are expected to start production at approximately 15 mmcf/day in each well. To expediate development, management is looking at renting the necessary gas processing units to allow the development to progress to first gas as quickly as possible. Should additional reserves be added, there is the potential for the gas to be sold to a gas aggregator which would increase competition for the gas and could allow the company to increase the unit price of this gas.

Further Exploration

Given that the company is looking to secure a rig to drill the two South Disouq development wells, management believes that it would make sense to add two exploration wells to this programme. The company has identified two prospects to drill and estimates that these prospects have mean prospective recoverable resources of approximately 150 BCF of gas. The main risk in the licence prior to drilling was whether the gas source and migration path has extended south sufficiently to charge the prospects and leads in the South Disouq licence. This risk has now been reduced with the discovery at SD-1X. Although the risks have been reduced, these two prospects are slightly different from the SD-1X discovery in that they are stratigraphic traps rather than a four way dip closure which was the case at SD-1X. With this trap type untested in the licence there is still some risk that there is not an adequate seal in this type of exploration play. Management believe that the chance of success is approximately 30 – 40%. Success would greatly enhance the economics of this licence.

Economics

The impact of success with these two exploration wells is material to the company. The following table details management's estimate of success assuming the wells cost US$2.5 million each. The proposed development would be similar to the SD-1X development and would result in tie-backs to the proposed rented processing facility to be used for the SD-1X development. Upon success of the two exploration wells, four development wells would be drilled (two for each discovery) to produce out the discovered volumes.

Egypt exploration success economics

Discovery size	75 BCF	150 BCF	200 BCF
IRR (%)	45.1%	84.6%	89.5%
NPV (US$m)	10.0	35.3	48.6
Payback (Years)	3.8	3.3	3.3
Multiple of invested capital	3.0	7.4	10.3

Source: Company

Deeper oil potential?

With the drilling of the initial SD-1X well, the well was deepened to test a lower interval in the Abu Roash and AEB intervals. These intervals have been prospective for oil in the Western Desert although they are untested nearer to the SD-1X discovery. Although SD-1X encountered a potential working hydrocarbon system at the deeper target intervals, well integrity was poor and management decided not to log the interval in case, in doing so, it compromised the completion of its shallower gas discovery. However, as part of the development well programme, SDX may deepen a development well to allow a re-test of this deeper formation to see if there are commercial reserves at these deeper levels. This could prove to be exciting as this is a potential oil play which has a higher sale price compared to gas on a calorific basis. The second development well will be drilled early Q1 2018.

Morocco

SDX entered Morocco with the acquisition of Circle Oil's assets in January 2017. The main asset was a 75% working interest in the producing Sebou concession in the onshore Rharb basin. SDX also acquired a 75% working interest in the Lalla Mimouna exploration area which encompasses two licences (Lalla Mimouna Nord and Lalla Mimouna Sud). This exploration acreage is also located in the Rharb Basin and surrounds the Sebou licence to the West and North although it is not yet proven to be contiguous with it. Since the acquisition of the Circle Oil assets, the company has been awarded a 75% working interest in the Gharb Centre exploration permit which sits between and connects the Sebou licence to the Lalla Mimouna licence.

Sebou

SDX has a 75% working interest in the Sebou permit which contained 2P (Proven & Probable) reserves of 6.8 BCF of gas. This concession is currently producing approximately 5.5 – 6.0 mmcf/day although the existing wells are starting to decline. The fields are connected to the gas buyers through the company's privately owned gas pipeline. The production is low cost with an estimated cost of production of less than US$1/mcf. Given that the current contract price of natural gas price is approximately US$10.00/mcf, this will prove to be a very high margin business. The pipeline is also a potentially valuable asset in that any discoveries were made by third parties in the surrounding area they would probably have to use this pipeline to take the gas to the industrial market and this could allow SDX to potentially benefit from tariff income in the future. There is significant demand for gas in the region and management is eager to prove up additional volumes that will satisfy this demand. The pipeline has a capacity of 24 mmcf/day so there is significant ullage available should discoveries be made.

Seven well development drilling programme

Initially, SDX was looking at drilling a five well development programme in the Sebou licence but after the successful fundraise, this has been increased to a six well programme in Sebou with the one additional well being drilled in the Gharb Centre licence close to the border of the Sebou licence. The programme has been called a development well programme. However, this is slightly misleading as the wells will be targeting separate new fault blocks in the producing region which have not been tested previously. This programme will therefore prove up additional reserves on top of the 6.8 BCF that the company acquired in the Sebou concession. The seven well programme is targeting seven of these fault blocks with each containing 1.0 - 1.5 BCF of gas to make a combined maximum potential target of 10.5 BCF. To date, the drilling in the Sebou licence has been low risk with an overall success rate of approximately 80%. If successful, the wells can be quickly brought onto production. To date, the gas found has been very good quality dry gas (with 99.5% methane) which does not need processing and so can be added directly into the pipeline. We believe that the timeframe could be as short as 3 - 4 months from drilling the well to having gas being sold to new customers. The programme will also start to prove up reserves in the Gharb Centre licence. Going forward, the company may undertake a further seismic programme in Gharb Centre to prove up additional prospects to drill and add more momentum to the operation.

The first well in this programme has now been drilled on the KSR-14 prospect in the Sebou licence. The early indications would appear to suggest that the size of structure exceeds pre-drill estimates. This well will now be further evaluated to get a better understanding of the recoverable reserves and should everything go as expected, then this well could be put on stream in approximately 30 days. This success reinforces management confidence and demonstrates the potential of the region.

Economics

The economics of this operation in Morocco are compelling. SDX estimates that the cost of drilling the wells are US$2.5 million per well. Even assuming the lower end of reserves at 1 BCF of gas, this equates to a cost of US$2.50/mcf whilst the additional incremental opex is expected to be a mere US$0.37/mcf to make full cycle production costs of less than US$3.00/mcf compared with current sale price of approximately US$10/mcf. With a sales royalty of a modest 5% and SDX still enjoying a corporation tax holiday for another five years, this will make a significant impact on the cash flow of the business. The following table is management's estimates of the impact of a successful discovery assuming a 3 month delay between capex and revenues.

Morocco success economics

Discovery size	0.5 BCF	1.0 BCF	1.5BCF
IRR (%)	69%	199%	213%
NPV 12.5% (US$m)	1.27	6.72	10.36
Payback (Years)	1.79	1.45	1.45
Multiple of invested capital	1.35	2.81	4.17

Source: Company

Lalla Mimouna

The company is also looking at drilling two exploration wells in its Lalla Mimouna licence. There has been some 3D seismic acquired here by Circle Oil who drilled three wells on the back of this in 2014. The first well discovered gas and flowed at 3.0 mcf/day from two zones. The subsequent two wells discovered gas but the reservoir quality was poor and hence these were not tested. This is encouraging as it proves the presence of gas in the region although the reservoir quality would appear to be one of the main risks in drilling further exploration wells. The first two wells to be drilled by SDX will target prospects, each with potential reserves of 1.0 - 1.5 BCF of gas. These will give management a better understanding of the geology of this licence. SDX believes that it needs 3 BCF of recoverable gas resources to justify building a pipeline to connect to the Sebou pipeline. Although these two wells, if successful, would by themselves almost take the company up to this economic threshold to justify building a pipeline, it would also mean that a significant number of additional prospects could now be drilled given that a volume of reserves (sufficient to justify the construction of a pipeline) had already been discovered.

Asset Valuation

Methodology

For valuing E & P companies we take the traditional approach of asset valuation that is used by the industry. Investors should therefore view any valuation in the context of their own assessments of the relevant risks. This valuation is derived through using a DCF (discounted cash flow) methodology to the known fields and discoveries of the company. The field production profiles, capital expenditure and operating costs are modelled under the appropriate fiscal regime to give a cash flow profile which is discounted to provide a net present value for each asset. We usually add an element of value for the risked exploration upside to give an indication of how this asset value may change over the next twelve months. However, with so many wells being drilled we have indicated later the potential upside but not factored this into our core valuation.

Commodity prices

Oil

For the oil price we use the forward futures curve for Brent oil over the next four years and then escalate those prices by 2.0% per annum. The price used in the models is then adjusted for the quality of the crude oil produced in the respective fields. For example, the crude oil in the Meseda field is heavy and so will attract an approximate 30% discount to the Brent crude price marker. At present, the forward curve is flat with the market expecting approximately US$57/bbl average in each of the next four years (2017 – 2020).

Gas

Gas within Egypt is slightly more complicated. The associated gas in the NW Gemsa field is sold at a very modest average price of US$1.20/mcf (“profit” gas is sold at US$1.00/mcf whilst “cost” gas is sold at US$1.40/mcf). However, on the South Disouq licence the gas will be sold under contract at “non-associated” gas prices. The current non-associated gas domestic market price is set at US$2.76/mcf (US$2.65/mmBtu). However, this gas price is starting to rise given the shortage in the country and we are assuming that the management is able to achieve a sales price of US$3.00/mcf. However, SDX Energy has the ability to market any gas discovered directly to end-users and thus not be tied into domestic gas prices paid by the State. Gas in Morocco is relatively straight forward. This is priced on contract-by-contract basis and, at present, the company is achieving a price of approximately US$10/mcf.

Discount Rate & Exchange rates

The discount rate that we use in the valuation is the standard 10%. Although it could be argued that this should be adjusted to reflect the company’s WACC (weighted average cost of capital), this is the standard rate that is used by the industry in making acquisitions.

The oil and gas industry very much works in US dollars. Therefore, we have modelled the assets in US dollars and will translate this through at the current exchange rate to allow investors to see a sterling based valuation. Sterling is currently trading at a USD/GBP level of approximately 1.35. On the Moroccan Dirham (MAD), the exchange rate is currently standing at a MAD/USD rate of 10.0.

SDX Valuation-

Asset base

We are not changing the underlying valuation of SDX's asset base in US Dollar terms. However, the sterling value has been reduced to reflect the recent strength of Sterling against the US Dollar which is now standing at a GBP/USD rate of 1.35 as opposed to our previous valuation which was at a GBP/USD rate 1.25. The "per share" value is also reduced to reflect the increased number of shares after the placing which has risen by approximately 17.6 million shares to a level of 204.5 million shares. The other change we have made is on the exploration upside. We have split this from the core valuation to allow investors to see the impact of the current drilling programme. We will change the valuation after the drilling campaign given the large number of wells that are going to be drilled and hence there is a wide range of possible reserve additions that might come through.

Overall

Using our pricing deck, our risked NAV (RENAV) of the company for its two main Egyptian assets (NW Gemsa and Meseda) and the Sebou concession in Morocco is standing at 48.3p/share. This is reduced from 57.1p/share purely through the exchange rate and change in the number of shares rather than any change to the underlying value of the asset. The valuation of the SD-1X field is also changed. This will reflect the lower volumes that GCA is assuming for this discovery but also we have removed the risking on the well given that we had assumed before the exploration well was drilled. We believe that this is the base case and if the development wells prove up additional reserves then these will have a substantial impact on the industry valuation since these can be produced with very little incremental costs. We have adjusted for the balance sheet with the increased cash that the company has post the placing. We have also included the receivables in Egypt given that this is likely to be crystalised as a result of the improved economic environment and the potential to accelerate the receipt of some of these receivables by accepting EGP which can then be used to pay for some of the costs in the development of the SD-1X discovery. The table below shows our asset valuation.

SDX Energy RENAV

		US$m	p/share
Egypt			
	Meseda	55.0	19.9
	NW Gemsa	27.7	10.0
Morocco			
	Sebou	50.7	18.4
Producing assets		**133.4**	**48.3**
Egypt	SD-1X	17.1	6.2
Discoveries		**17.1**	**6.2**
Balance sheet			
	Cash	37.0	13.4
	Receivables	30.0	10.9
Total		**217.5**	**78.8**

Source: Company & Progressive Research estimates

Exploration upside

Given the very active drilling programme, we have detailed the potential upside that could come through from the drilling programme. We have not given our usual risked programme value per share on an individual well basis given that there are so many wells and the individual outcome of each well will vary. With so much uncertainty we would prefer to show what the potential upside is to shareholders and we will readjust our valuation once the programme is finished at the end of Q1 2018. It should also be noted that we are valuing the prospects on our standard industry metric which is on the basis of a PV 10 (using a discount rate of 10%) rather the previous valuations which were management estimates which used a discount rate of 12.5%.

SDX Energy impact of current drill programme

	Size	NPV	
Egypt		**US$ m**	**p/share**
Kelvin & Brage	150 BCF	40.0	14.5
Morocco			
Single prospect	1 BCF	3.6	1.3
7 prospects	7 BCF	25.2	9.1

Source: Company & Progressive Research estimates

Financials

Balance Sheet

SDX Energy is in a strong position following its fundraise. At the end of June 2017 the company had US$27.6 million of net cash and this fund raise will increase this to approximately US$37 million. This is more than sufficient to meet its exciting drilling programme which will cover 13 wells at a cost of approximately US$32.5 million. This though does not include the costs of developing the SD-1X discovery.

Fund Raise

On 6 September, SDX Energy announced that it was raising gross proceeds of US$10 million through the issue of 17.6 million shares at a price of 43.75 p/share. This represented a 9.4% increase in the number of shares in issue. The price that the shares were issued was the closing price on the evening before this issue. The rationale for this raise was that the company was planning to increase the number of wells in its already busy drilling programme from two to four in Egypt and from seven wells to nine in Morocco. The gross cost of each of these wells was US$2.5 million.

Receivables

The other advantage that SDX has is its large receivables position in Egypt. This is due partly from money owed by the state for previous gas and NGL production and also the company inherited approximately US$15 million with the acquisition of Circle Oil's Egyptian assets. As at 30 June 2017, this was standing at approximately US$30 million. Historically, the state has been unable to pay the oil and gas companies for their production in US dollars leaving them to either take Egyptian pounds or wait for US Dollar payments at some time in the future. However, this large receivables position is becoming a benefit for SDX. Firstly, the Egyptian pound has now become free floating making it easier to exchange Egyptian pounds for US dollars. Secondly, with the success at the SD-1X well, the company is now looking to embark upon a major capital expenditure programme where it will pay a meaningful proportion of the contractors in Egyptian pounds. This should allow the company to crystalise much of this receivables position to fund the SD-1X development.

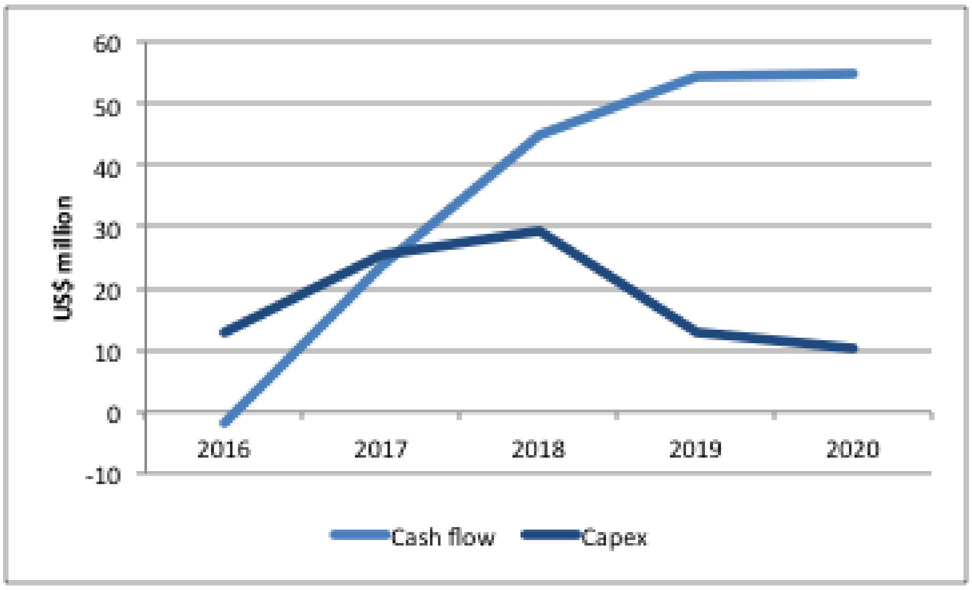
Cash flow statement

We have adjusted the cash flow statement for the company to reflect this active drilling programme and a potential 3D seismic programme in Morocco. In Morocco, the drilling programme is expected to cost approximately US$24 million which is roughly split between 2H 2017 (US$14.2 million) and 1H 2018 (US$10.0 million). Although the 3D seismic programme has not yet been contracted for it could cost an additional US$6.5 million and to be conservative, we are assuming that this will be done over the course of 2018.

In Egypt, the company is continuing its low level of capital expenditure on the Meseda and NW Gemsa licences. This is expected to be US$2.2 million in 2H 2017 and US$3.2 million in 2018. However, there is a large jump is spend due to the development of the discovery in South Disouq. US$6.1 million is expected to be spent on the pipeline in H2 2017. The spend increases with the drilling programme for the four well programme and the remainder of spend on the pipeline expected to cost US$9.4 million. All in, the company is expected to spend US$22.5 million in 2H 2017 and US$29.1 million in 2018.

As an offset of this increased spend, the company should start to see a contribution from the South Disouq discovery which is expected to be on stream at the end of Q1 2018. Also assuming some success in its Morocco drilling programme the company should be able to start boosting production from a current level of 5.5 mmcf/day and we would hope to see production in 2018 of 7.5 mmcf/day and then rising further in subsequent years. That being said the impact of the new cash flows from Egypt and Morocco do not offset the increased spending in 2018 so the rate of free cash generation is reduced. Subsequent years will see the free cash flow generation increase further.

SDX Energy – forecast capex v cash flow (US$m)



Source: Progressive Research estimates

Profit & Loss Account

The profit & loss account, is relatively immaterial for an E & P company with the main driver being the value of the assets rather than headline profitability. With its low cost operations, the company has very profitable businesses in Egypt and Morocco. However, as with all E & P companies, the reported profits will fluctuate dependent on exploration success. Under current reporting standards, E & P companies are expected to write off, through the profit & loss account, any costs (current and historic) associated with unsuccessful drilling. With a very active drilling programme over the next 12 months, the profitability will fluctuate wildly. We have reduced our 2017 net income to US$14.4 million from US$34.8 to reflect a higher exploration charge of US$5 million (previous none) and slightly lower production than expected in Egypt. 2018 net income is reduced to US$38.8 million from US$40.6 million which reflect a higher exploration charge offset by increased production from SD-1X in Egypt and some success in Morocco leading to rising production.

Dividends

SDX Energy does not propose to pay any dividend. This is similar to most of the E & P companies. Management feels that it is better to reinvest any cash generated in growing the business giving shareholders a better capital return.

SUMMARY FINANCIALS – profit & loss account (US million)

	2014A	2015A	2016A	2017E	2018E	2019E	2020E
Net revenues	**24.53**	**11.37**	**12.91**	**42.09**	**78.49**	**79.63**	**76.41**
Operating costs	(3.64)	(4.97)	(3.55)	(13.59)	(18.15)	(16.96)	(14.58)
Exploration expense	(2.77)	(0.07)	(28.70)	(5.00)	(10.00)	(1.00)	(1.00)
DDA	(1.60)	(2.06)	(2.39)	(3.20)	(3.20)	(3.20)	(3.20)
Impairment	-	(6.84)	-	-	-	-	-
Share awards	(1.06)	(0.76)	(0.78)	(0.80)	(0.82)	(0.84)	(0.86)
Associate	1.13	1.02	0.90	0.90	0.90	0.90	0.90
Loss on disposal	-	(0.00)	-	-	-	-	-
G & A	(2.90)	(4.77)	(4.89)	(5.01)	(5.14)	(5.27)	(5.40)
Total	(10.84)	(18.46)	(39.41)	(26.70)	(36.41)	(26.37)	(24.14)
Operating profit	**13.69**	**(7.08)**	**(26.50)**	**15.39**	**42.08**	**53.26**	**52.28**
Net interest expense	(1.01)	(0.10)					
Gain on acquisition	-	18.29	-	-	-	-	-
Pre-tax profit	**12.68**	**11.11**	**(26.50)**	**15.39**	**42.08**	**53.26**	**52.28**
Current tax	(4.31)	(1.17)	(1.48)	(0.95)	(3.20)	(2.66)	(2.26)
Deferred tax	(0.02)	0.11					
Taxation	(4.33)	(1.06)	(1.48)	(0.95)	(3.20)	(2.66)	(2.26)
Net income	**8.36**	**10.05**	**(27.98)**	**14.44**	**38.88**	**50.60**	**50.02**
FX	(0.42)	(0.65)	-	-	-	-	-
Income	**7.94**	**9.40**	**(27.98)**	**14.44**	**38.88**	**50.60**	**50.02**
EPS							
Basic	0.148	0.195	(0.350)	0.077	0.190	0.247	0.245
Diluted	0.144	0.195	(0.350)	0.077	0.190	0.247	0.245
Share							
Basic	56.35	51.63	79.84	186.90	204.50	204.50	204.50
Diluted	57.91	51.63	79.84	186.90	204.50	204.50	204.50

Source: Company information, Progressive Equity Research estimates

SUMMARY FINANCIALS - Cash flow statement (US$ million)

	2014A	2015A	2016A	2017E	2018E	2019E	2020E
Pre tax profits	12.68	11.11	(26.50)	15.39	42.08	53.26	52.28
Adjustments for							
DDA	1.60	2.06	2.39	3.20	3.20	3.20	3.20
Exploration expense	2.77	0.07	28.70	5.00	10.00	1.00	1.00
Impairment expense	-	6.84	-	-	-	-	-
Amortisation of transaction costs	-	0.38	-	-	-	-	-
Finance cost	0.03	(0.01)	-	-	-	-	-
Stock based compensation	1.06	0.76	0.78	0.80	0.82	0.84	0.86
Gain on acquisition	-	(18.29)	-	-	-	-	-
Equity in associate	(1.13)	(1.02)	(0.90)	(0.90)	(0.90)	(0.90)	(0.90)
Loss on disposal	-	0.00					
Operating cash flow	**17.02**	**1.90**	**4.47**	**23.49**	**55.20**	**57.40**	**56.44**
Working capital change	12.94	(2.18)	(5.00)	1.00	(7.28)	(0.23)	0.64
Cash flow before tax	29.96	(0.28)	(0.53)	24.49	47.92	57.18	57.08
Tax paid	(4.43)	(4.93)	(1.48)	(0.95)	(3.20)	(2.66)	(2.26)
Cash flow	**25.53**	**(5.21)**	**(2.01)**	**23.54**	**44.72**	**54.51**	**54.82**
Plant and equipment	(1.96)	(1.39)	(2.30)	(19.48)	(23.73)	(10.94)	(8.29)
Exploration	(11.67)	(3.73)	(10.50)	(6.00)	(5.37)	(2.00)	(2.00)
Office assets	-	0.01					
Dividends received	1.11	0.92	0.90	0.90	0.90	0.90	0.90
Acquisitions	-	-	-	(30.00)	-	-	-
Cost of acquisition	-	-	-	(2.00)	-	-	-
Sea Dragon working capital	-	3.91	-	-	-	-	-
Cash used in investing activitie	**(12.52)**	**(0.28)**	**(11.90)**	**(56.58)**	**(28.20)**	**(12.04)**	**(9.39)**
Repayment of debentures	-	(2.05)					
Shares issued	-	-	10.00	50.00	-	-	-
Repayment of bank facility	-	(1.65)					
Cash used in financing	-	(3.70)	10.00	50.00	-	-	-
Charge in cash	**13.01**	**(9.20)**	**(3.92)**	**16.97**	**16.52**	**42.48**	**45.43**
FX effects	(0.62)	(0.57)					
Cash at start	5.54	17.94	8.17	4.25	21.22	37.74	80.22
Cash at end	**17.94**	**8.17**	**4.25**	**21.22**	**37.74**	**80.22**	**125.65**

Source: Company information, Progressive Equity Research estimates

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