Pryme Energy Limited (ASX:PYM)

PRODUCER | **CONVENTIONAL OIL** | **SHALE OIL POTENTIAL**

COMPANY DATA

ASX Code	**PYM**
Recommendation	**SPECULATIVE BUY**
Share Price (A$)	**A$0.009**
Ordinary Shares on Issue (m)	**790.7**
Options on Issue (m)	**513.7**
Market Capitalisation (A$m)	**A$7.1**
Cash at 30-Jun-14 (A$m)	**A$1.0**
Rights issue cash, pre costs (A$m)	**A$4.0**
Pro forma cash (30-Jun-14)	**A$5.0**
Non-recourse debt (US$m)[1]	**nil**
Enterprise Value (A$m)	**A$2.1**

1. *A purchase and sale agreement was entered into in May 2014 in order to extinguish the Macquarie Bank non-recourse debt.*

SHARE PRICE PERFORMANCE

BOARD & MANAGEMENT

George Lloyd	Non-Executive Chairman
Justin Pettett	Managing Director
Ryan Messer	Executive Director
Greg Short	Non-Executive Director
Swapna Keskar	Company Secretary

MAJOR SHAREHOLDERS

Panorama Ridge	5.4 %
Belmont Park Investments	4.8 %
Board Members	6.1 %

SPECULATIVE BUY

Pryme Energy – Funding "yes", drilling "next"

SUMMARY

Pryme has successfully raised A$4.0 million in an underwritten rights issue. Accordingly, **Pryme is now fully funded for Phase I of its Capitola Oil Project ("Capitola") drilling program, with two wells planned to commence drilling in mid-September 2014**, with completion and flow rate results expected during late October 2014.

Pryme is targeting, *firstly*, two oil fields at Capitola (Sweetwater and Claytonville) in the highly prospective Eastern Permian Basin, Texas, that have previously produced c.6 MMBbl of oil. *Secondly*, significant value-enhancement from the Cline Shale Oil horizon in the fields where adjoining US companies, such as Devon Energy, are spending significant amounts up to Capitola's boundaries to 'unlock' the Cline shale's potential (which has been compared to the Eagle Ford shale in prospectivity).

Pryme's near-term and longer-term **value appreciation** will be driven by the **results of the Q3'14 two well oil drilling program**, which is part of the farm-in to the Capitola Oil Project in the oil prolific Permian Basin, Texas, USA. Longer-term price appreciation will also be led by the ongoing **demonstration of Pryme's Cline shale prospectivity**, with third parties actively leading this demonstration now through extensive drilling activities.

RECOMMENDATION

We recommend Pryme as a **SPECULATIVE BUY**. Our recommendation is on the basis of the merits and risks of the investment as described in this report and in our Pryme Energy initiation report dated 14 May 2014.

- **Funding arranged**: Pryme is funded for the first phase of its two well oil drilling program at Capitola, commencing in mid-September 2014;
- **Exposure to near term oil drilling program**: the Sweetwater and Claytonville fields have previously produced oil and Pryme intends to drill vertical wells into those previously produced horizons. Also third parties, such as Gunn Oil, are currently producing from oil horizons near to Capitola using vertical wells; and
- **Upside value potential from the Cline shale**: previous well core data from Capitola shows the existence of the Cline shale on Pryme's acreage, and third parties, such as Devon Energy, continue to actively demonstrate the Cline shale's prospectivity by continuing their production, drilling and well permitting activities nearby to Capitola.
- Given the pre-drill status of Capitola currently, and Helmsec Global's participation in Pryme's recent underwritten rights issue, a valuation has not been undertaken for the purpose of providing the recommendation in this report.

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FUNDING UPDATE

Underwritten rights issue

In July 2014, Pryme undertook a 3 for 2 rights issue with free attaching options. The rights issue was successfully underwritten to A$4.0 million providing the funding for the first two well drilling program, the August 2014 farm-in payment, and costs/working capital.

Pryme's capital structure is now:

- Shares on issue: 790.7 million ordinary shares; and
- Options on issue:
    - 423 million options over ordinary shares with an exercise price of A$0.02 each and an expiry date of 23 July 2016; and
    - 90.7 million Management options on the same terms but which also have certain performance criteria requirements in order to fully vest.

Pro forma cash position and main near-term outgoings

The 30 June 2014 pro forma cash balance (ie. including the rights issue raising pre-costs) is approximately A$5.0 million before capital raising costs.

The main cash outgoings by Pryme over the coming months include:

- August 2014 lease payment under the terms of the Capitola farm-in: US$0.75 million; and
- Two well drilling program: Pryme's estimate is US$1.9 million in the success case.

Accordingly, in the case of drilling success for the coming two well program, Pryme's cash balance is likely to be in the range of A$1.5 to A$2.0 million, depending on actual amounts paid and revenue received from Pryme's existing oil production in Louisiana. In the event of a dry well, the drilling costs are significantly lower, so the cash balance could be approximately US$1.0 million greater in that scenario and represent a helpful preservation of capital under that scenario.

Pryme is expected to consider its funding options for the remainder of the Capitola farm-in and beyond following receipt of results from the first two well drilling program, which is understood will cover a range of options including consideration of asset-based and non-equity-based funding arrangements.

Increased Management/Board Alignment with Shareholders

Simultaneously with the recent rights issue, the Managing Director and the Chief Operating Officer demonstrated their confidence in Pryme's outlook and increased their alignment with Pryme shareholders, by both reducing their base salary levels significantly and both taking on an options package that is tied directly to the performance of the Capitola Oil Project as follows (all net to Pryme):

- Tranche 1 (25% of total available Management Options vest) – 200 BOE/day in production;
- Tranche 2 (25% of total available Management Options vest) – 1.0 MMBOE of 2P reserves;
- Tranche 3 (25% of total available Management Options vest) – 2.0 MMBOE of 2P reserves; and
- Tranche 4 (25% of total available Management Options vest) – 700 BOE/day in production.

Also, all Directors hold a combined total of 6.1% of the shares on issue and each participated in capital raisings undertaken by Pryme in 2014.

UPCOMING VERTICAL DRILLING PROGRAM

Initial Two Well Program

Pryme will undertake a two well vertical drilling program commencing in mid-September 2014, with completion and flow rate results expected in late October 2014. Success in the initial program may lead to production coming online in early November 2014.

These initial wells will be located in the southern part of the Sweetwater acreage block and are planned to vertically intersect the main Capitola "stacked" horizons through to the Cline Shale approximately 6,000 feet deep with the primary target horizons being:

- Breckenridge Lime: This is a shallower conventional target (4,500 feet) which is a carbonate encased in shale setting just above the Canyon Sands, and will be tested to determine commercial hydrocarbons providing potentially as much upside to Pryme's vertical well program as the Cline Shale;
- Canyon Sands: This is a conventional target that previously produced oil predominantly from the C Sand and has multiple sands ranging from 4,900 feet deep to 5,500 feet deep; and
- Cline Shale: The initial vertical wells are planned to be drilled through to the Cline Shale for testing purposes. Overall, Pryme does not currently have plans to undertake expensive horizontal drilling in the Cline Shale, but instead, if productive, to produce through a vertical well bore and to 'learn' from both (i) any testing of the Cline Shale during Pryme's vertical drilling program and (ii) the extensive horizontal Cline Shale activity of nearby neighbours (see further details below).

As noted above, Pryme's cost estimate for the two well program is approximately US$1.9 million in the success case which would include completion, fracture stimulation and surface production facilities.

Pryme has built an impressive network of local specialists including:

- Experts in petroleum geology, engineering and land with extensive experience through the Permian Basin each having worked with several independent oil companies exploring for and developing fields throughout the Permian Basin with a focus on the Eastern Shelf of the Permian Basin where the Capitola Oil project is located; and
- Pryme and Pryme's joint venture partners at Capitola are understood to have cooperative relationships with other local owners and operators in and around the Eastern Permian Basin including with Gunn Oil who is undertaking an extensive vertical well program nearby to Capitola.

Overall Capitola Farm-In Drilling and Longer-Term Drilling Program

At Capitola Pryme is earning into a 75% WI (56.25% NRI) in 9,333 acres to all depths from the surface to the top of the Cline Shale (7,000 net acres to Pryme) and a 50% WI (37.5% NRI) in all depths from the top of the Cline Shale and deeper (4,666 net acres to Pryme).

The farm-in terms give Pryme the option, at its discretion, to drill a total of up to 9 vertical wells and 1 horizontal well into the stacked formations above the Cline Shale in a phased program over 2 years. Pryme is fully funding the first 3 vertical wells and Pryme is able to recover 100% of its costs on these 3 wells prior to the joint venture partner moving back to its 25% WI in those first 3 wells.

Pryme's future decision to pursue the subsequent vertical wells under the Capitola farm-in terms (i.e. up to 7 subsequent verticals) will depend in part upon the results of the initial two well program and ongoing drilling, production and appraisal results.

Subject to ongoing results and Pryme's discretion, the longer term vertical well development plan for the entirety of the Capitola oil project encompasses:

- 200+ vertical locations to drill in Capitola's acreage at 40 acre spacing targeting multiple zones (including previously produced zones) and other secondary objectives;
- Well locations to be down-spaced and step-out wells to previous historical well bores; and
- Pryme's estimate of initial production rates is 60 to 140 BOE/day and a EUR range of 50,000 to 140,000 BOE.

DRILLING ACTIVITY PROXIMATE TO CAPITOLA

Ahead of Pryme's initial two well program on its Capitola acreage, the continued high level of third party activity on the boundaries of and surrounding the Capitola project provide a strong endorsement and are very encouraging for the prospectivity of Pryme's initial two wells and Capitola more generally. The prospectivity is also evidenced by Capitola's history where the Sweetwater and Claytonville fields were successful with approximately 6 MMBbls of previous oil production from approximately 150 well bores.

Nearby Vertical Drilling Activity

Gunn Oil, a large private US company, has successfully brought into production over 40 wells within 5 miles of Capitola. Gunn Oil is continuing its extensive vertical well program near and to the north of Capitola, including:

- Within 1 mile of Capitola: Gunn is currently drilling the Cave-1 well within one mile of the Claytonville acreage block's northern boundary. Gunn is planning a 7,500 foot well to test the Canyon Sands, Ellenberger, Palo Pinto and Strawn formations which Pryme also expects to encounter in Capitola; and
- Attractive choked-back IPs: Gunn has reported attractive IPs in its vertical well program, for example the Martin QR-6 well had an IP of 83 bopd under choke-back from the Ellenberger horizon alone.

The location of Gunn's Cave-1 pending well is shown in Figure 1 (and Figure 2), and the Martin QR-6 well location is shown in Figure 1. Figure 1 below highlights the extensive third party vertical well programs all within a handful of miles from Pryme's Claytonville block.

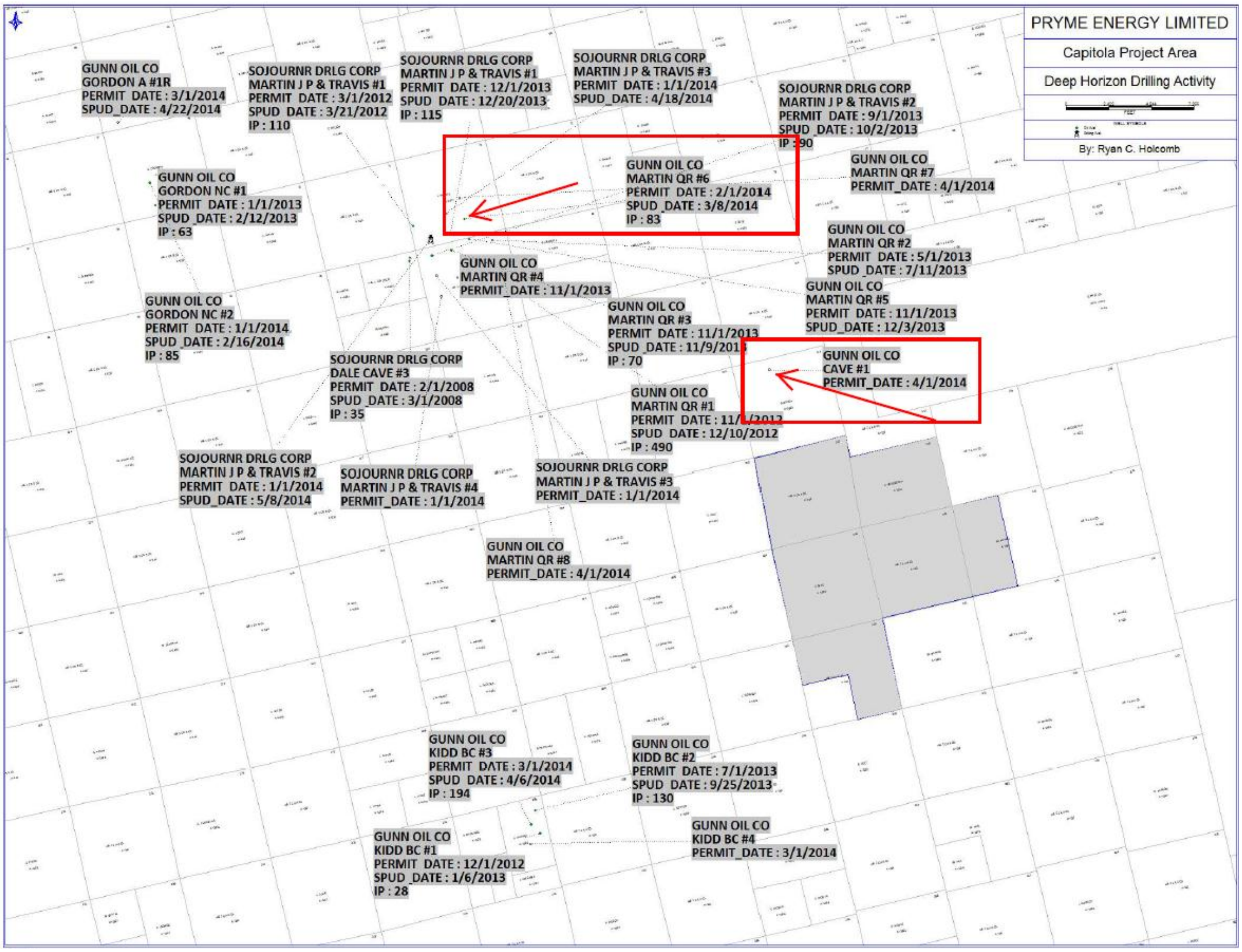

Figure 1: Public file vertical well locations near Capitola. Source: Pryme

Nearby Cline Shale Horizontal Drilling Activity

The Cline Shale is roughly 140 miles long and 70 miles wide in the Eastern Permian basin in mid Texas. It is known from cores taken by the industry to be regionally extensive. Industry prognoses for the Cline shale range up to potentially having more total recoverable oil and gas than both the Eagle Ford Shale and the Bakken Shale combined.

Devon Energy (NYSE:DVN) has had production success in its extensive Cline Shale focussed horizontal well program at locations surrounding Capitola (as close as 1 mile from Capitola's boundary) - see Figure 2. Devon's current activities include:

- W Ranch No.1H well, to the west of the Claytonville block, has flared gas and is in the process of being put into production;
- Parker No.1H well, next to the Claytonville block's eastern boundary, has completed drilling and is in flow-back phase;
- Bishop No.2H well, an offset well to the successful Bishop No.1H, next to the Sweetwater block's western boundary, has been drilled and is currently awaiting completion; and
- Davenport No.3H well has also been recently drilled and is currently awaiting completion.

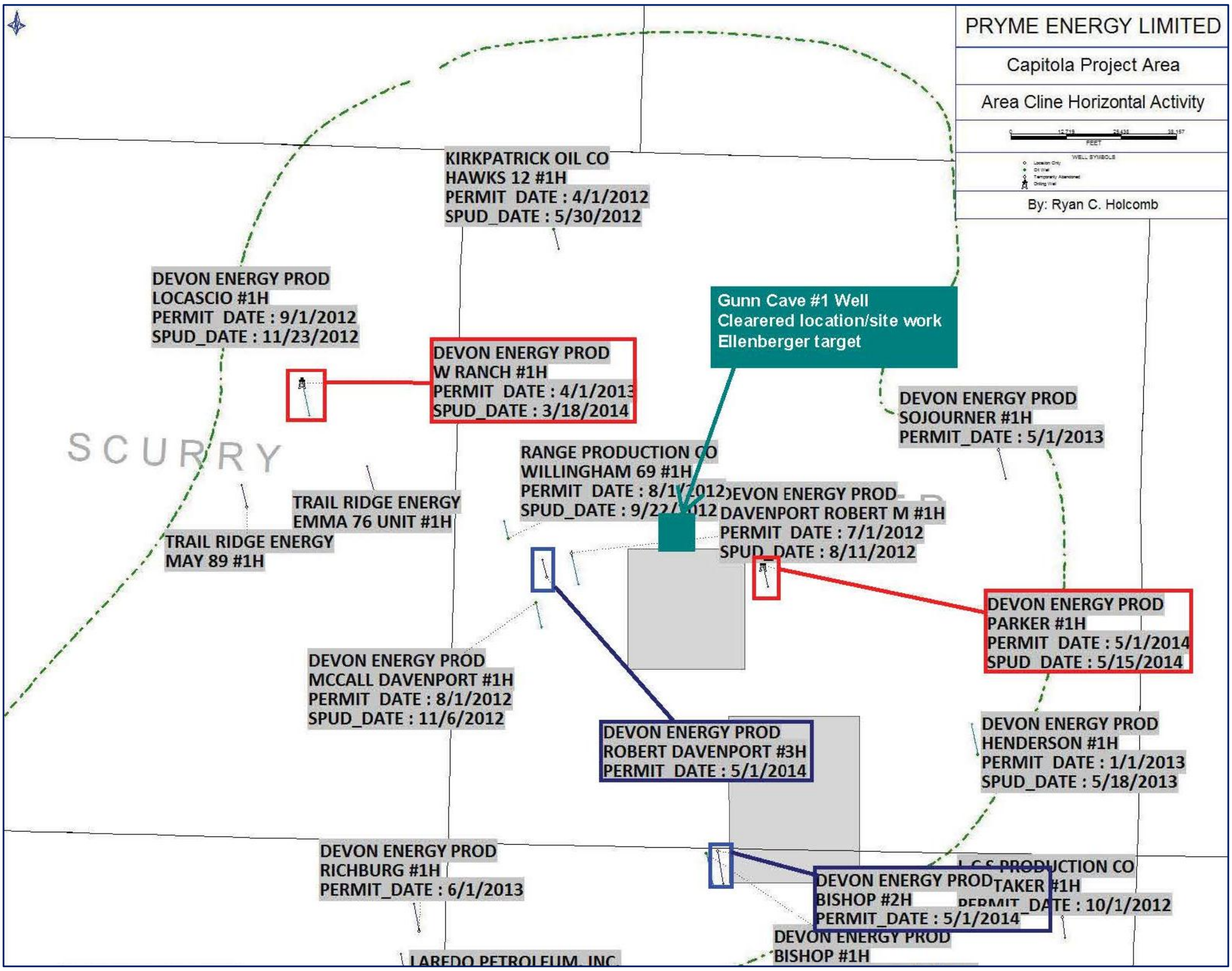

Figure 2: Public file horizontal well locations for Devon energy near Capitola. Devon's wells in the flow back/completion phases are shown in red, and Devon's wells awaiting completion are shown in blue. Source: Pryme

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RISKS

- Commodity price and currency risks: in particular US crude oil prices and US domestic gas prices and the Australian dollar to US dollar exchange rate are risks for an investment in Pryme.
- Exploration, drilling, development and operating risks: Pryme is confident that the previously produced oil horizons at Capitola will be producible on an in-fill and step-out basis to existing well bores. This is exposed to risks relating to geological and reservoir conditions, drilling and completion techniques, flow rates (IP, EUR, decline rates, oil/gas mix), etc that exist for oil developments. Exploitation of the Cline shale horizon by Pryme is also subject to these types of risks.
- Credit/funding risks: The commencement of the well program and payment of farm-in amounts depend on successfully raising equity or other non-debt capital, which is subject to market and other risks, and Pryme electing to pursue its option to make these expenditures. To the extent this is not undertaken there is a risk of Pryme owning less of the Capitola project than expected. Pryme's roll-out of the full vertical well program at Capitola is intended to be predominantly funded by non-equity sources such as cash flow and lending facilities. The availability of these sources is subject to risks such as results of the drilling program, well performance, reserves certification, and lending market appetite. Depending on the lending that may be arranged in the future and Pryme's ability to repay through well performance, Pryme may need to raise further capital through an equity raising, sale of assets or alternative financing to repay any future outstanding debt. Pryme's current cash burn is approximately A$1.2 million per year.
- Market price and liquidity risks: an investment in Pryme is subject to general and specific market and pricing risks, including the level of liquidity in the ASX traded market for Pryme.
- Reserves and commercial project risks: whilst upside exists from conventional oil development and exploitation of unconventional Cline Shale, there is no guarantee that resources and potential formations can be produced or will result in the discovery of economic reserves on the project.

An investment in Pryme is also subject to other general and specific investment risks.

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