Insight: From the capital

Testing times

An ASX-listed junior energy company puts all options on table in its quest to rediscover lost value

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Elk Petroleum Ltd directors are figuratively throwing up their hands in disbelief at an undervalued share price and saying "we've got to do something different". There is nothing unique in the Elk Petroleum value predicament except that its directors are showing commendably rare courage in deciding to put all the options on the table in their search for lost value.

ASX-listed Elk Petroleum had been aiming to use enhanced recovery techniques employing carbon dioxide and water injection to extract oil from its now 35%-owned Grieve field in Wyoming, USA. Gas pumping started in March 2013 with production initially slated for late 2014 once the pressure in the field had risen enough for oil to flow freely.

Grieve produced in excess of 30 million barrels after being discovered in 1954 rendering minimal any exploration or discovery risk for Elk. In theory, as each day passes and field pressures rise, the investment risk is reduced and the market value of the field should increase.

Recently, the Elk equity market value fell to as little as A$15 million (US$14 million). This was despite the company being within two years of accessing forecast annual operating cash flows of US$10 million-US$25 million for its interest. These cash flows would persist for a decade, according to a commissioned study presented to the company in 2013.

The Elk directors have been frustrated at the lack of market reaction to their imminent good fortune. As it happens, Elk is not conspicuously out of line with many similarly positioned mining and oil and gas companies.

Investors are expressing considerable scepticism about companies sticking to their development timetables and pricing them accordingly. They have good reason. Elk has not helped its case by delaying its own production start until sometime in 2016. The most recent delay has come from the Grieve operator, NYSE-listed Denbury Resources Inc, modifying the mix of relatively expensive gas and water being injected as a capital saving measure.

Another A$40 million will be needed for the A$100 million project. With a stock price so far below their assessed project value, Elk directors felt it made no sense to raise even modest amounts of additional capital. Nor did selling down another portion of the project to fund commitments seem worthwhile. There was one way to demonstrate the underlying value: put it on the market.

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In one respect, Elk directors are in an unusually fortunate position. The market for oil and gas assets in the USA is relatively deep. Middlemen, operators, principals and financiers abound and the time taken to execute deals can be quite short. Elk expects to have completed a transaction to sell its assets in Wyoming, with shareholder approval, by early October.

In April, the company acquired a parallel development opportunity, in Nebraska, that could still leave it positioned as an enhanced oil recovery specialist after having sold in Wyoming. It has unusual corporate flexibility.

In theory, the proposed asset sales should drag forward by two or three years a share price appreciation, which could have otherwise been delayed until as late as 2017 when profits would be reported and valuations hi their peaks.

Getting a sale price consistent with its own commissioned valuation range of A$54-95 million would have a dual benefit. It would not only bolster the financial resources of the company, but would also send positive signals to equity markets about the prospective value of the remaining Nebraska assets.

Elk may still face a valuation problem, as do other cashed-up companies. The equity market rarely takes cash held in corporate treasuries at face value. A typically substantial discount could leave the company in much the same position as it is now, namely, with an undervalued asset – only this time it will be in the form of cash rather than oil in the ground.

Refreshingly, the Elk directors have put all the options on the table in their search for an improved investment outcome. In announcing the sale of the Wyoming assets, they held out the chance of a capital distribution. This would be a relatively immediate gain for shareholders and a signal from directors about their determination to search out value.

Unfortunately, a one-off capital return may not affect the ongoing discount investors apply to future income streams. This will be influenced by a complex array of macro factors, but confidence about the timely completion of developments always rates high in this context. A successful track record, which Elk will have foregone through the proposed asset sale, counts for much.

In London recently, Elk chief executive Scott Hornafius also pointed to the possibility of winding up the company, a heretical topic for most salaried executives no matter how bleak the outlook.

To emphasise the desire of directors to go in whatever direction made sense for shareholders, he admitted the possibility, too, of using freshly acquired financial firepower from a sale to engineer mergers.

Neither of these latter two alternatives had been mentioned in the formal materials initially lodged with the stock exchange. Hornafius is to be commended for another break from the practices of the typical Australian company in releasing an audio recording of his responses to questions about his intentions.

Speaking so freely does create uncertainty about corporate strategies. That could be counterproductive if not resolved quickly and definitively. Some courses might simply signal desperation rather than the pursuit of shareholder interests. No matter how well financed, for example, buying into other projects or companies investors have already shunned might be a sure way to keep the share price anchored in the valuation basement.

Elk directors are not alone in facing this valuation conundrum. They are, however, distinguishing themselves by breaking the mould in how directors go about looking for a solution. Others might be encouraged to follow similar paths if there is evidence of more asset trades eliciting higher market valuations. ▼

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