Equity Research
Oil & Gas sectors

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i3 Energy (I3E LN)

MARKET DATA

Bloomberg	ticker	I3E LN
Share price	p/shr	11.0
Target	p/shr	25.0
TP upside	%	127%
Shares out	Million	1,091.4
Fd shares	Million	1,277.6
Mkt cap	US$m	166.9
EV	US$m	157.0

UPSCALING

This week, i3 Energy is expected to complete its first major acquisition of the year, buying a suite of assets from Canadian heavyweight producer Cenovus Energy. Using the proceeds of a £40m equity placing, i3 is purchasing the assets for a cash consideration of C$65m (US$54m), equivalent to under 1.7x next twelve-month operating income (NTM NOI). The new assets almost double production, adding some 8,400 boepd (51% liquids). Furthermore, both PDP and 2P reserves are more than doubled, increasing the reserve life of the asset base and offering greater organic growth opportunity. With the acquired assets overlapping i3's existing portfolio, the transaction is not expected to materially increase corporate overheads meaning field cash flow will predominantly flow to the bottom line and increase dividends to shareholders disproportionately. Accordingly, we consider the transaction as materially accretive on all fronts. Having updated our numbers, we reiterate our BUY recommendation, with an updated target price of 25p/shr. With the stock currently trading at 11p/shr, this offers some 127% upside, on top of the generous running dividend yield of 8.4%.

Figure 1: Summary financial forecasts

		2021 (OLD)	2021 (NEW)	*Δ (%)*	2022 (OLD)	2022 (NEW)	*Δ (%)*
Production, net	**boepd**	**8,980**	**12,249**	***+36%***	8,382	**17,438**	***+108%***
Revenue	US$m	75.9	120.2	*+58%*	71.1	170.4	*+140%*
EBITDA	**US$m**	**22.4**	**56.1**	***+150%***	**20.6**	**83.1**	***+303%***
EBITDA/shr	c/shr	3.1	5.1	*+66%*	2.9	7.6	*+167%*
Margin	%	30%	47%	*+55%*	29%	49%	*+68%*
FCF ᶲ	**US$m**	**13.8**	**38.6**	***+180%***	**10.2**	**68.0**	***+567%***
FCF yield	%	16.6%	23.1%	*+39%*	12.3%	40.8%	*+231%*
Dividend paid	c/shr	0.68	0.45	*-34%*	0.89	1.28	*+44%*
Dividend yield⁺	%	n/a	2.9%	-	n/a	8.4%	-
FCF / dividend (cover)	x	2.8x	7.9x	*+182%*	1.6x	4.9x	*+203%*
Net debt / EBITDA	x	1.1x	0.52x	*-52%*	0.9x	-	*-100%*

Source: Tennyson Securities. *Blended average. ᶲNet cash flow, post capex, pre dividend. ⁺Paid yield.

ANALYST

Tim Hurst-Brown
+44 (0) 20 7186 9038
tim.hurst-brown@tennysonsecurities.co.uk

James Midgley
+44 (0) 20 7186 9037
James.midgley@tennysonsecurities.co.uk

SALES

Pav Sanghera
+44 (0) 20 7186 9036
pav.sanghera@tennysonsecurities.co.uk

Guy Wheatley
+44 (0) 20 7186 9034
guy.wheatley@tennysonsecurities.co.uk

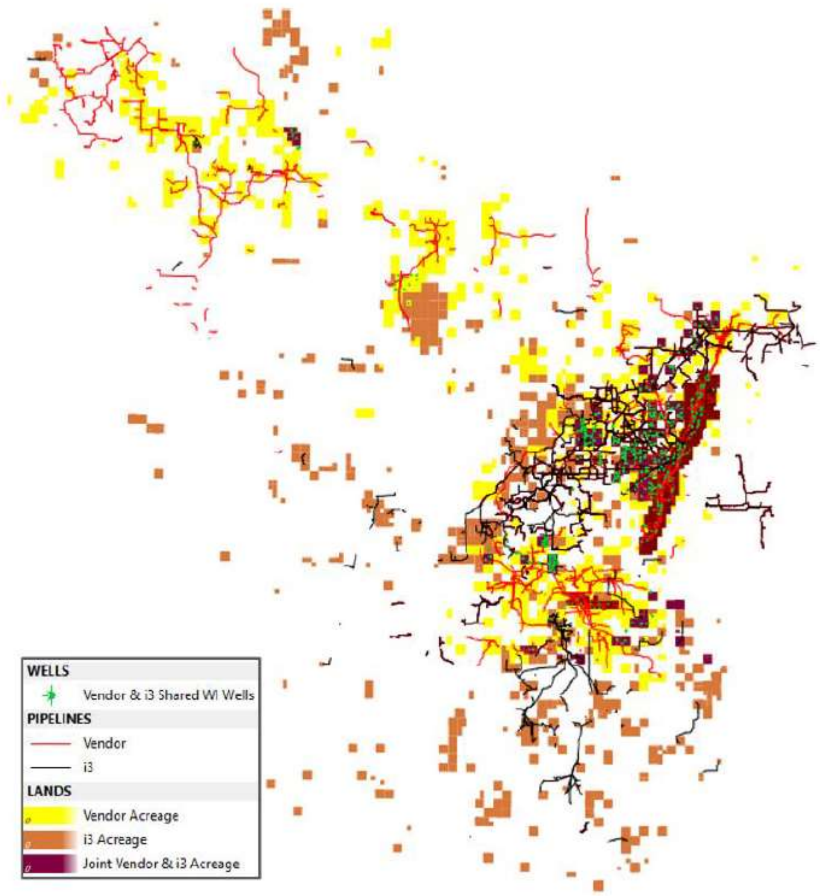
Jason Woollard
+44 (0) 20 7186 9035
jason.woollard@tennysonsecurities.co.uk

Cenovus acquisition highlights

The asset package acquired includes around 8,400 boepd of current production in Central Alberta, as well as 1,400 km of operated pipeline, and over 200 individual well targets and reactivation opportunities. As the map in Figure 2, below, illustrates, there is substantial overlap with i3's existing portfolio, including 3,091 boepd of shared production assets. Perhaps unsurprisingly therefore, the acquired assets change neither the hydrocarbon mix substantially (acquired assets are 14% oil, 37% NGL and 49% gas, versus the enlarged portfolio of 19% oil, 28% NGL and 53% gas), nor operating break-even (acquired assets US$10.66/boe, vs enlarged portfolio of US$11.05/boe). There are, however, expected to be material savings resulting from synergies at both the asset level, and the group level. i3 estimates that year 1 cash flow from the new assets may be boosted by as much as 20% thanks to operational savings on the ground. Meanwhile central overheads are not expected to increase substantially, meaning higher margins flowing through. The net result is that we expect dividends paid out to shareholders to increase by 44% on a per share basis as a result of the transaction, equivalent to a FY22 payout of 1.28¢/shr – up from the 0.89¢/shr in our previous forecast – and providing a running yield of 8.4%.

The asset package has good provenance, with previous operator Cenovus (Canada's third largest oil and gas producer) acquiring the assets from ConocoPhillips as part of a wider transaction in 2017. Increasingly however, Cenovus has been focusing on oil sand production, a move accelerated by the acquisition of Husky Energy at the start of the year. Accordingly, the company had been looking to shed non-core conventional assets as it repositions its portfolio. Negotiations with i3 commenced around the turn of the year, with initial prices discussed valuing the assets at around 3x NTM NOI based on the lower prevailing commodity strip. Impressively, despite the sharply rising commodity price environment, i3 was able to secure exclusivity on the discussions and keep the headline purchase price unchanged throughout negotiations, leading to an ultimate price of just 1.7x. Incidentally, this multiple even excludes the impact of positive operating cash flow between the 1 April 2021 effective date and completion which we expect in the region of c.US$10m.

Figure 2: Central Alberta assets (existing and new)



Source: i3 Energy

Strong operational performance

With such an accretive acquisition, it is easy to overlook the progress being made on the ground in Canada. Production from i3's existing asset base exited July at over 10,000 boepd, with additional production to come onstream from drilling and completion activities in the coming weeks. The production gains over H1 have been made through a number of relatively small projects adding incremental volumes, on top of a base which is performing ahead of expectations. The company acquired interests at South Simonette and Wapiti for a combined consideration of US$5.1m (including near term capex commitments) which are expected to add c.1,000 boepd on a NTM basis following well reactivations. i3 also plans to drill two wells in the Wapiti area at a net cost of US$2.1m. These two projects are expected to generate some US$6m of operating income combined over the next 12 months. Meanwhile i3 recently tied in the new Noel gas production well, at a rate of 650 boepd (c.30% ahead of expectations), and has completed the drilling of the first two wells in the Clearwater acreage (including eight horizontal lateral sections). The two Clearwater wells are anticipated onstream imminently, with expected combined production rates in the region of 275 boepd (12-month average, net to i3).

In total, the five development projects (Noel, Clearwater, Simonette, Wapiti drilling and Wapiti acquisition) are expected to add c.1,400 boepd of net production (+16% from base) and US$10.5m of net operating income (+31% from base, thanks largely to an oilier mix). The four, combined, will cost a total of US$12.1m (acquisition consideration plus capex), implying an acquisition multiple of just 1.15x.

Next steps

Looking ahead, we expect i3 to focus on a combination of M&A and organic growth opportunities as it looks to further expand its production base. With some 130 mmbbls of certified 2P reserves refinancing options will be available to i3, should it wish to restructure its £22m 2019 Loan Note facility. On our numbers, we estimate a current net debt/EBITDA multiple of under 0.5x (and falling sharply), implying a potential to draw additional debt to finance new acquisitions, thereby reducing, or eliminating the requirement to raise additional equity.

Meanwhile i3 has plenty of opportunities to continue to grow production organically. As mentioned above, the acquired assets have almost 80 mmbbls of 2P reserves, including over 50 mmbbls undeveloped/unproducing, with c.140 drilling locations and c.80 well reactivations already worked up. Meanwhile the existing portfolio includes a further c.60 mmbbls of 2P reserves, of which c.23 mmbbls is currently not in production. These reserves currently not in production include modest, easy wins, sufficient to stave off natural decline across the portfolio (such as the reactivations and small developments which have been i3's focus since the start of the year), as well as major new development opportunities, such as the South Simonette field.

Figure 3: South Simonette development concept production & cash flow profile (gross)

Source: i3 Energy

Based on initial development plans, i3 believes that South Simonette could ultimately sustain production rates in excess of 18,000 boepd (c.65% oil), of which the company now has a 99% stake (including operatorship) following its recent acquisition (see Figure 3 above). The development would be relatively capital intensive, with 12 wells per year envisaged and peak capex exposure of US$45m. Accordingly, we would expect i3 to seek external finance, most likely in the form of industry farm out, to develop the field without material outlay. We would expect i3 to formally start marketing the asset later this year.

North Sea: Serenity update

Marketing of Serenity also continues, with the company recently announcing that it has agreed indicative farm out terms in principle with a prospective partner. The partner is in the process of confirming funding commitments before the deal can be finalized. We expect such an event to provide a major boost for the stock for a number of reasons. The shift in focus to Canada combined with last year's weakness in oil prices and industry appetite for exploration and appraisal has resulted in the market attributing very little value, if any, to the Serenity discovery. Industry validation should address this, as well as provide a market valuation for the asset. Furthermore, it would add a major catalyst for the stock, in the form of a high impact, near term appraisal drilling.

Financial forecasts and valuation

We have updated our numbers to reflect the Cenovus transaction, the recent operational production gains, and the US$54m equity placing. We have also updated our near term Brent oil and Henry Hub gas price forecasts in line with the current strip, maintaining our long term US$60/bbl and US$3.0/mcf forecast. As before, we have assumed a small amount of development drilling each year to monetise the large 2P reserve base and offset natural decline across the portfolio.

Next year, the first full year to benefit from the Cenovus acquisition, we estimate average production of c.17,500 boepd (47% liquids), leading to gross revenues of c.US$170m. This flows through on margins of 49% to EBITDAX of US$83m – placing the company on an FY22 EV/EBITDA multiple under 2x. Note that at this stage we have given no benefit from operational synergies with respect to the acquired assets, which i3 internally estimates could boost net cash flow from the acquired assets by as much as 20%, or c.US$6m. Adding these savings into our forecast implies c.7% upside to our FY22 EBITDAX estimate.

After accounting for around US$15m of FY22 capex spend (including new wells and asset retirement obligation), we estimate a FY22 cash dividend payout of US$14m – equivalent to 1.28¢/shr and a running dividend yield of 8.4% at today's prices. This still leaves an estimated US$54m of cash building on the balance sheet, which can be used for either organic or inorganic growth. Our full financial forecasts are shown on page 6.

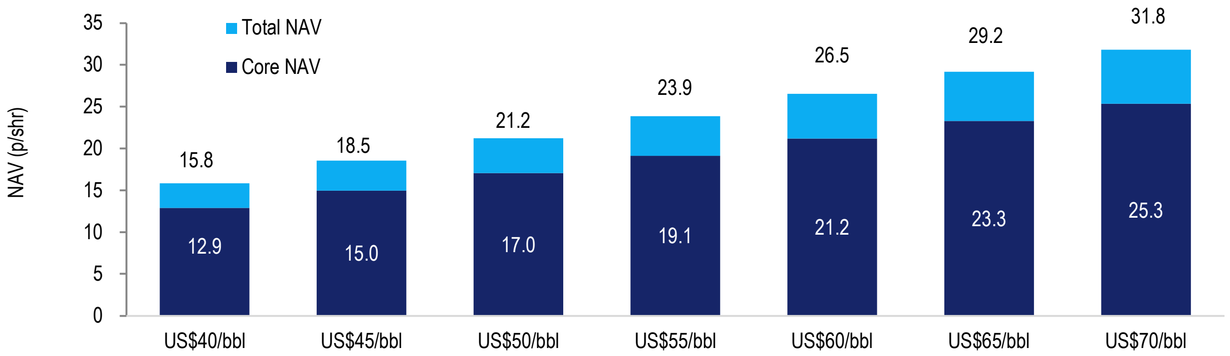
We have also integrated the new assets into our DCF model, and factored in the dilutive effect of the recent equity placing. The result is an upgraded risked Core NAV of 21.2p/shr, including PDP NAV of 10.4p/shr. Our Total NAV of 26.5p/shr also includes 5.3p/shr of value for Serenity, although this is based on a very conservative 12.5% chance of commercial success, which factors in future dilution risk in funding the work programme. Unrisked, we estimate Serenity could be worth as much as 43p/shr, and progress with the ongoing farm out programme, including confirmation of farm out terms, could see significant upgrade to our valuation.

Figure 4: Valuation summary table

NET ASSET VALUE									
Asset	**Gross**		**Net**		**Unrisked**			**Risked**	
	mmboe	**Interest**	**mmboe**	**US$/boe**	**US$m**	**p/shr**	**CoS**	**US$m**	**p/shr**
Canada PDP reserves	n/a	n/a	50.4	3.7	184	10.4	100%	184	10.4
Canada 2P reserves	n/a	n/a	82.2	2.8	233	13.1	75%	174	9.8
Deduct: net cash*					10	0.6		10	0.6
Add: corporate items					8	0.4		8	0.4
Core NAV			**132.6**		**434**	**24.5**		**376**	**21.2**
Serenity	69.0	100%	69.0	10.98	757	42.6	13%	95	5.3
Total NAV			**201.6**		**1,192**	**67.1**		**471**	**26.5**

Valuation assumptions:
Brent price: US$68.5/bbl 2021, US$66.7/bbl 2022, US$63.8/bbl 2023, US$60/bbl flat thereafter.
NGL price (at local sales point): 35% of Edmonton Light long term.
Henry Hub gas price: US$3.48/mcf 2021, US$3.42/mcf 2022, US$2.98/mcf 2023, US$3/mcf flat thereafter.
Discount rate 10%.
1.39 US dollar / sterling.
1,091.4m ordinary shares outstanding. 186.2m options and warrants outstanding with exercise prices 0.01p-11p/shr.

Oil price sensitivity – NAV at various flat Brent prices (2021 onwards):



Source: Mirabaud Securities. *Forecast net debt at YE21.

Figure 5: Financial summary – P&L, cash flow and balance sheet

FYE 31ST DEC		2020	2021E*	2022E	2023E	2024E
Net oil & gas production	**boepd**	2,998	**12,249**	**17,438**	**16,219**	**15,122**
Average realised price	US$/boe	19.0	26.7	25.2	24.2	25.6
Net gas volumes	mmscf/d	9.8	41.1	56.0	50.4	45.4
Gas revenue	**US$m**	**8.6**	**42.0**	**56.9**	**44.0**	**43.1**
Net NGL volumes	bpd	843	3,050	4,950	4,455	4,010
NGL revenue	**US$m**	**4.8**	**23.0**	**35.4**	**30.2**	**26.6**
Net oil volumes	bopd	517	2,350	3,150	3,360	3,549
Oil revenue	**US$m**	**7.1**	**59.0**	**64.4**	**65.0**	**67.4**
Revenue	**US$m**	20.8	**120.2**	**170.4**	**151.7**	**141.1**
Operating costs (inc. royalties)	US$m	(12.1)	(55.1)	(78.3)	(72.2)	(67.3)
Unit	*US$/boe*	*(11.1)*	*(12.3)*	*(12.3)*	*(12.2)*	*(12.2)*
G&A costs	US$m	(7.8)	(9.0)	(9.0)	(9.0)	(9.0)
Unit	*US$/boe*	*(7.2)*	*(2.0)*	*(1.4)*	*(1.5)*	*(1.6)*
EBITDA	**US$m**	0.8	**56.1**	**83.1**	**70.5**	**64.8**
EBITDA margin	*US$/boe*	*4.0%*	*46.6%*	*48.8%*	*46.5%*	*45.9%*
DD&A	US$m	(6.6)	(15.6)	(22.3)	(20.7)	(19.3)
Finance and other expenses	US$m	24.3	(7.3)	(8.1)	(9.1)	(9.7)
Profit before tax	**US$m**	18.5	**33.1**	**52.7**	**40.6**	**35.8**
Income tax	US$m	1.5	-	-	-	(4.5)
Net income	**US$m**	**20.0**	**33.1**	**52.7**	**40.6**	**31.3**
Adjusted EPS (fully diluted)	c/shr	*1.6*	*2.6*	*4.1*	*3.2*	*2.5*
Profit before tax	**US$m**	18.5	**33.1**	**52.7**	**40.6**	**35.8**
Cash flow reconciliation	US$m	17.2	23.0	30.4	29.8	29.0
Working capital movements	US$m	(3)	-	-	-	-
Interest paid, net	US$m	(0.2)-	-	-	-	-
Tax paid	US$m	0.5-	-	-	-	(4.5)
Net operating cash flow	**US$m**	(1.2)	**56.1**	**83.1**	**70.5**	**60.3**
Cash flow margin	*US$/boe*	*(1.1)*	*12.5*	*13.1*	*11.9*	*10.9*
Capex (including A&D)	US$m	(24.2)	(17.4)	(15.1)	(15.1)	(15.1)
Free cash flow	**US$m**	(25.4)	**38.6**	**68.0**	**55.4**	**45.2**
Dividend pay-out	US$m	-	(4.9)	(14.0)	(14.0)	(14.0)
Acquisitions/divestments	US$m	(24.8)	(43.4)	-	-	-
Debt movement, other	US$m	-	-	-	-	-
Share issuance	US$m	37.1	53.0	-	-	-
Net increase (decrease) in cash	**US$m**	(13.1)	**43.3**	**54.0**	**41.4**	**31.2**
Cash	US$m	8.4	51.8	105.8	147.1	178.3
Other current assets		11.9	11.9	11.9	11.9	11.9
O&G assets		214.4	255.6	243.9	233.8	225.1
Total assets	**US$m**	234.7	**319.3**	**361.6**	**392.8**	**415.3**
Debt	US$m	37.7	41.9	46.5	51.6	57.3
Other liabilities & decommissioning	US$m	111.4	110.6	109.6	109.1	108.6
Shareholder equity	US$m	99.8	180.9	219.6	246.3	263.6
Total equity & liabilities	**US$m**	248.8	**333.4**	**375.7**	**406.9**	**429.4**
P/E - adjusted, fd	*x*	-	*5.0x*	*3.2x*	*4.1x*	*5.3x*
EV/EBITDAX	*x*	-	*3.5x*	*1.9x*	*1.5x*	*1.1x*
Dividend paid	*c/shr*	-	*0.45*	*1.28*	*1.28*	*1.28*
Dividend yield	*%*	-	*2.9%*	*8.4%*	*8.4%*	*8.4%*
Dividend cover	*x*	-	*7.9x*	*4.9x*	*4.0x*	*3.2x*
FCF yield	*%*	-	*23.1%*	*40.8%*	*33.2%*	*27.1%*
Net debt /EBITDA	*x*		*0.5x*	-	-	-

Source: Tennyson Securities. *2021 numbers assume Cenovus transaction completion on 20 August. **Net of assumed US$10.6m purchase price adjustment

DISCLAIMER

RECOMMENDATIONS HISTORY

Market index: AIM ALL SHARE ENERGY

Date	Market Index level	Share Price (p)	Target Price (p)	Opinion
13 May 2021	1359.6	8.3	16.0	BUY
17 August 2021	1469.4	11.0	25.0	BUY

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