finnCap

Company Flash

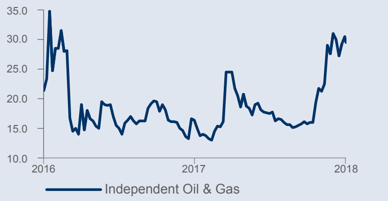
31 July 2018

Corp

Ticker	**IOG:AIM**
Oil & Gas	
Shares in issue (m)	123.5
Next results	H1 Oct
Price	**29.5p**
Target price	59.0p
Upside	100%
Market cap	**£36.4m**
Net debt/(cash)	£12.2m
Other EV adjustments	£11.6m
Enterprise value	£60.3m

What's changed?	From	To
Adjusted EPS	-2.1	-2.1
Target Price	50.0	59.0

Share price performance



%	1M	3M	12M
Actual	-4.8	82.9	80.2

Company description

UK based E&P company with interests in seven UK SNS gas assets and associated infrastructure

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Independent Oil & Gas*

SNS gas hub development update

Events at IOG are moving forward at a rapid pace. The Thames pipeline is looking increasingly likely to be recommissioned and new acreage awards have extended the potential scope of its Southern North Sea gas hub developments. While the initial pig malfunction on its Thames pipeline has caused some slippage to the start-up of Phase 2 of the project, this is more than offset by portfolio additions and potential pipeline tariff income. As a result, we are raising our risked NAV and price target by 18%, to 59p/sh.

- **Phase 2 slippage.** The recently announced optimised Thames pipeline integrity programme keeps Phase 1 of its SNS gas hub development on track, although the start-up of Phase 2 is now expected a year later in Q2 2021. All else equal, this lowers our unrisked valuation of the project by ~$25m, or ~6p/sh.
- **New discovery and tariff potential more than compensate.** Two items more than offset this. First, IOG was awarded new acreage in the recent UK licensing round, containing existing discoveries that could be tied back to its SNS gas hubs. Second, we are ascribing some heavily risked tariff income value for the Thames pipeline. Combined, these raise our risked NAV and price target by 18%, from 50p to 59p/sh.
- **Goddard valuation.** IOG was awarded three new licence areas in the recent 30th UKCS licensing round that materially raise IOG's total gas resource base, from 393 bcf to 617 bcf. The bulk of this comes via the 189 bcf Goddard discovery, which is within tie-back distance of the Thames pipeline infrastructure. Assuming start-up in H2 2022, we estimate an unrisked project NPV of $165m (39p/sh). Applying a 50% Geological CoS and 50% Commercial CoS gives a risked NPV of $36m, or 8.6p/sh.
- **Tariff upside.** With the growing likelihood that the Thames pipeline will be recommissioned, and given its increasing strategic importance as an export option for third-party stranded SNS gas, we are including some heavily risked value for potential future tariff income from the spare ullage of this asset; applying just a 10% Commercial CoS adds $14m, or 3.3p/sh, to our risked NAV.
- **Converts renegotiation key.** IOG has been one of the top performers in the AIM Oil sector this year. But, with the shares still trading at a 50% discount to our 59p/sh risked NAV, we still see material upside potential. Critical to this will be the successful renegotiation of its London Oil & Gas convertible loans, which are currently secured against IOG's assets. Freeing these up will allow the company's independently certified 2P reserves to be used to secure development funding.

Key estimates | Year end: Dec		2016A	2017A	2018E	2019E	2020E
Revenue	£m	0.0	0.0	0.0	1.8	108.9
Adj EBITDA	£m	-0.5	-0.9	-1.5	-0.7	88.1
Adj EBIT	£m	-0.5	-0.9	-1.5	-1.1	60.9
Adj PBT	£m	-1.4	-2.7	-6.4	-6.0	27.5
Adj EPS	p	-1.1	-2.0	-2.1	-1.9	8.8
DPS	p	0.0	0.0	0.0	0.0	0.0

Key valuation metrics		2016A	2017A	2018E	2019E	2020E
EV/EBIT (adj)	x	-110.1	-69.0	-40.2	-53.7	1.0
P/E (adj)	x	-27.4	-14.7	-14.3	-15.3	3.3
Dividend yield	%	0.0%	0.0%	0.0%	0.0%	0.0%
Free cash yield	%	-14.3%	-10.2%	-168.6%	-341.0%	-501.3%
Pre-tax ROCE	%	-12.2%	-11.5%	-2.0%	-0.6%	15.1%

Income statement Year end: Dec		2017A	2018E	2019E	2020E
Sales	£m	0.0	0.0	1.8	108.9
Gross profit	£m	-0.2	0.0	1.1	90.6
EBITDA (adjusted)	£m	-0.9	-1.5	-0.7	88.1
EBIT (adjusted)	**£m**	**-0.9**	**-1.5**	**-1.1**	**60.9**
Associates/other	£m	0.0	0.0	0.0	0.0
Net interest	£m	-1.8	-4.9	-4.9	-33.4
PBT (adjusted)	**£m**	**-2.7**	**-6.4**	**-6.0**	**27.5**
Total adjustments	£m	-0.0	0.0	0.0	0.0
PBT (stated)	£m	-2.8	-6.4	-6.0	27.5
Tax charge	£m	0.0	0.0	0.0	0.0
Minorities	£m	0.0	0.0	0.0	0.0
Reported earnings	£m	-2.8	-6.4	-6.0	27.5
Adjusted earnings	**£m**	**-2.7**	**-6.4**	**-6.0**	**27.5**
Shares in issue (year end)	m	109.5	120.2	120.2	120.2
EPS (stated)	p	-2.5	-5.4	-5.0	22.8
EPS (adjusted, fully diluted)	**p**	**-2.0**	**-2.1**	**-1.9**	**8.8**
DPS	**p**	**0.0**	**0.0**	**0.0**	**0.0**

Growth analysis Year end: Dec		2017A	2018E	2019E	2020E
Sales growth	%	n/m	n/m	n/m	n/m
EBITDA growth	%	-60.1%	-72.2%	55.3%	n/m
EBIT growth	%	-59.5%	-71.6%	25.1%	n/m
PBT growth	%	-87.1%	-137.6%	6.9%	558.4%
EPS growth	%	-85.9%	-3.3%	6.9%	558.4%
DPS growth	%	n/m	n/m	n/m	n/m

Profitability analysis Year end: Dec		2017A	2018E	2019E	2020E
Gross margin	%	n/m	n/m	59.3%	83.1%
EBITDA margin	%	n/m	n/m	-36.9%	80.8%
EBIT margin	%	n/m	n/m	-61.7%	55.9%
PBT margin	%	n/m	n/m	-329.2%	25.2%
Net margin	%	n/m	n/m	-329.2%	25.2%

Cash flow Year end: Dec		2017A	2018E	2019E	2020E
EBITDA	£m	-0.9	-1.5	-0.7	88.1
Net change in working capital	£m	-0.1	0.0	0.0	0.0
Other operating items	£m				
Cash flow from op. activities	**£m**	**-1.1**	**-1.5**	**-0.7**	**88.1**
Cash interest	£m	0.0	-4.9	-4.9	-33.4
Cash tax	£m	0.0	0.0	0.0	0.0
Capex	£m	-2.6	-55.0	-118.7	-237.3
Free cash flow	**£m**	**-3.7**	**-61.4**	**-124.2**	**-182.6**
Acquisitions / disposals	£m				
Dividends	£m				
Shares issued	£m	0.0	0.0	0.0	0.0
Other	£m	4.3	75.0	130.0	175.0
Net change in cash flow	**£m**	**-0.1**	**11.0**	**2.2**	**-7.6**
Opening net cash (debt)	£m	-8.6	-12.2	-76.3	-204.1
Closing net cash (debt)	**£m**	**-12.2**	**-76.3**	**-204.1**	**-386.7**

Cash flow analysis Year end: Dec		2017A	2018E	2019E	2020E
Cash conv'n (op cash / EBITDA)	%	n/m	n/m	n/m	100.0%
Cash conv'n (FCF / EBITDA)	%	424.9%	n/m	n/m	-207.4%
U/lying FCF (capex = depn)	£m	-1.1	-6.4	-6.0	27.5
Cash quality (u/l FCF / adj earn)	%	39.0%	100.0%	100.0%	100.0%
Investment rate (capex / depn)	x	882.7	n/m	262.4	8.7
Interest cash cover	x	n/a	n/a	n/a	2.6
Dividend cash cover	x	n/a	n/a	n/a	n/a

Working capital analysis Year end: Dec		2017A	2018E	2019E	2020E
Net working capital / sales	%	n/m	n/m	-333.6%	-5.6%
Net working capital / sales	days	n/m	n/m	-1,217	-20
Inventory (days)	days	n/m	n/m	0	0
Receivables (days)	days	n/m	n/m	194	3
Payables (days)	days	n/m	n/m	1,412	24

Balance sheet Year End: Dec		2017A	2018E	2019E	2020E
Tangible fixed assets	£m	21.3	78.9	200.8	410.8
Goodwill & other intangibles	£m	0.2	0.2	0.2	0.2
Other non current assets	£m	0.0	0.0	0.0	0.0
Net working capital	£m	-6.1	-6.1	-6.1	-6.1
Other assets	£m	0.0	0.0	0.0	0.0
Other liabilities	£m	-8.0	-8.0	-8.0	-8.0
Gross cash & cash equivs	£m	0.1	11.1	13.3	5.7
Capital employed	**£m**	**7.6**	**76.2**	**200.2**	**402.7**
Gross debt	£m	12.4	87.4	217.4	392.4
Net pension liability	£m	0.0	0.0	0.0	0.0
Shareholders equity	£m	-4.8	-11.2	-17.2	10.3
Minorities	£m	0.0	0.0	0.0	0.0
Capital employed	**£m**	**7.6**	**76.2**	**200.2**	**402.7**

Leverage analysis Year end: Dec		2017A	2018E	2019E	2020E
Net debt / equity	%	n/a	n/a	n/a	n/m
Net debt / EBITDA	x	n/a	n/a	n/a	4.4
Liabilities / capital employed	%	162.5%	114.7%	108.6%	97.4%

Capital efficiency & intrinsic value Year end: Dec		2017A	2018E	2019E	2020E
Adjusted return on equity	%	56.8%	57.4%	34.9%	267.4%
RoCE (EBIT basis, pre-tax)	%	-11.5%	-2.0%	-0.6%	15.1%
RoCE (u/lying FCF basis)	%	-13.8%	-8.4%	-3.0%	6.8%
NAV per share	p	-4.4	-9.3	-14.3	8.5
NTA per share	p	-4.5	-9.5	-14.5	8.4

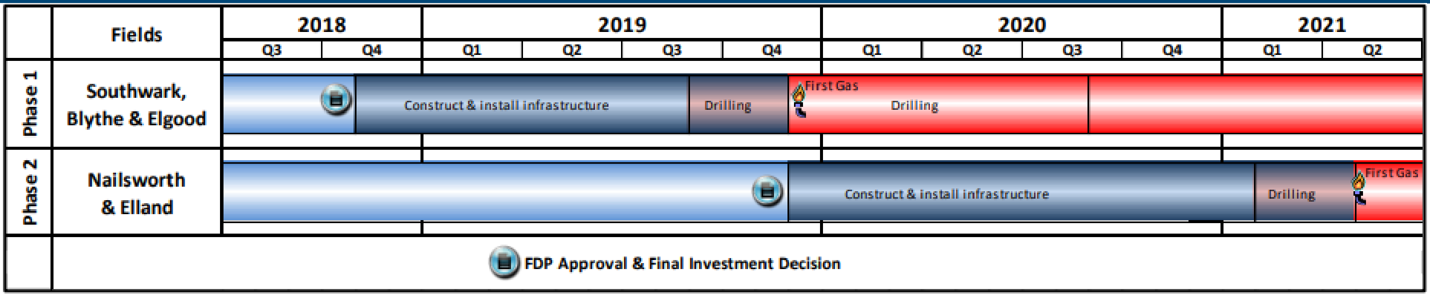
SNS gas hub development update

IOG recently announced a new optimised Thames pipeline integrity programme, which keeps any delay to Phase 1 of its Southern North Sea (SNS) gas hub development to a minimum, with start-up still expected in late 2019.

Phase 2 project slippage…

However, in its latest Corporate Presentation, it shows Phase 2 of the development, which includes the Nailsworth, Elland and Harvey fields, now starting up in Q2 2021 versus our previous expectation of Q2 2020. All else equal, this would lower our unrisked valuation of the project by ~$25m, or ~6p/sh.

Figure 1: IOG Blythe and Vulcan Satellite hubs development schedule



Source: IOG

Goddard discovery award and tariff income potential offset this

Fortunately, there are two items that more than offset this. First, IOG was awarded new acreage in the recent UK licensing round, containing existing discoveries that could be tied back to its SNS gas hubs. Secondly, with the Thames pipeline recommissioning approval looking extremely likely, we are ascribing some heavily risked tariff income value for this pipeline.

NAV raised 18% to 59p

All told, these two items, discussed in more detail below, alongside a change in our £/$ fx assumption (1.40 to 1.35) raises our risked NAV and price target by 18%, from 50p to 59p/sh.

Figure 2: Independent Oil & Gas Net Asset Value

Net Asset Valuation	Net reserves mmboe	EV/bbl $/boe	Unrisked value $mm	Geological CoS	Commercial CoS	Dry hole cost $mm	Risked NPV p/sh
Net cash / (debt)			-16.5				-3.9
G&A costs			-22.8				-5.4
Tax loss optimisation			2.2				0.5
Thames pipeline tariff value			136.8		10%		3.3
1P: Core value			**99.7**				**-5.6**
Discovered/Undeveloped reserves:							
Blythe Hub	9.7	3.71	35.9	90%	90%		6.9
Vulcan Satellites	43.1	4.30	185.3	90%	90%		35.7
2P: Core + discovered value			**320.8**				**37.1**
Contingent resource:							
Harvey	20.0	7.43	148.5	50%	85%	5.7	13.8
Goddard	30.0	5.51	165.3	50%	50%	5.7	8.6
3P: Core + discovered + contingent resource			**634.6**				**59.4**

Source: finnCap

IOG has been one of the best-performing names in the AIM Oil & Gas sector this year and is up 94% over the past three months. Despite this, we continue to see material upside potential, with the shares still trading at a 50% discount to our 59p/sh risked NAV.

Convertible loan restructuring critical to development funding

Critical to closing this valuation gap will be the restructuring of its convertible loans with London Oil & Gas (LOG) over the coming months. At end-17, IOG had £13.0m of borrowings outstanding on its LOG facilities, including accrued interest; £10m of this was a convertible loan with an 8p conversion price. A second £10m convertible loan with LOG was agreed in February 2018 at a conversion price of 19p/share. These convertible loan facilities are currently secured against IOG's assets. To put development funding in place this will have to be addressed.

Multiple avenues are being pursued for this development funding, which is expected to include a mix of conventional debt, equity finance, finance linked to gas off-take and contractor finance. The company's independently certified 2P reserves provide a solid basis to secure this development funding once the converts have been renegotiated.

UK 30th Licensing Round

IOG was awarded three new licence areas, comprising four blocks, in the 30th UKCS licensing round in May. It has a 100% interest in all these areas:

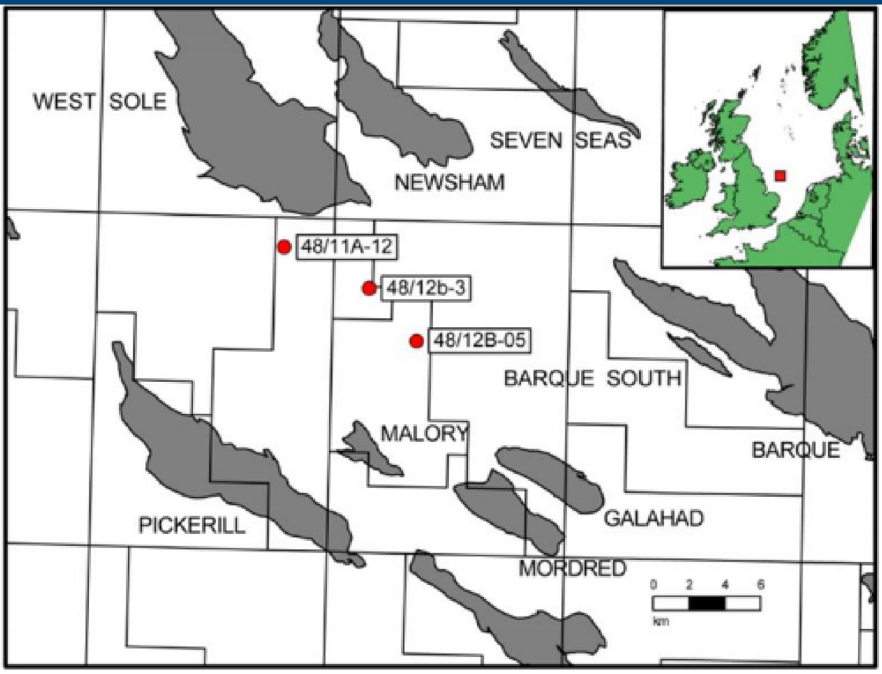
- Block 48/24a – this is contiguous to the east of the Harvey licence, giving IOG 100% of the mapped Harvey structure which extends into this block. It increased IOG's mid case prospective resources on Harvey by 24 bcf to 114 bcf. The work commitment includes PSDM reprocess of existing 3D seismic. IOG still intends to drill an appraisal well on Harvey in Q4 2018, subject to financing.
- Blocks 48/11c & 48/12b – these contain the Goddard discovery with 2C contingent resources of 189 bcf. The work programme includes PSDM reprocessing of existing 3D seismic and an appraisal well within three years
- Block 53/1b – this block contains the Aberdonia discovery, renamed Abbeydale, with 2C contingent resources of 11 bcf. This discovery is currently too small to justify development, but IOG intends to reprocess the seismic across the acreage, which may change size expectations.

All three licence areas are within potential tie-back range of the Thames pipeline, which IOG intends to recommission as part of the Blythe and Vulcan Satellites gas hubs development.

Goddard

This is an existing discovery, formerly called Glein, which is located on blocks 48/11c and 48/12b and has been proved up by five wells. Management is familiar with this asset from their time at Fairfield, which was awarded the asset in the 26th Seaward Licensing Round in 2011 with a drill or drop work programme. The discovery is located 5km south of Perenco's West Sole field and 11km north of its Pickerill field.

Figure 3: Goddard discovery location map



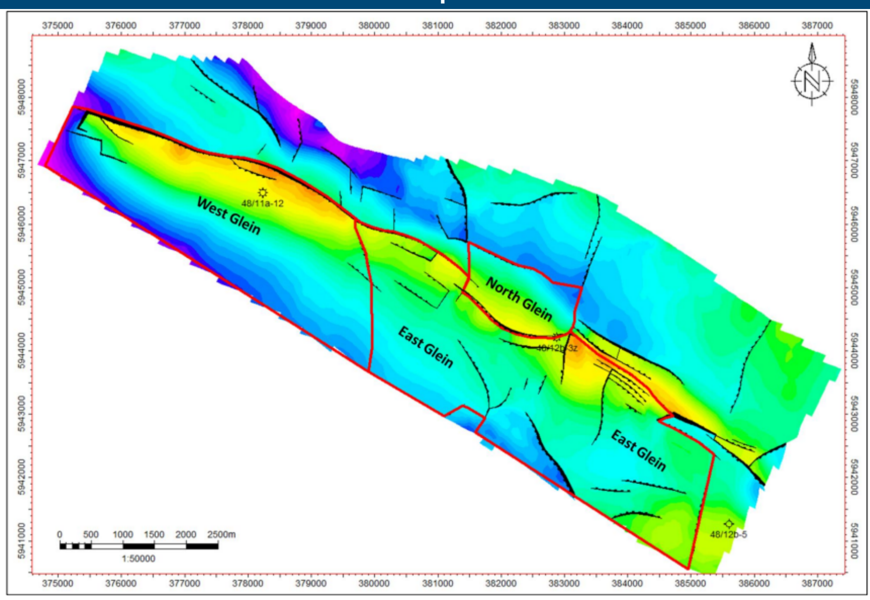
Source: Fairfield Cedrus Ltd.

Goddard was discovered by the 48/11a-12 well, drilled by ARCO in 1994. This well encountered 499ft of Rotliegendes sandstone and a full gas column, with net to gross of 74%. No gas-water contact was encountered.

The well flowed 0.4mmcfd on test, with reservoir permeability estimated in the range 0.1-0.7mD. The low permeability of the Rotliegendes reservoir means that the field would be developed using hydraulic fracturing, as seen on nearby fields, West Sole and Barque.

Gas Initially In Place (GIIP) for West Glein (see map below) was estimated in the range 86-113-126 bcf (Low-Base-High cases). This gave rise to a recoverable reserves range of 31-36-52 bcf (Low-Med-High cases). However, capital costs for the development at the time were deemed too high for a commercial project, and hence the acreage was relinquished.

Figure 4: Glein structure subdivision map



Source: Fairfield Cedrus Ltd.

Management now estimates contingent resources on Goddard of 45-189-396 bcf (1C-2C-3C) taking into account the additional potential of the north and east compartments. These estimates will be firmed up once the CPR, being compiled by ERC Equipoise, is completed in the next several weeks.

Within tie-back range of Thames pipeline

The discovery is just about within range of the Thames pipeline, 50km away, and could be tied back via the Blythe or Nailsworth platforms. Alternately, the gas could be sent north, via the West Sole Alpha platform, to the Dimlington Gas Terminal in East Yorkshire.

We have modelled the development as a tie-back to the Thames pipeline infrastructure, with start-up in H2 2022. Taking the 180 bcf mid case resource estimate, development capex of $170m ($85m for 3 wells, $34m platform cost, $47m pipeline cost), $34m abandonment cost, plus life of field opex and gas processing costs of $186m, gives an unrisked NPV for Goddard of $165m (39p/sh).

High return project with low breakeven price

We estimate the project has a 53% IRR and a gas price breakeven of ~19p/th. In our IOG NAV we have applied a 50% Geological CoS and 50% Commercial CoS, giving a risked NPV of $36m, or 8.6p/sh, for the project.

Thames pipeline tariff opportunity

Analysis of the three 12m cut sections of the Thames pipeline brought to surface have confirmed that the offshore portion of the pipeline is in excellent condition, practically 'as new'. After discussions with regulatory authorities, a new integrity confirmation plan for the pipeline has been agreed that provides significant cost savings and minimises the impact to the project schedule of the first inconclusive intelligent pigging operation. Another intelligent pigging run is now not required until the line is recommissioned, shortly before first gas in 2019.

IOG will now check the near shore condition of the pipe by running a crawler based measurement device in August. This is the section of the pipe most at risk of degradation since its decommissioning in 2015. This data will help IOG determine the safe maximum pressure of a subsequent 24-hour hydrotest, which is required under the Pipeline Code.

All of this points to the increasing likelihood that the Thames pipeline is suitable for recommissioning. Not only will it deliver material capital and operating cost savings (~£200m over the life of the project), but this critical piece of infrastructure also offers a tariff revenue opportunity once spare ullage is available.

Terminal closure offers potential opportunity

This opportunity is helped by the fact that ConocoPhillips is closing its Theddlethorpe Gas Terminal on the Lincolnshire coast in Q4 2018. This terminal satisfies ~10% of the UK's gas needs, receiving and processes gas volumes from three offshore pipeline systems: the Lincolnshire Offshore Gas Gathering System (LOGGS), the Caister Murdoch System (CMS) and the Pickerill System. 10 fields are dependent on this pipeline and will need to find alternate evacuation routes once it is decommissioned, or be shut down.

While there are a myriad of uncertainties relating to this potential income stream, we believe some value should be apportioned, albeit heavily risked at this stage. For modelling purposes, we have assumed Thames pipeline capacity of 300 mmcfd, £10m of tie-in capex for third-party gas, initial third-party gas deliveries in 2022, a tariff of 25p/mcf, a 20 year pipeline life and a 7% discount rate. On an unrisked basis, this points to a discounted valuation for this tariff stream of $137m. In our NAV we heavily risk this, applying just a 10% Commercial CoS. Still, this adds 3.3p/sh to our risked NAV.

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