# Ahead of the Herd Newsletter - 2018 Issue Two

## Advantagewon With Bread and Butter

*As a general rule, the most successful man in life is the man who has the best information*

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The decline in oil prices over the past four years combined with expensive projects that favor large companies, has meant the average retail investor has shied away from oil and gas exploration companies. Many switched to safer blue chip stocks and lately, mining companies as the prices of metals especially gold and battery components like lithium carbonate surged.

While oil and gas juniors used to be the lifeblood of the Canadian oil market - discovering new pools and becoming takeout targets for their larger rivals who gobbled them up to help grow their reserves - that trend is now on the wane.

## Shrinking junior oil & gas sector

In 2007 there were 94 oil & gas juniors producing between 500 and 1,000 barrels of oil equivalent a day, but a decade later that number had dropped to 25. The reason is that many Canadian juniors just aren't able to raise the capital needed to find and drill new wells. For example it could take up to $14 million to drill and complete a single well in the Duvernay shale formation in Alberta, which would eat up a small company's entire exploration budget. The result is that many, especially those carrying a lot of debt, have either gone bankrupt or have been sold to private equity firms. For example ARC Financial Corp, one of Calgary's largest private equity companies, has backed eight small producers or oilfield service companies in the past two years.

The rule of contrarian investing here is key, and should never be forgotten by serious resource investors. When a sector looks to be down and out, that is the time to consider taking positions. Ahead of the Herd recently identified a very interesting oil company that has developed an intriguing business model that flies in the face of what traditional oil and gas development companies do. Moreover, it is at odds, in a good way, with the big shale oil producers that have received so much attention in the press about how shale is going to pave the way to US energy independence and overtake Russia as the globe's dominant oil producer. While that is still up for debate, what is beyond dispute is the simplicity of the company's business model, and the investor upside that could easily accrue if its strategy and production plan stay on track in 2018.

## Advantagewon Oil

We are talking here of Advantagewon Oil Corp (CSE:AOC). The Toronto-based company is headed by Charles Dove, a veteran oilman who had great success with Dejour Energy (which before 2006 was a uranium focused company and renamed DXI Energy in 2015). Flow thru share money had been raised by Dejour on their Uranium prospect in the Athabasca basin. When that prospect was sold, management approached Dove to find oil and gas prospects where the flow-thru funds could be utilized. Dove incorporated Dejour Energy (Alberta) in the late spring of 2006 as a partnership between Dejour Enterprises Inc and a private company he owned.

So Dejour refocused its efforts on oil and gas projects in the Peace River Arch of northwest Alberta and northeast BC - one of the most productive oil and gas regions in Canada's Western Sedimentary Basin including discovery of the massive Ladyfern gas field in the 1990s. Dove decided to concentrate on B.C. because new pool discoveries had a royalty holiday while a good well in Alberta had as much as a 50% royalty applied at the time.

Dejour secured a land deal in Feb 2007 and had prepared two well applications by March 15. Two wells were down, cased and tested by the end of the first week of April 2007. Over the remainder of 2007, Dejour acquired more land and planned a drilling program for winter 2008. An additional 4 wells were drilled in B.C. and one successful well in Alberta bringing the company production to 1000 bopd by July 2008 - a large volume for a small company. A 2008 NI 51-101 report valued Dejour's proven and probable reserves at $58.2 million.

An important point about Dejour is that all of the oil and gas produced was a result of exploration work done on new areas the company had identified rather than the purchase of existing producing wells. That's because Canadian companies that raise flow-through shares are required by law to spend the money on exploration for new pools. A quick flow-through share refresher: The flow-through share has been in the Canadian tax code for 30 years. It has generated billions for mining companies and contributed to developing some of the country's best mines including the Ekati and Diavik diamond mines. Flow-through shares are popular with investors because they allow the explorer to "transfer" their exploration expenses to individuals, who can write them off against their income. The government gets to tax the explorer's capital gains and will tax its production if it ever gets to that stage.

Advantagewon is planning to apply the same technical methods used in Canada to its current strategy of exploring for and further developing existing oil pools and producing oil in Texas, a jurisdiction it believes is far superior to Canada in a number of ways. According to Dove, while he originally thought that Texas was drilled out, a sentiment shared by many others in the industry, in fact he found the opposite, there are many under developed pools both in terms of drilling and recovery of oil in place.

AOC's strategy is a combination of additional drilling in existing pools, additional recovery of oil from existing pools using methods such as re-pressuring and pressure maintaining through water flooding, as well as exploration for new pools. Dove believes that in the company's main focus area there are additional productive sands underlying current proven producing sands which can be evaluated by drilling a well or wells through all prospective zones identified. In this way, Advantagewon has a reasonably predictable result in the proven zone as well as additional upside in the proximal deeper zones.

## Shallow sands vs shale

While the trend in Texas is for oil companies to drill in big shale basins like the Eagle Ford and the Permian, Dove's experience as a geophysicist and consultant to many oil companies told him that wasn't the way to build a successful junior.

"A few years ago everybody including minimally capitalized startups were being pushed to horizontal drilling and multi-stage fracking," Dove said in a

recent exclusive interview with Ahead of the Herd. “Some of these wells cost in the millions and some over $10 million. It’s a game a small operator can’t play. If you have wells that cost $2-5 million and you haven’t raised $50-$100 million you just can’t make that work.”

Instead Advantagewon is concentrating on small, shallow wells, in particular the layered sands around San Antonio, rather than the “elephants” many oil juniors go after. Says Dove:

“They only want to go for the very expensive kind of home run plays. Most of them don’t last, because not a lot of people are successful at that. Those that do what I call bread and butter exploration and development work, come up with something simple that generates cash, that’s repeatable, so once you have defined the prospect you have some running room to drill a number of wells into that prospect, those are the ones that grow and survive.”

Dove says Advantagewon is able to drill 10 to 30 wells for the cost of one horizontal shale well. Each well can be drilled and cased for about US$75,000.

“When you’re a small company trying to make your capital go as far as it can, it’s just good risk management to be able to test a number of areas with a nominal amount of money. That’s what I really liked about Texas is you go in there with a relatively small amount of risk capital per well - $75K per well is pretty minimal in this business. And work in areas proximal to where production has existed for 50, 80 years.”

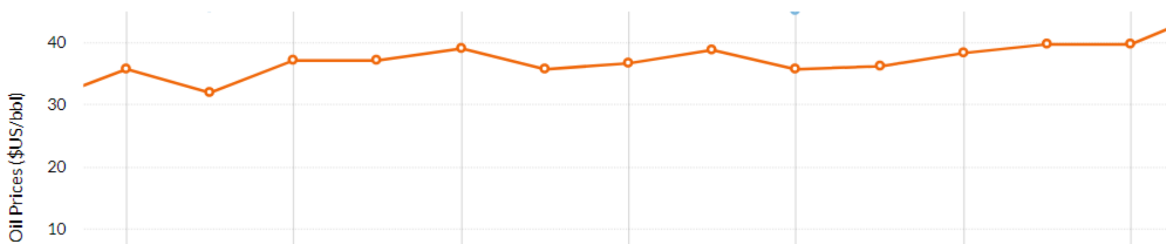
The beauty of the model is that the money invested in exploration can be returned in a short period of time, then the process is repeated. Meaning the business is a constant cash flow generator with minimal risk to deployed capital. Not only that, the company is being paid based on the US benchmark, West Texas Intermediate (WTI), not Western Canadian Select, which trades at a significant discount to WTI.

**The Texas advantage**

Dove ran us through some numbers, and they’re impressive.

Using Jan. 22 oil prices, if WCS is at $39.33 USD and WTI is at $63.43 USD, Advantagewon would receive $24 USD (approximately $30 CDN) less if it was operating in Canada. A well that costs $75,000 to put into production at just 10 barrels of oil a day (bopd) is paid out in 7 months. Increase production to 15 bopd and the capital is recovered in 5 months, and 3 months if production rises to 25 bopd. Compare that to a horizontal multi-stage shale well which costs around $3 million and can produce at best 500 bopd. AOC can drill 20 wells for the same money and actually produce more oil, 800 barrels @ 20 bopd.

WTI price above versus WCS below




“The risk management profile of one well at $3 million versus 40 wells at $75,000 is just a very different story and this is where the expensive process, the horizontal well with multi-stage fracs is a greater risk. If you’re not right the first time or two, capital is depleted and it’s very hard to ever build a business after that,” stated Dove.

Texas is better as an oil jurisdiction than Canada due to less regulation, it has a plentiful labor pool and is friendlier to exploration than Canada. A well of similar depth to the Texas sands such as those drilled in Canada’s Bonnyville or Cold Lake regions would run around $200,000 to $300,000, Dove estimates. “So you get 60% more for your oil and you spend half as much to drill it.”

So how does Advantagewon find the oil and where is it currently producing from?

The firm's strategy is to identify landowners and oil and gas lease holders with existing wells and prospective lands  who own the oil and gas rights. Advantagewon will purchase those rights and the landowner then keeps a royalty, usually between 15 and 25%. Most are more than happy to take a royalty on wells located on their properties. They can then watch as work is conducted at no cost to themselves with the expectation of regular royalty payments from any oil produced for the productive life of the wells. The situation is vastly different from Canada, where subsurface oil rights are almost exclusively owned by the state, meaning a landowner has little incentive to allow an oil company to set up rigs.

The idea is to tap existing oil reservoirs that have been depleted or only partially developed. Advantagewon plans to use the cheapest method of enhanced oil recovery (EOR), water flooding, whereby water is pumped into the reservoir to raise the pressure, thus allowing oil to again be pumped. The technology has the potential to increase recoveries to as much as 75% of the oil in place.

"We devise a water flood program where you maintain or even increase pressure in these depleted reservoirs and increase the recovery of oil in place," Dove explains, noting that even a 10% increase in oil recovery can be significant in a large oil reservoir.

The company currently has 34 leases in Texas and is producing in roughly equal amounts from two areas: Saratoga and LaVernia. Saratoga is a salt-dome play near Beaumont where Advantagewon recently brought on a dormant well, adding to another  production wells on the 400-acre property.

The more prospective leases are in the LaVernia area, where wells can be drilled for quite a bit less than Saratoga (8 to 12 wells for the cost of one at Saratoga). The area has historical production of 7 million barrels from hundreds of wells and AOC owns just under 4,000 of the 10,000 acres. The plan is to drill six new wells at LaVernia and put them into production quickly, thus boosting production from the current 45 bopd to 135 to 200 - a 3 to 4-fold increase. With success, the program will be expanded to a minimum of 10 wells in Q1 and Q2 2018 resulting in estimated company

production of 200 to 300 bopd. Existing company land holding could provide as many as 100 locations.

“These wells should not take greater than a day and a half to two days to drill and don’t require any down hole stimulation such as a frac, so you can just put them on production as soon as necessary equipment and services are installed. I want to see oil coming out of the ground in 2 weeks after completion,” says Dove. “The goal here is to try and recycle our cash as fast as we can. We achieve immediate cash flow from our operations, and that puts more money back in the till to keep drilling more wells. We want to get to the point where the recycle rate on our cash is very rapid.”

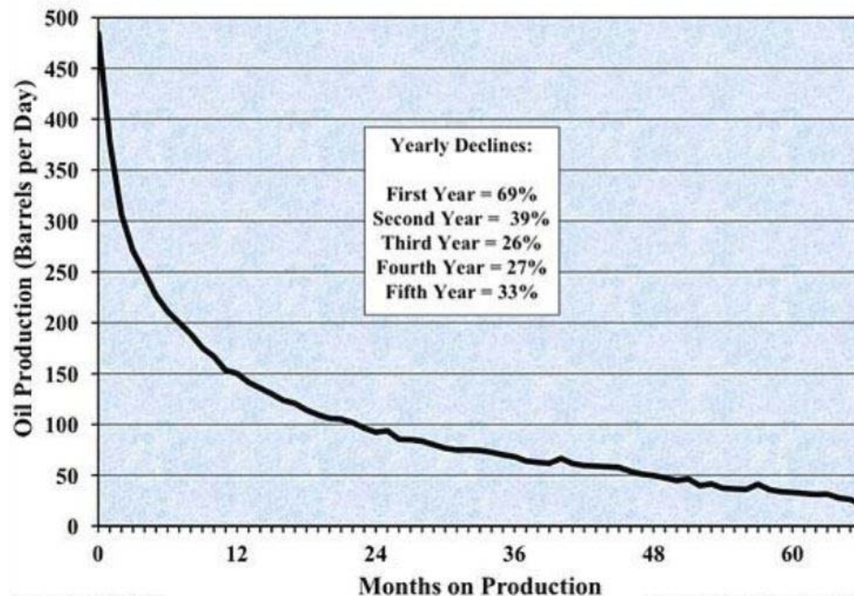
Advantagewon’s objective was to be cash flow positive in 2017 and while that didn’t happen, Dove says with two recent private placements the company has about a million in the till which will easily take it through the drill program.

The company is also considering drilling a deeper well into the Austin Chalk zone on its Lerma lease, which could add another 100 - 500 bopd, but that play is not the company’s priority right now. “The cheap, repeatable sands will take the majority of  our effort,” says Dove.

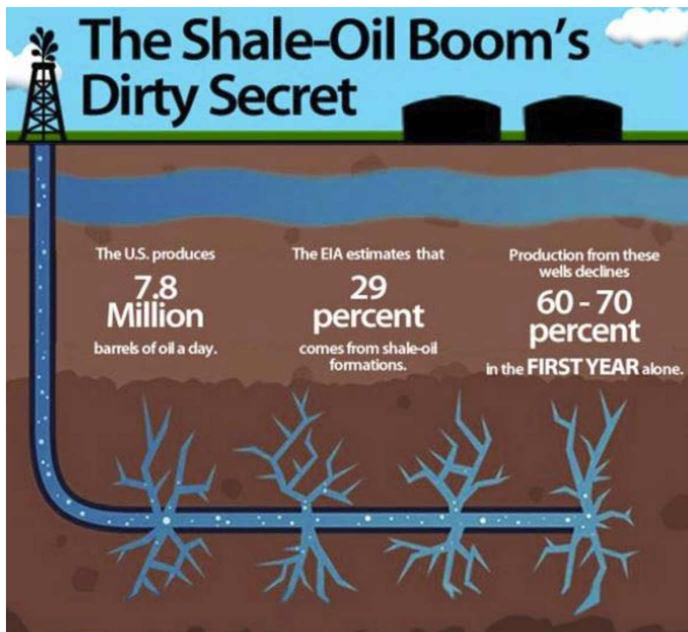
**US oil market tighter than we think**

Dove was asked whether he thinks the current drive by the United States towards apparent energy independence, thanks to shale oil and gas, is achievable. His answer surprised me. He said the States actually has a long way to go before it doesn’t need foreign oil, noting it still imports 8 million bopd. According to the American Geosciences Institute, in Q3 2017 the US imported around 10 million barrels a day, with 39% coming from Canada, versus exporting 6 million bopd.

Moreover, far from moving towards a global oil glut many predict will happen as US output barrels along at 10 million bopd - thus counteracting OPEC’s production cuts - Dove said he doesn’t see that happening anytime soon, due to the decline rates characteristic of shale wells.




The wells typically produce at high rates at first but then drop off quickly, meaning producers have to keep drilling just to maintain existing production levels. A year after coming on-stream production can drop to 20-40% of the original level. Howard Kunstler, author of *The Long Emergency*, calls this "the Red Queen syndrome" which alludes to the character in Alice in Wonderland who famously declared that she had to run faster and faster just to stay where she is.




"It's my belief that the confidence in the US shale oil and gas is overstated. Based on the decline rates, to maintain rates of production and further to that, to increase these rates by the millions of barrels per day to replace imports will require a tremendous amount of activity and capital if it is achievable at all. It appears pretty ambitious to me," says Dove, adding he also casts doubt on oil pools in the Middle East being able to maintain output, noting that to produce at current rates, they are pressure

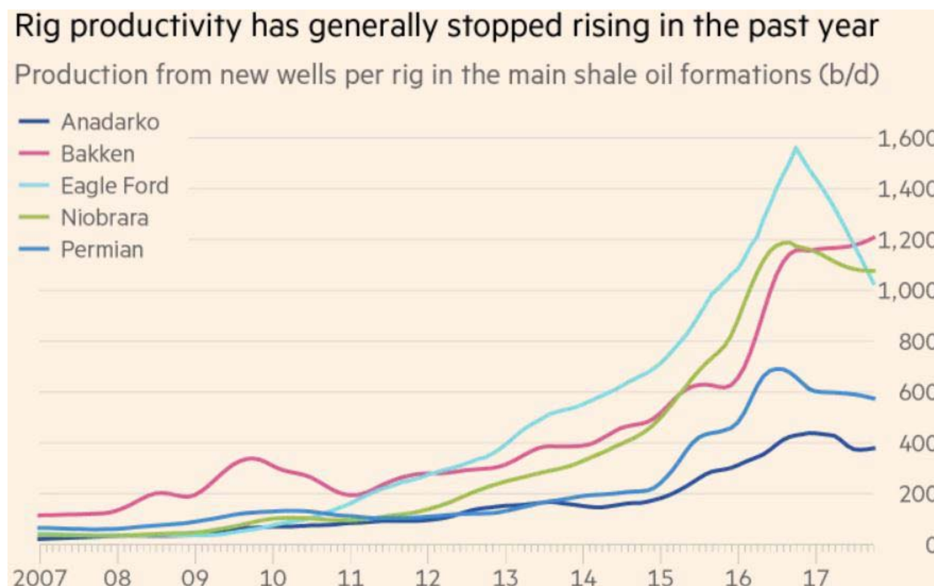
maintaining reservoirs by pumping millions of barrels of seawater into them and have been for years.

Of course that is exactly what shale drillers ARE trying to do. But while drillers have boasted of higher initial productivity (IP) rates due to increased efficiencies like longer laterals and increased use of frac sand and fluids, the reality is that higher rates don't necessarily mean increased production.

Oilprice.com quotes Rystad Energy saying that in fact, "A sample of wells in the Eagle Ford showed steadily higher IPs in recent years, but they also exhibited steeper and steeper decline rates." This is because drilling more wells closer together kills the pressure in each well, lowering the amount of oil that can be recovered.

Marathon Oil for example had a peak IP rate of 35,600 barrels of oil equivalent per month in 2012, but that fell to below 8,000 boe a year later.

In the BOE Report, 35-year oilman Randy Evanchuk wrote that the idea of US shale reaching 10 million barrels a day, as the EIA predicts, is "fiction." "My best guess for peak shale oil production is 5.8 million BPD coinciding with peak Permian production of 3.5 Million BPD in 2020. During this timeframe, the Bakken should produce at a rate 1.0 million BPD, and the Eagleford at 1.3 million BPD."




Consultancy Wood Mackenzie said last fall that the Permian Basin, the world's top shale play, could see peak production by 2021. Even US shale

giant Pioneer Natural Resources agreed that a production ceiling looks imminent.

“At some point you reach a peak on logistics, limits on sand, water volumes..that’s where we are getting to, (although) we’re not quite there as an industry,” Platts quoted Pioneer CEO Tim Dove.

From an investment point of view, shale players are hardly top tier, either. Oilprice found a study from Riyadh-based Al Rajhi Capital claiming that despite rising oil prices, most US shale companies were showing losses and the average return on investment “is still a measly 0.8 percent.” The reason? Cash required per barrel has risen for several consecutive quarters hitting an average $64 a barrel in Q3 2017, which is even lower than WTI was trading at the time.

What does this mean for the oil market in general? Energy analyst Phil Flynn wrote recently that the global oil market is actually in deficit, not surplus, to the tune of 1.1 million bopd in the fourth quarter of 2017. Oil inventories in the US, Japan, European ports and Singapore are currently just below their 5-year average.

Writes Flynn:

*In other words, we have no oil glut! We have the tightest oil market we have had in years. Don’t blame bubbles or speculators or even oil companies. It is just good old fashioned supply and demand. Jobs day and the impact on the dollar will impact crude. The weaker dollar makes oil cheaper in Euro terms and that will help support a booming U.S. oil export market!*

Combine shrinking supply with exploding global oil demand and you have the making of a spectacular oil bull market. Flynn quotes the EIA saying that oil demand increased from 92 million bopd in 2015 to 98.38 million in 2017, and is on track to add another 2 million this year thanks to higher consumption in the US, China and Europe.

**Bullish bets on oil**

As for where oil is heading, the best indication would seem to come from hedge funds who invest big bucks in oil futures. MINING.com reported a

week ago that hedge funds have pushed long positions on oil futures to their highest level in five years across five energy markets including WTI and Brent crude benchmarks, and US gasoline and diesel fuel.

Indeed the bigwigs at the World Economic Forum in Davos, Switzerland last week were bullish not only on oil, but on the whole suite of commodities including metals and agriculture. Bloomberg's Commodity Spot Index which tracks a number of raw materials from oil to wheat, has risen 41% over the last two years, to highs not seen since November 2014, the news outlet reported.

**Conclusion**

While there is no doubt that the US oil industry is resurging on the back of higher oil prices, increased shale production, more efficient drilling technologies, and the lifting of the oil export ban, one must look carefully as to where to invest. The herd will follow shale oil companies which seem to be the pointy end of the stick of the US shale "revolution". But shale oil wells are depleting as fast as new ones are being drilled (the "Red Queen syndrome"), many shale companies are losing money even at today's prices, and these wells are expensive to drill and maintain.

Advantagewon has a different strategy for exploring for oil in Texas and it has nothing to do with shale. If the company can make good on its plans to grow its barrels from the current 45 to up to 500 this year, it would mean a significant lift in its profitability and stock price. I like AOC's strategy of drilling shallow wells for under $75.000, getting fast payback, earning oil revenue, then repeating the process. It's a good formula for generating constant cash, and it's low risk.

For all these reasons, I've got Advantagewon Oil on my radar screen. Do you?

If not, maybe you should.

Richard (Rick) Mills
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