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RESEARCH

Gulfsands Petroleum

25th January 2016

Ongoing conflict in Syria coupled with the collapse in the oil price drive shares to an all-time low

Gulfsands Petroleum is an AIM listed oil & gas exploration and development company whose primary asset is a 50% working interest in a Production Sharing Contract (PSC) on Block 26 in Syria. Other assets are located in Morocco, Tunisia and Colombia.

Force Majeure served in December 2011

Having advanced production to 24,000 barrels a day on Block 26, December 2011 saw a Notice of Force Majeure served by Gulfsands under the Block 26 PSC following the imposition of EU sanctions on Syria. Economic activity by Gulfsands has been prohibited, although the firm maintains a presence in the country and is focussed on the hoped for eventual restart of production.

Rescue fundraising completed and all other assets seeking to be divested/ farmed out

In January 2016 a $21.4 million rescue fundraising was completed in order to pay off a convertible loan brought into being by the previous executive management and Arawak Intl and for working capital purposes. All assets outside of Syria are currently being divested or farmed out in order to reduce the firm's financial liabilities. However, management were clear at the time of the recent fund raising that further funds will be needed within the next 12 months.

Valuation

Attributing a value to the company is difficult given the multitude of risks involved. However, we note that the fair value attributed to the Syrian assets by the company as at 30th June 2015 was $102 million (£71.5 million) – 5.25 times the market cap – this figure itself being discounted some 74% from the company's base case NPV(15) of $392 million. Subsequently there has recently being an additional reclassification of the reserves from 2P TO 2C status.

Table: Financial overview

Year to 31st Dec	2011A	2012A	2013A	2014A
Production (bopd)	8,542	239	175	0
Revenue ($m)	125	5.6	4.4	0
Net profit ($m)	55.1	(27)	(26.8)	(16.1)
Free cash	124.2	91	33.8	7.9

Source: Company accounts

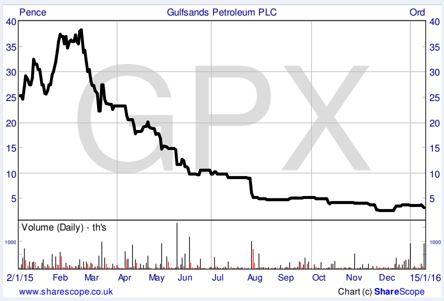
Preview note

Gulfsands Petroleum

Key data

EPIC	GPX
Share price	2.875p
52 week high/low	38.25p/2.625p
Listing	AIM
Shares in issue	472.72m
Market Cap	£13.6m
Sector	Oil & Gas

12 month share price



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History

Gulfsands Petroleum is an oil & gas exploration and development company which listed on AIM in April 2005, initially valued at £120 million. At listing the company's primary assets were that of oil & gas exploration and production fields in the US, and Syria. As it stands today the firm holds assets and operations in the Middle East, Africa and South America, having exited the US operations over the years.

But the main story at Gulfsands relates to its interests in Syria. Here, the firm has a 50% working interest in a Production Sharing Contract (PSC) on Block 26 along with partner Sinochem. The firm first entered Syria in 2000 as the junior partner of Ocean Energy, in a venture which was subsequently awarded a licence to explore and develop Block 26. The resultant PSC was signed in May 2003 following a public tender and signed into Syrian law via presidential decree.

Block 26 covers an area of 5,414km² in north east Syria with the rights to explore, develop and produce hydrocarbons from all depths outside pre-existing fields within the area and from the deeper levels below the pre-existing discovered fields.

25 year production licences are held for:

- Khurbet East - Massive and Kurrachine Dolomite reservoirs

- Yousefieh

- Khurbet East - Butmah reservoir

These licences run from 2008, 2010 and 2011 respectively, with each having a possible extension, at the contractor's option, of ten years.

In June 2007 Gulfsands announced the discovery of four significant hydrocarbon bearing reservoirs at the Khurbet East oil field and commercial production began just over 12 months later. By August 2011 the field was producing at an average gross production rate of c.21,500 barrels of oil per day. A second discovery, the Yousefieh field, was brought on-stream in April 2010 and reached production levels of 2,500 barrels of oil per day.

The troubles begin

September 2011 saw the European Union (EU) impose sanctions restricting the import of Syria sourced oil into the EU as a result of the political and humanitarian troubles seen in the country. The same month saw crude storage capacity become increasingly limited due to the sanctions, with the Syrian Oil Ministry instructing Gulfsands to reduce production. Combined with routine refinery maintenance in the country, production was reduced by 75% to just 6,000 barrels of oil a day.

December 2011 saw further sanctions being brought in against Syrian activity, with a prohibition on the supply of key equipment and technology to the oil and gas industry. Also, the General Petroleum Corporation (GPC) of Syria - the Syrian government's principal holding company for investments in the oil and gas sector – was added to the list of proscribed organisations. Production from Block 26 for the company's benefit stopped soon after, although GPC has been producing intermittently for itself in accordance with the terms of the PSC.

As a result of the EU sanctions the company has been prohibited from participating in petroleum production and general operations in Syria although it is not precluded by the EU sanctions from continuing to maintain a presence in the country. All exploration activities have also ceased and the fields are now under essentially a "care and maintenance" program. Under the PSC, on 12th December 2011, a Notice of Force Majeure was served by Gulfsands.

Currently, it remains unclear as to when the company can return to its previous role and, equally importantly, if any modifications will be made to its permits. Particularly in the event of a change of Government in Syria. Since the imposition of the Force Majeure notice, Gulfsands has ensured it remains compliant with all applicable sanctions and continues to state its intent to return to production and exploration activities as soon as permitted. The final exploration period of the PSC was set to expire in August 2012 but the company is optimistic that an extension can be negotiated with the Syrian authorities to at least replace the period of time lost when Force Majeure was declared.

The total effect of the Syria sanctions, along with the more recent plunge in the oil price, has been catastrophic, causing the share price to plunge from a peak of just over 400p at the start of 2011 to the current 2.875p.

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Current Assets, Resources & Status

Syria

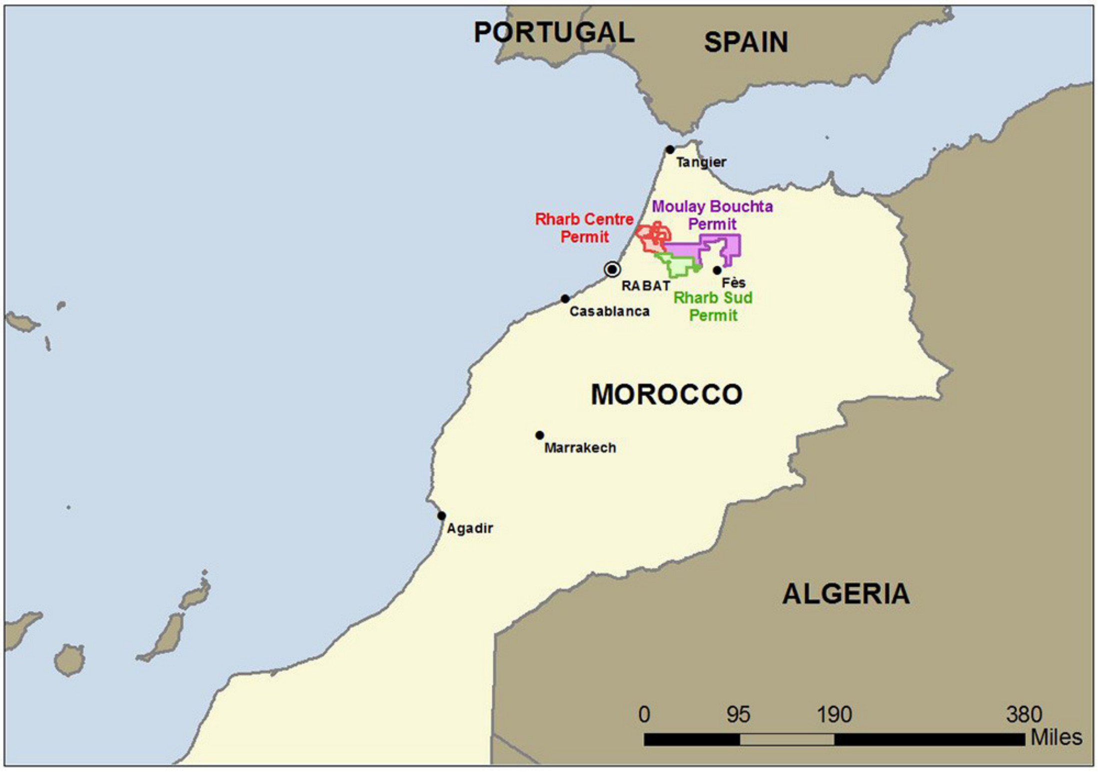
At Block 26 Gulfsands has made discoveries within the Massive, Butmah and Kurrachine reservoirs of Khurbet East field, and the Yousefieh field. Total 2C contingent resources (as now classified) are 77.1 MMbbls oil equivalent on a working interest basis. These were recently reclassified from higher value 2P reserves as a result of the continuing EU Sanctions in Syria. The company has also identified a discovery at Al Khairat estimated to contain 2C contingent resources of 12 MMbbls of oil equivalent on a working interest basis but Al Khairat has not yet declared commercial and no development plan has been agreed.

Morocco

In Morocco, Gulfsands is the operator of, and has a 75% interest in, the Moulay Bouchta petroleum agreement, for which the initial period expires in June 2016. Here the company has identified best estimate prospective resources of 11.4MMboe in the Moulay Bouchta permit area on a working interest basis.

However, Gulfsands is currently looking to divest or farm-down its interest in order to reduce its future financial commitments. If this is unsuccessful the company is at risk of forfeiting its interest and $1.75 million of restricted cash held as a performance guarantee for completing the minimum work programme on the permit area.

In Morocco Gulfsands also holds interests in three exploitation concessions – Zhana 1 & 2 and Sidi Amer. There are four wells on these three concessions that penetrate depleted, or near depleted gas reservoirs, but there are no plans to re-enter or produce from these wells.



Tunisia

Gulfsands has a 100% in the Chorbane permit in central Tunisia, with the area close to a number of producing oil fields and associated oil and gas infrastructure. The company has a best estimate for Chorbane of 44.2MMboe of prospective resources.

While the first renewal period expired in July 2015, Gulfsands has been granted a 2 year extension of the permit which now expires in July 2017.

Gulfsands has initiated a process of divestment or farm-down of its interests in the contract area before any significant resources are spent on further exploration work.

Colombia

In Colombia Gulfsands is the operator of, and has a 100% interest in, the Llanos Block 50 and Putumay Block 14 exploration contracts. Both blocks are in established oil producing basins and are on trend with existing oil fields and new discoveries.

The strategy here is to look at divestment or farm-down options before any significant finances are committed to additional exploration work. Gulfsands has around $3.2 million of restricted cash associated with performance guarantees for completing the minimum work obligations for the two blocks.

Financials

As Syria provided the firm's primary source of revenues, the effect on the accounts of the EU sanctions has been dramatic. In 2014 revenues were zero, although the previous year's loss of $26.8 million was cut to $16.1 million as costs were cut. More notably, previously strong cash balances dwindled from $124.2 million at the end of 2011 to just $1.5 million by 30th June 2015, mainly due to outflows on exploration activities.

	2009	2010	2011	2012	2013	2014
Production (boepd)	7,393	10,308	8,542	239	175	0
Revenues ($m)	84.4	115.6	125	5.6	4.4	0
Net profits ($m)	28.3	44.7	55.1	-27	-26.8	-16.1
Free cash at year end ($m)	57.6	80.6	124.2	91	33.8	7.9

The financial position forced the company in August last year to announce an emergency $21.4 million open offer rescue fundraise at a price of 4p per share. Completed in January 2016, largely by 2 shareholders – Waterford Finance & Investment Ltd and Welsh financier Richard Griffiths, the proceeds were used to pay off a $14.2 million convertible loan that had been taken on by the previous executive from Arawak and for working capital purposes. Gulfsands believes that following the offer it has enough financial resources to support activities until the end of 2016 but, barring a resumption of activities in Syria, further funds will be required.

Risks

The risks associated with Gulfsands are substantial and varied. The key ones are:

- no revenues are currently being generated.

- given the ongoing troubles in Syria it is uncertain when EU sanctions will be lifted.

- the oil price fall continues and investor sentiment over the sector remains low – we see the risks in this scenario being skewed to the upside given the current oil price of $27/bbl (Nymex Light Sweet benchmark).

- by the company's own admission, further funds will need to be raised in January 2017 with inevitable dilution should this be done by way of a non-pre-emptive placing to major shareholders Griffith's and Waterford.

- if the company is unable to divest or farm-out its interests it will not have sufficient cash to complete minimum work obligations outstanding under each of its contracts or agreements. This puts it at risk of losing $4.9 million of restricted cash and at risk of damage payments.

- Moroccan partner ONHYM has a $7.5 million claim against the company over the recently expired Rharb Petroleum Agreement. The claim is equal to the estimated cost of the minimum exploration work programme of the Agreement, less the costs incurred.

- former CEO, Mahdi Sajjad, has brought a claim against the company for fundamental breach of contract and constructive unfair dismissal.

Valuation

At the current share price of 2.875p Gulfsands Petroleum is capitalised at £13.6 million. We believe that this pretty much prices the company for bankruptcy.

Attributing a fair value to the company is difficult given the multitude of risks involved. **However, we note that the fair value attributed to the Syrian assets as at 30th June 2015 was $102 million (£71.5 million) – 5.25 times the market cap.**

This figure is derived by the company from an assessment of the present value of estimated future cash flows from Block 26, with Brent forward oil prices being used along with a 2% inflation assumption beyond the end of the quoted curve. The NPV derived using a 15% discount rate is then put through a further scenario analysis, which takes into account the deemed risks associated with Syria, including the potential for a significant delay in resumption of oil production.

The final NPV of $102 million represents a 74% discount to the produced "base case" figure. Since this valuation by the company's management and auditors, Brent crude has however fallen by a further c.50% (at time of writing) and so it is fair to assume that this value will be written down further in the next set of accounts.

But at the current price we believe that Gulfsands is priced for effective bankruptcy, with fears over control and influence by the two major shareholders and a further capital raising expectation depressing the valuation. The shares represent an "option" on the adherence to good corporate governance by the Board of Directors regarding any attempt to take the company private at a knock down valuation (given the 81.05% holding by the concert party of Griffiths and Waterford) and/or a political resolution to the ongoing civil war in Syria that allows the company to once more begin pumping oil from its low cost fields.

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