

April 16, 2010

# Epsilon Energy Ltd.<sup>1,7</sup> (EPS-T)

Last: \$2.66

**BUY**

Target: \$4.00

## WHAT'S CHANGED

	NEW	OLD
Rating	BUY	n/a
Target	\$4.00	n/a
Production 2010E (boe/d) 6:1	1,815	n/a
Production 2011E (boe/d) 6:1	3,800	n/a
CFPS 2010E (f.d.d.)	\$0.24	n/a
CFPS 2011E (f.d.d.)	\$0.76	n/a

## SHARE DATA

Shares o/s (mm, basic/f.d.)	50.3/53.3
52-week high/low	\$3.50/\$0.65
Market capitalization (mm)	\$134
Enterprise value (mm)	\$114
Net debt (mm) – 2009	(\$20)
Dividend yield	-
Projected return	50%

## FINANCIAL DATA

	2009A	2010E	2011E
Oil & NGLs (mb/d)	0.0	0.0	0.1
Natural Gas (mmcf/d)	3.0	10.7	22.4
Total (mboe/d) 6:1	0.5	1.8	3.8
Equivalent growth	32%	268%	109%
WTI (US\$/b)	61.99	80.00	85.00
HHUB (US\$/mmbtu)	4.16	4.75	6.00
FX rate (USD/CAD)	0.88	0.99	0.95
EPS (f.d.)	(\$0.40)	(\$0.01)	\$0.17
CFPS (f.d.d.)	(\$0.00)	\$0.24	\$0.76
Net Debt (mm)	(\$13.5)	(\$25.6)	(\$59.1)
Debt/CF	nm	nm	nm
P/CF		11.2x	3.5x
P/CF (d'adj'd)		9.2x	2.0x

Fiscal year ending December 31

## Initiating coverage: "Free" access to Big Exposure in the Marcellus Shale Play

### Investment Thesis

Epsilon is a unique story as they have significant upside exposure to one of the lowest cost gas plays in North America: The Marcellus shale. A farm-in by Chesapeake Energy means that the company will reap the benefits of a US\$190 million gross (US\$95 million net) drilling program into the shale at no capital cost to EPS. We feel the fact that Chesapeake farmed-in on Epsilon's acreage speaks volumes to the quality of the land potential.

### Forecast Summary

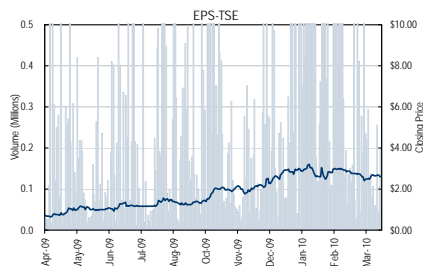
Over the next two years, we forecast that EPS will deliver some of the strongest per share growth in production and cash flow in our coverage universe at no capital cost to the company. Through the Chesapeake JV we forecast that EPS will grow net production to over 5,000 boe/d by year end 2011 while generating ~US\$40 million of free cash flow over that time.

### Valuation

Epsilon is currently trading at only 2.9x our 2011 debt adjusted cash flow forecast, at only \$19,666 our 2011 net average production forecast, and at only \$14,950 our 2011 exit rate production forecast. While not in our valuation, we see value of US\$115 million from the company's current cash position plus its net drilling capital from the JV (US\$20 million cash plus US\$95 million future drilling capital) which implies that the asset base is essentially "free" based on the current market cap.

### Recommendation

Epsilon has big, unique exposure to the Marcellus shale play in Pennsylvania and New York. Epsilon's lands directly offset some of the most successful recent Marcellus wells and we feel the fact the Chesapeake has farmed in on their acreage speaks volumes to its quality. Based on our analysis we believe that investors are getting the assets for "free" with basically an option on the upside exposure associated with these properties. We are initiating coverage with a BUY recommendation and a \$4.00 per share target price, which indicates potential upside of 50% from current levels.





## INVESTMENT THESIS

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### *Investment thesis – BUY recommendation and \$4.00 target price*

We believe Epsilon is a unique story as they have significant upside exposure to one of the lowest cost gas plays in North America. The fact that Chesapeake Energy, with access to over 1.5 million acres on the Marcellus trend farmed in on EPS speaks volumes to the quality of their acreage position in Susquehanna County in north east Pennsylvania. We also see upside potential in its Bakken oil position in S.E. Saskatchewan which could provide a oil resource dynamic to the story. While we have not assigned any immediate value to its exposure to the Utica shale play in Quebec and its Ethiopia assets due to the exploratory nature of the plays, we do see significant option value in these two plays and if either (or both) work out we expect the stock to react positively. While not in our valuation, we see value of US\$115 million from the company's current cash position plus its net drilling capital from the Chesapeake JV. The current market cap is only \$134 million so the what we feel is a high quality asset base, with good exposure to some of the hottest North American shale plays, is almost completely unvalued at this time in our opinion. We are therefore initiating coverage with a BUY recommendation and a \$4.00 per share target price, which indicates potential upside of 50% from current levels.

**Junior producer with unique exposure to the Marcellus shale play.** EPS has accumulated 43,500 gross (21,750 net, accounting for the Chesapeake J.V.) acres in the Marcellus shale gas fairway in north east Pennsylvania and southern New York. This translates into over 320 gross (+160 net) horizontal locations in one of the lowest cost gas plays in North America.

**The Chesapeake JV effectively gives Epsilon \$95 million of net drilling capital.** Chesapeake will earn a 50% interest in Epsilon's 11,500 acres on the Highway 706 project in exchange for \$5 million in cash upfront and a commitment to spend another \$190 million on the project over a 30 month period beginning February 1, 2010. With the 50/50 split this effectively gives Epsilon \$95 million of future net drilling capital while also gaining the expertise of a major shale player.

**Strong balance sheet.** Epsilon currently has no debt and has approximately US\$20 million in cash. With no major capital commitments over the next two years and expectations of strong free cash flow from the J.V. we see EPS maintaining a very healthy balance sheet through 2011, giving them strong financial flexibility.

**"Free" Marcellus Exposure.** Epsilon is currently trading at only 2.0x our 2011 debt adjusted cash flow forecast, at only \$19,666 our 2011 net average production forecast, and at only \$14,950 our 2011 exit rate production forecast. While not in our valuation, we see value of US\$115 million from the company's current cash position plus its net drilling capital from the JV (US\$20 million cash plus US\$95 million future drilling capital) which implies that the asset base is essentially "free" at current prices.

## FORECAST SUMMARY

### *Strong organic growth*

Our 2010 and 2011 forecasts are summarized in the exhibit below. There is no official guidance from management but our forecasts assume that Chesapeake will drill 36 gross horizontal Marcellus wells under the farm-out agreement by year end 2011; which should leave room for more wells under the agreement in 2012. Driven by the farm-out agreement, Epsilon is expected to deliver high organic growth over the next two years without incurring any direct capital costs from the Marcellus program. This is reflected in our forecasts which call for limited capital outlays but high organic production growth over the next two years. We would note that our production forecast is quoted on a net of royalty basis. Cash flow is also expected to grow over the next two years due to a combination of production growth and our forecast for higher natural gas prices in 2011. With the limited capex and growing cash flow, Epsilon's cash base is expected to increase to \$59.1 million by year end 2011.

#### Epsilon Energy – Forecast summary

	<u>2009A</u>	<u>2010E</u>	<u>2011E</u>
<b>Net Production</b>			
Oil & NGLs (b/d)	0	25	70
Natural gas (mmcf/d)	<u>3.0</u>	<u>10.7</u>	<u>22.4</u>
Equivalent (boe/d)	494	1,815	3,800
% Oil & NGLs	0%	1%	2%
<b>Financial</b>			
Net income (\$mm)	(\$20.2)	(\$0.6)	\$8.8
EPS (basic)	(\$0.40)	(\$0.01)	\$0.18
EPS (f.d.)	(\$0.40)	(\$0.01)	\$0.17
Cash flow (\$mm)	(\$0.0)	\$12.1	\$38.6
CFPS (basic)	(\$0.00)	\$0.24	\$0.77
CFPS (f.d.d.)	(\$0.00)	\$0.24	\$0.76
Capital spending (\$mm)	\$9.7	\$0.0	\$5.0
Net debt (\$mm)	(\$13.5)	(\$25.6)	(\$59.1)
Debt/cash flow	nm	nm	nm

Source: Company reports, GMP estimates

## VALUATION

### *“Free” Marcellus Exposure*

While not applied to our valuation methodology, we feel that there is almost “free” exposure to the asset base if we value the US\$95 million of net drilling capital from the JV at US\$95 million. Combining this JV value with the US\$20 million of cash currently on the balance sheet we see a combined value of

US\$115 million. The market cap is only \$134 million which effectively means that the Oil & Gas assets, that include exposure to one of the hottest gas shale plays in North America, are valued at only \$19 million at this time. Based on this methodology all the current production and upside in the oil & gas assets (all the Marcellus, Bakken, Utica, and Ethiopian upside) would almost be valued at zero at this time. Essentially giving investors “free” exposure to what we feel is a high quality asset base that includes a strong position in the Marcellus shale play.

### ***Land Focused Methodology Derives \$4.00 Target Price***

Our target price is derived from a land focused methodology that assigns risked per acre value to the company’s Marcellus and Bakken land. For the Marcellus land, we use Chesapeake’s unrisks value for its Marcellus acres as a benchmark value point. For the Bakken, our benchmark is comparable land sales in the direct vicinity of Epsilon’s acreage. Chesapeake values its undeveloped Marcellus acres at US\$35,900 per acre on an unrisks basis, using US\$7.00/mmbtu natural gas prices. Based on this analysis we have given Epsilon’s Marcellus acreage in Pennsylvania a value of US\$12,565/acre (US\$35,900 adjusted for a US\$6.00/mmbtu gas price environment, and then risked at 50%, due to the early nature of the play) and given its New York Marcellus lands a value of US\$6,283/acre, which is 50% of the Pennsylvania lands due to the regulator uncertainty surrounding the Marcellus in NY right now. We have given the S.E. Saskatchewan lands a value of \$300/acre, which is roughly the average of the latest Crown land sales in this area. For the Quebec and Ethiopian assets we have given no value right now given the lack of commercial activity.

Epsilon also has no debt and roughly US\$20 million of cash on its balance sheet (no direct value assigned to the US\$95 million of future net drilling capital) which adds another US\$0.38 per share. Given the fact that the outstanding options are in-the-money we use the fully diluted share count and add back option proceeds. All in this approach nets a per share value of US\$3.89, which implies \$4.10/share on our long term Canadian dollar forecast. We view the \$4.00/share value as very conservative and with Chesapeake expected to start drilling on the EPS acreage starting this June/July we anticipate that the stock will have a number of catalysts to potentially move higher before year-end.

### **Epsilon Energy – Forecast summary**

	Net Acres	Value (\$/acre)	Total Value	\$/Share (f.d.d)
Marcellus, PA	5,750	US\$12,565	US\$72,248,750	US\$1.36
Marcellus, NY	16,000	US\$6,283	US\$100,520,000	US\$1.89
Saskatchewan	16,690	US\$300	US\$5,006,901	US\$0.09
Quebec Utica Shale	n/a	n/a	n/a	-
Ethiopia	n/a	n/a	n/a	-
Option Proceeds			US\$9,750,000	US\$0.18
Cash			US\$20,000,000	US\$0.38
<b>Total US Dollar Value</b>			<b>US\$205,525,651</b>	<b>US\$3.89</b>
<b>Canadian Dollar Value</b>				<b>\$4.10</b>

*Source: Company reports, GMP estimates*

The risked land value we used for the Pennsylvania Marcellus implies US\$8.0 million of value per section which we feel is conservative given multiple factors. Firstly, each section represents 8 potential horizontal locations and in our analysis each well represents an estimated PV of \$4.3 million per well (under a US\$5.50/mmbtu pricing environment) for a total potential PV per section of over \$34 million. Secondly, our estimated PV per well and Chesapeake’s estimated value per acre factor the upfront well



costs into the equation; whereas, through the farm-out agreement, Epsilon is not responsible for most of the capital requirements in a full development program on its Pennsylvania acreage. This has a dramatic impact and would add another \$3.5 million of PV to a typical horizontal well.

## RECOMMENDATION

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We believe Epsilon is a unique story as they have significant upside exposure to one of the lowest cost gas plays in North America. The fact that Chesapeake Energy, with access to over 1.5 million acres on the Marcellus trend farmed in on EPS speaks volumes to the quality of their acreage position in Susquehanna County in north east Pennsylvania. We also see upside potential in its Bakken oil position in S.E. Saskatchewan which could provide a light oil resource dynamic to the story. While we have not assigned any immediate value to its exposure to the Utica shale play in Quebec and its Ethiopia assets due to the exploratory nature of the plays, we do see significant option value in these two plays and if either (or both) work out we expect the stock to react positively. While not in our valuation, we see value of US\$115 million from the company's current cash position plus its net drilling capital from the Chesapeake JV. Therefore, with a current market cap of only \$134 million and what we believe to be a high quality asset base, with good exposure to some of the hottest North American shale plays, investors appear to be getting a free ride on the upside potential from future drilling activity. **We are therefore initiating coverage with a BUY recommendation and \$4.00 per share target price, which indicates potential upside of 50% from current levels.**



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**BUY.** These stocks will have 15% or greater (small cap) or 10% or greater (large cap) total return potential.

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