



May 12, 2010

# Ember Resources Inc. (EBR-T)

**HOLD**

Last: \$0.69

Target: \$0.80↓

## WHAT'S CHANGED

	NEW	OLD
Rating	HOLD	BUY
Target	\$0.80	\$0.85
Production 2010E (boe/d) 6:1	4,083	4,500
Production 2011E (boe/d) 6:1	4,350	5,050
CFPS 2010E (f.d.d.)	\$0.21	\$0.25
CFPS 2011E (f.d.d.)	\$0.41	\$0.46

## SHARE DATA

Shares o/s (mm, basic/f.d.)	74.9/80.2
52-week high/low	\$1.25/\$0.55
Market capitalization (mm)	\$52
Enterprise value (mm)	\$139
Net debt (mm) – Q1/10	\$87
Dividend yield	-
Projected return	16%

## FINANCIAL DATA

	2009A	2010E	2011E
Oil & NGLs (mb/d)	0.0	0.0	0.0
Natural Gas (mmcf/d)	25.3	24.5	26.1
Total (mboe/d) 6:1	4.2	4.1	4.4
Equivalent growth	72%	(3%)	7%
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.)	(\$0.35)	(\$0.16)	(\$0.07)
CFPS (f.d.d.)	\$0.22	\$0.21	\$0.41
Net Debt (mm)	\$81.8	\$85.2	\$85.1
Debt/CF	6.0x	5.1x	2.6x
P/CF		3.3x	1.7x
P/CF (d'adj'd)		6.7x	3.9x

Fiscal year ending December 31

## Q1/10 results below expectations, lowering target and recommendation

### Q1/10 results below expectations

EBR delivered Q1/10 results below our expectations. All in cash costs (op + transp + royalties + G&A + interest) were \$2.83/mcf which is solid but still highlights a tight profit margin against current gas pricing.

### Reduced outlook on low natural gas prices

With its high debt levels, EBR's investment is limited to the cash flow it earns and thus operations are essentially at the mercy of natural gas prices. With the current low pricing environment EBR is reducing its 2010 budget to \$20 million from \$30 million and is reducing its average production guidance to 24 – 25 mmcf/d from 26 – 27 mmcf/d. EBR added 4.8 mmcf/d of new production over the last two quarters over a program covering 38.5 net wells with a total cost of \$15.3 million. This implies an average IP of 125 mcf/d, an average cost of \$0.40 mm per well, and a production addition cost of \$19,125 per barrel.

### Changes to our estimates

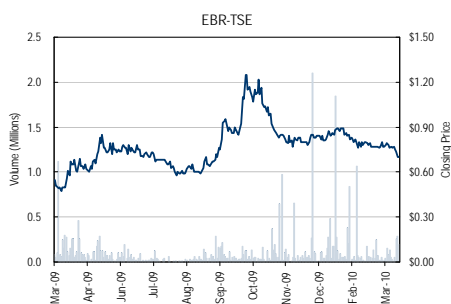
We have adjusted our estimates for the Q1/10 results and the new guidance.

### Valuation

EBR has essentially become a call option on natural gas price as it is a 100% dry gas producer with little operational risk. The company's NAV15 at \$6/mcf flat is \$1.58/mcf but at \$5/mcf flat it is only \$0.76/mcf so its value is highly contingent on natural gas prices. Again there is little risk in the actual drilling and development of the asset.

### Recommendation

The reduced guidance exemplifies how EBR is at the mercy of natural gas prices and we believe the value of the company is just as sensitive to pricing. As such, this becomes more of a call on natural gas. In the current uncertain gas price environment we are hesitant to recommend EBR as a BUY, it is trading close to its NAV15 at \$5/mcf flat and current AECO prices are below \$3.70/mcf. However, a rally in natural gas prices could make EBR an easy double and so we will monitor that outlook. At this time we are lowering our recommendation to HOLD from BUY and lowering our target price to \$0.80 from \$0.85.





## Q/10 RESULTS BELOW EXPECTATIONS

### *Q1/10 results below expectations, conference call held*

EBR released its Q1/10 results this morning, before market open and held a conference call to go over the results. The Q1/10 results were below our expectations and we provide highlights below:

- Average production of 4,003 boe/d came in below our 4,167 boe/d estimate but did represent the first quarter of sequential growth since the Cordero acquisition in 2008.
- CFPS of \$0.07 basic was slightly below our estimate of \$0.08 due to higher than expected operating and interest costs. EBR's combined first quarter cash cost (royalties + operating + transportation + G&A + interest) was \$2.83/mcf which is solid and should allow the company to remain competitive in a low gas price environment. However, it does also highlight a tight profit margin against current pricing. Another way to look at this is management estimates its total cash costs at \$3.20/mcf, including \$1.87/mcf for operating, transportation and G&A expenses with another \$1.33/mcf to convert PUD's into PDP reserves over the winter drilling season.
- Net debt of \$86.9 million remains a concern but is manageable relative to the \$92 million bank line. However, if natural gas prices remain distressed we could see a reduction in the credit facility so it is likely that EBR will be prudent in its spending moving forward.

### **Q1/10 results versus GMP estimates**

	Q1/10	GMP Q1/10 Estimates	% Variance
<b>Production</b>			
Oil & NGLs (b/d)	0	0	nm
Gas (mmcf/d)	24.0	25.0	(3.9%)
Total (boe/d)	4,003	4,167	(3.9%)
<b>Cash Flow (\$mm)</b>			
Cash Flow (\$mm)	\$5.0	\$5.8	(14.3%)
CFPS (basic)	\$0.07	\$0.08	(14.3%)

*Source: Company reports, McDaniel*

## REDUCED OUTLOOK ON LOW NATURAL GAS PRICES

### *Lowering outlook on natural gas prices*

With its high debt levels, EBR's investment is limited to the cash flow it earns and thus operations are essentially at the mercy of natural gas prices. With the current low pricing environment EBR is reducing its 2010 budget to \$20 million from \$30 million and is reducing its average production guidance to 24 – 25 mmcf/d from 26 – 27 mmcf/d.

### *Good results from an aggressive drilling program over the last two quarters*

EBR added 4.8 mmcf/d of new production over the last two quarters over a program covering 38.5 net wells with a total cost of \$15.3 million. This implies an average IP of 125 mcf/d, an average cost of \$0.40 mm per well, and a production addition cost of \$19,125 per barrel. While \$15.3 million for 4.8



mmcf/d may seem expensive relative to tight gas resource plays, the HSC CBM has much flatter decline that would result in a comparable F&D cost at the end of the day.

## CHANGES TO OUR ESTIMATES

### *No changes to core 2010 and 2011 estimates*

We have adjusted our estimates for the Q1/10 results and the new guidance. A summary of our changes is below:

#### Changes to our estimates

	2010E			2011E		
	Old	New	% Change	Old	New	% Change
<b>Production</b>						
Oil & NGLs (b/d)	0	0	nm	0	0	nm
Natural Gas (mmcf/d)	27.0	24.5	(9.3%)	30.3	26.1	(13.9%)
Total	4,500	4,083	(9.3%)	5,050	4,350	(13.9%)
<b>Financial</b>						
Net Income	(\$13.2)	(\$12.2)	nm	(\$6.9)	(\$5.3)	nm
EPS (b)	(\$0.18)	(\$0.16)	nm	(\$0.09)	(\$0.07)	nm
EPS (fd)	(\$0.18)	(\$0.16)	nm	(\$0.09)	(\$0.07)	nm
Cash Flow	\$20.3	\$16.9	(17.0%)	\$35.9	\$32.1	(10.4%)
CFPS (b)	\$0.27	\$0.22	(17.0%)	\$0.48	\$0.43	(10.4%)
CFPS (fdd)	\$0.25	\$0.21	(18.0%)	\$0.46	\$0.41	(10.9%)
CapEx (\$mm)	\$30.0	\$20.0	(33.3%)	\$35.0	\$32.0	(8.6%)
Net Debt (\$mm)	\$91.4	\$85.2	(6.8%)	\$90.6	\$85.1	(6.1%)
Debt/CF	4.5x	5.1x	12.3%	2.5x	2.6x	4.8%

Source: GMP

## VALUATION

### *Essentially a call option on natural gas prices*

EBR has essentially become a call option on natural gas price as it is a 100% dry gas producer with little operational risk. The company's NAV15 at \$6/mcf flat is \$1.58/mcf but at \$5/mcf flat it is only \$0.76/mcf so its value is highly contingent on natural gas prices. Again there is little risk in the actual drilling and development of the asset. In the current uncertain gas price environment we are hesitant to recommend EBR as a BUY, it is trading close to its NAV15 at \$5/mcf flat and current AECO prices are below \$3.70/mcf. However, a rally in natural gas prices could make EBR an easy double and so it is worth holding and monitoring. We are lowering our target price to \$0.80 from \$0.85 which is based on a debt adjusted target multiple of 4.1x to our new 2011 cash flow estimate (was 3.9x)

## RECOMMENDATION

The reduced guidance exemplifies how EBR is at the mercy of natural gas prices and we believe the value of the company is just as sensitive to pricing. As such, this becomes more of a call on natural gas. In the current uncertain gas price environment we are hesitant to recommend EBR as a BUY, it is trading close to its NAV15 at \$5/mcf flat and current AECO prices are below \$3.70/mcf. However, we



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believe a rally in natural gas prices could make EBR an easy double and so we will monitor that outlook. At this time **we are lowering our recommendation to HOLD from BUY and lowering our target price to \$0.80 from \$0.85, attainment of which represents 16% upside from last night's close.**



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**FOCUS BUY.** Small cap stocks (defined as stocks with less than \$500 million market capitalization) in this category have a total return potential (including dividends payable) of greater than 25% and large cap stocks a greater than 20% total return potential, as well as superior qualitative and timing characteristics.

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

**SPECULATIVE BUY.** These stocks will have a 30% or greater total potential return and they will have a speculative component which could be material to the return expectations.

**HOLD.** Small cap stocks ranked Hold will have a total return potential of 0% to 15%; large cap stocks ranked Hold will have a total return potential of 0% to 10%; and stocks that have a speculative component which could be material to the return expectations ranked HOLD will have a total return potential of 0% to 30%.

**REDUCE.** Companies ranked Reduce have a negative potential total return.

**FOCUS REDUCE.** Companies ranked Focus Reduce have a significant negative potential total return and materially compromised qualitative and timing characteristics.

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