

## Special Report July 2011



### **Red Emperor Resources: Consilio et Animis - by Wisdom and Courage!**

In the 5<sup>th</sup> Century BC the Ancient Greek historian [Thucydides](#) claimed in his wisdom that “*the bravest are surely those who have the clearest vision of what is before them, glory and danger alike, and yet notwithstanding, go out to meet it.*”

Such is the theme we will be following here as we consider a rather high-octane Oil & Gas opportunity and the value proposition it offers investors!

There have been some significant technological advancements in the field of exploration which are already transforming the discovery process from what many investors once viewed as little more than a “hit and hope” exercise, into something more demonstrably methodical and predictable. And those with the *wisdom* to embrace these new methodologies will also be looking to employ the latest technology to maximise project economics by enhancing production levels and recovery rates.

The relentless global expansion of recent decades has also taken its toll on the world’s resources, which means that those on the trail of major new discoveries now need to work that much harder and search more innovatively than ever before. It also takes a fair degree of *courage* to be willing to venture into ever more challenging operational environments.

This applies most critically to the search for new oil and gas resources, where higher oil prices are now supporting the investment case for quality prospective exploration projects. But to rise to such a challenge and win investor support, a very special combination of qualities and skills will be required.

And this brings us nicely back to our *Wisdom and Courage* theme with [Red Emperor Resources](#) (AIM:RMP, ASX:RMP), now an oil and gas exploration company. We say ‘now’ because previously Red Emperor were a precious metals exploration business and, in fact, still hold a free carried interest in one gold project, [Jillewarra, in Western Australia](#). But don’t be confused, this company is oil and gas focused, and that is exactly where we are focusing here.

Red Emperor is also a bit of a hybrid. Headed up by Executive Director [Greg Bandy](#), the management team comes from an investment background. Very much the deal-makers and financiers, who, having pulled together and financed much of operational partner [Range Resources](#) earlier funding requirements are now strategically positioned in the sector with their own investment vehicle.

The two companies are closely aligned and it was through this relationship with Range Resources that the opportunity arose for Red Emperor to gain a significant level of participation in two highly prospective projects: Namely Georgia and Puntland.

Back in June 2010, Red Emperor announced the acquisition of a 10% interest in [Puntland Oil and Gas licences](#). This included an option to further increase the interest to 20% which was exercised by the company. Then, in January 2011 the company announced the acquisition of a 20% interest in [Georgian Oil and Gas licences](#). And with both these acquisitions the future of the company changed dramatically and presented investors with the opportunity to participate in what we believe to be two of the most exciting, and painstakingly constructed, oil and gas exploration programmes in the market today.

To achieve this, Red Emperor, a small company with limited funds, had to raise significant monies. A\$2.8 million was raised successfully in mid 2010 and a further A\$12million in early 2011. In addition, reflecting on the appetite for oil and gas exploration in the UK, in March 2011 Red Emperor announced their intention to [dual list on the London Alternative Investment Market](#) and completed the process when they joined AIM in June 2011.

As a result, UK investors now have direct access to Red Emperor shares and thanks to their dual listed status, the shares will also qualify for inclusion in your ISA, thus avoiding any potential capital gains tax liability.

So, where to now and what is the Value Proposition here?

Well let's look at the licences, starting first with Georgia because there the drill is already turning.

### **Georgian Licences:**

Red Emperor has a 20% interest in Georgia as outlined in [the news from January 2011](#), taking 10% from Range Resources and 10% from Strait Oil and Gas, joint venture partners on the project. The two licences cover a total 7,000 square kilometres and were previously subject to extensive exploration during the Soviet era. There are images from Georgia showing residual gas bubbling through at surface and although anecdotal evidence such as this certainly buoys the spirit, hard exploration evidence is much more critical.

So 410km of 2D seismic was completed in March 2010 leading to the identification in the RPS Group report of 68 individual drillable multi-stacked structures. Quite an exploration target portfolio, particularly when one considers the independent, best estimate of gross, unrisksed oil-in-place amounts to 2.05 billion barrels.

From this gigantic overall target, six drill targets were identified with gross unrisksed oil-in-place of some 728million barrels, still a huge target by anyone's estimations. But to maximise their chances of success, Range Resources and Strait Oil & Gas commissioned a helium survey, covering the key areas within the licences, to provide independent evidence of the viability of the drill locations selected through the seismic work.

This survey, conducted by [Actual Geology](#) measured the helium concentrations in the earth's surface acting as pathfinders to identify the very best drill locations. (you see what we mean by innovative techniques!) The results were [published in February 2011 by Range Resources](#) and indicate active oil and gas presence in the first two drill targets, as previously identified, following the RPS seismic report, within the Mukhiani and Kursebi areas.

Now the importance of the Helium Survey should not go without comment. Helium surveys have been used previously to complement seismic surveys particularly in Russian exploration and there is sufficient evidence to suggest that together, seismic and helium surveys increase the chance of success on drilling and are a particularly successful way to find oil in the ground.

After the Helium survey the drill partners moved to commence the drilling operations leading to the [announcement on 14<sup>th</sup> July 2011](#) confirming that the first Georgian drill had spudded with 55 days to target depth. This drill is targeting 115million barrels of oil, which amounts to a net 23million barrels in respect of Red Emperors 20% interest. In exchange for its 20% interest, Red Emperor is covering 40% of the drill costs which on face value may sound a little unfair, but is actually something of a deal because the extra contributory percentage is effectively in lieu of all the preparatory work that was undertaken by the original joint venture partners Range Resources and Strait Oil and Gas. This

work was extensive and incurred material time and financial costs. In effect Red Emperor walked into a project at a much more advanced stage, on the cusp of drilling, (drilling that is now underway).

So, the important question is – will they find oil and how should you value the company based on the oil it could, or does, find?

To do this we would like to reference the recent [Edison Investment Research Report](#) on Range Resources. This report suggested an EMV of \$344million for Range's 40% interest assuming a 20% chance of success attaching to the Georgian operations. That translates into a \$172million EMV for Red Emperor's 20% stake, which amounts to \$1.13 or 70p per share. Not bad when you consider the current share price is around 30p.

But then, remember this is the current valuation. One could argue that with the combined seismic and helium surveys, the chance of success may be materially higher. If so, and for indicative purposes only; at 40% chance of success the value leaps to £1.40 per share; at 60% £2.10; 80% £2.80 and if successful as estimated (ie 100% COS) then £3.50 per share.....

The value on offer can certainly leap and, on top of all, there is also the prospect of the remaining 66 individual drillable multi-stacked structures, starting with the four remaining key targets, as already identified. In fact with over two billion barrels of gross unrisks oil-in-place the value of the Georgian prospects could potentially dwarf the company's current market capitalisation of around £46 million.

So that's the potential for Georgia, but we haven't even got to the real blue sky element, which of course is Puntland!!

#### **Puntland Licences:**

Puntland is a semi-autonomous region situated in Northern Somalia. Red Emperor has a 20% interest in two licences in the Nugaal and Dharoor blocks as outlined in the [news announcement from June 2010](#). In exchange for a 20% interest Red Emperor is committed to funding 30% of the cost of the first well drilled.

The operator for Puntland is [Africa Oil Corp](#) (TSX.V:AOI) and the latest Production Sharing Agreement (PSA) requires a well to be "spudded" this summer. Technically this deadline extends until 27th July 2011 and in reality it is unlikely that this deadline will be met. However the strong relationship between the drill consortium and the Puntland government suggests that there will not be problems if a reasonable delay occurs.

Finding an appropriate drilling contractor has not been easy, reflecting the location and particularly the security risks attached to operating in this area. That said, it was positive progress to see an announcement confirming a letter of intent had been signed with a [proposed contractor in May 2011](#).

Followers of the Puntland story will no doubt be aware of the level of excitement surrounding the planned first drill for oil in Puntland in over 20 years. But why? - is the question.

Well in simple terms it's because the licence areas cover some 40,000 square kilometres. This ground has been independently assessed to contain the prospective oil in place of a combined 19 billion barrels with 4.5billion barrels recoverable. With a 20% interest, that amounts to potential recoverable oil of 910million barrels to Red Emperor. At \$100 oil it's worth noting that 910million barrels would present gross oil revenue of some \$90billion. Ok this may be pie in the sky pre-drilling, but as investors, we will always be looking to size of the prize, and it also helps provide some measure of understanding as to why Puntland offers so much potential.

And it can't be forgotten that this is drilling in the most challenging of territories and if oil is found, the scale of operations required to bring Puntland into production, will be immense. So immense that it would likely require the resources of a serious major operator to develop its potential.

But such is the scale that should oil be encountered, the event in itself would undoubtedly flag the attention of the major players from the get-go. The resulting financial benefits of an acquisitive interest to Red Emperor and/or any form of diluted interest howsoever forged, would be extremely compelling – to say the least!

Again, turning to the [Edison Investment Research](#) Report for help with valuations, which concludes that assuming a 7% chance of success the EMV to Range Resources of the 20% stake in Puntland is worth \$318million. As Red Emperor holds an equivalent 20% stake this amounts to \$318million also, or \$2.09/£1.29 per share.

Once again, this is a current calculation and should the chance of success improve, for whatever reason, the value increments will be substantial. In fact, if successful, the value to Red Emperor would amount to something like £18.47 per share.

Now perhaps we should be backtracking a little here to reflect on exactly why Puntland is so prospective. Puntland is located on the Horn of Africa with licences located in the Dharoor and Nugaal Cretaceous and Jurassic age sedimentary basins of the East African rift system. These basins are considered to be extensions of the Marib Shawba and Sayun Masila basins across the Gulf of Aden in Yemen. The latter basins have been the source of substantial petroleum production. As to the prospective resource, [Gaffney & Cline Associates](#) (now part of Baker Hughes) estimated unrisksed oil in place of 12.5billion barrels in Nugaal block and 5.8billion barrels in the Dharoor block.

Make no mistake as to the potential magnitude of the prospective resource here and the impact this would have to the inherent value of Red Emperor should the drilling planned for 2011 achieve a successful outcome.

#### **Overall Value Proposition:**

Red Emperor have achieved something quite unique in the last 12 months; changing the focus of the company entirely and positioning themselves within two hugely exciting exploration campaigns. They have also raised significant financial resources and had approximately A\$14million cash at bank at the point of drilling in Georgia.

The first Georgian drill is now turning and we can expect regular drill updates and, hopefully, the achievement of target depth in just under two months. The second Georgian well will commence immediately thereafter so investors have two shots at drill success in 2011.

In Puntland, it seems more likely than ever that mobilisation will be commenced shortly. The Puntland programme has been deferred and delayed for quite some time so one has to be cautious predicting spud dates. It does however seem to be tantalisingly close.

So investors interested in the company's activities have a choice:

- Wait and monitor progress and accept that drill success is likely to be accompanied by a substantial re-rating of the shares to reflect the value generated;
- Consider securing a position now, in the hope that fortune smiles on the drill bit and discovers oil.

As Investors ourselves we believe this is very much a personal decision and, as always, would not advise an approach. It is however interesting that, as it stands, the markets have been pretty miserable recently and the share price of Red Emperor has not galvanised as much as we expected and has certainly not reflected the positive news that spudding has occurred in Georgia. Sometimes the market throws opportunities the way of the investor – could this perhaps be one of those occasions?

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There is no doubt that the resource sector is where the action is right now, though much of the coverage out there can be too technical for the average person to understand. Our objective is to empower the private investor and encourage more people to take an interest in the sector, so we will ensure that our content is straight talking, accessible to all and as jargon free as possible.

We are building a network of investors who are, like us, on the lookout for value propositions and prefer a no nonsense approach to investing in the natural resource sector.

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