

31<sup>st</sup> March 2011

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## Sefton Resources\* - Californian Oil Producer with CBM and Pipeline Assets. Speculative Buy with 5p Target.

Small in size but big on promise, Sefton Resources owns outright oil production assets in California which have proven reserves with a Present Value of £50 million, as well as gas and infrastructure assets in Kansas. The company has been listed on AIM for more than a decade and now is not only cash generative but profitable and looking to increase its profile. This year the board have three key objectives: to increase oil production in California, activate the Kansas gas assets and increase reserves. All these moves will allow further value to be added.

Production is set to increase from Sefton's primary producing asset in California at Tapia Canyon which currently produces 140 barrels of oil per day (bopd) thanks to the implementation of a cyclic steam pilot implemented in 2009 as an enhanced recovery technology. The company has now transitioned to the next phase of testing a continuous steam flood pilot, as a way of further increasing recoveries and production. This pilot project currently running at Tapia is providing vital data for the study by consultant Dr Farouq Ali and implementing these findings is expected to lead to increased production.

The Kansas gas assets are planned to be activated this year. These represent Sefton's more recent acquisitions where conventional gas, Coal Bed Methane (CBM) and gas infrastructure assets have been aggregated as a contrarian play in a low price natural gas environment. In acquiring such assets Sefton has gained a strangle hold over a substantial area in NE Kansas as these pipelines provide the root to market for gas reserve and wells that are currently shut in. Sefton plan to unite the LAGGS and Vanguard pipelines eventually to serve both its own production and that of others.

Key Data	
EPIC	SER
Share Price	1.625p
Spread	1.5p - 1.75p
Total no of Shares	280,031,959
Market Cap	£4.6 million
12 Month Range	0.5p - 2.375p
Net Debt	\$6.7 million (estimated)
Market	AIM
Website	<a href="http://www.seftonresources.com">www.seftonresources.com</a>
Sector	Oil & Gas
Contact	Jim Ellerton, Acting Chairman and CEO Tel: +1 (303) 759 2700

Reserves are expected to rise in 2011. At Tapia Canyon, this should be achieved through Dr Farouq Ali's study and the continuous steam pilot which are expected to demonstrate that oil recovery can be improved by heating the oilfield with steam. With a higher recovery, proven reserves will increase. Also activating the Kansas pipeline should allow some of the reserves in the possible and probable categories to become proven reserves.

At the year-end, the Present Value (PV10) of Sefton's proved oil reserves at the year-end was \$80.6 million (£50 million). In February 2011, the board announced this PV10 along with the updated reserves estimate for Tapia and Eureka oil fields which revealed, total proven reserves at year-end 2010 stood at 3.8 mmbbl, comprised of 1.6 mmbbl proven developed reserves and 2.2 mmbbl proven undeveloped reserves. Whereas in Kansas estimated possible gas reserves stood at 2.3 Bcf (billion cubic feet of gas).

Sefton recognises the need to improve its profile and has thus embarked on an aggressive broker and Investor Relations programme since the beginning of the year. These initiatives are being undertaken in the belief that Sefton's assets are materially undervalued and that operational progress together with investor education will drive the share price to more appropriate levels. Recent placings have ensured that the company has the finance in place to fund its Tapia and Kansas activities through to the next stage of development.

Based on the company's California assets alone, GEGR initiates coverage of Sefton Resources with a 5p target price and **speculative buy** recommendation.

#### Forecast Table:

Year to 31 <sup>st</sup> Dec	Turnover (US\$ Million)	Pre-tax Profit (US\$ Million)	Earnings Per Share (cents)	Price Earnings Ratio	Dividends Per Share (cents)	Dividend Yield (%)
2008A	4.69	0.33	0.29	9.0	0	0.0
2009A	2.74	(0.29)	(0.25)	NA	0	0.0
2010E	4.1	0.5	0.2	13.0	0	0.0
2011E	5.2	1.2	0.47	5.5	0	0.0

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## Background

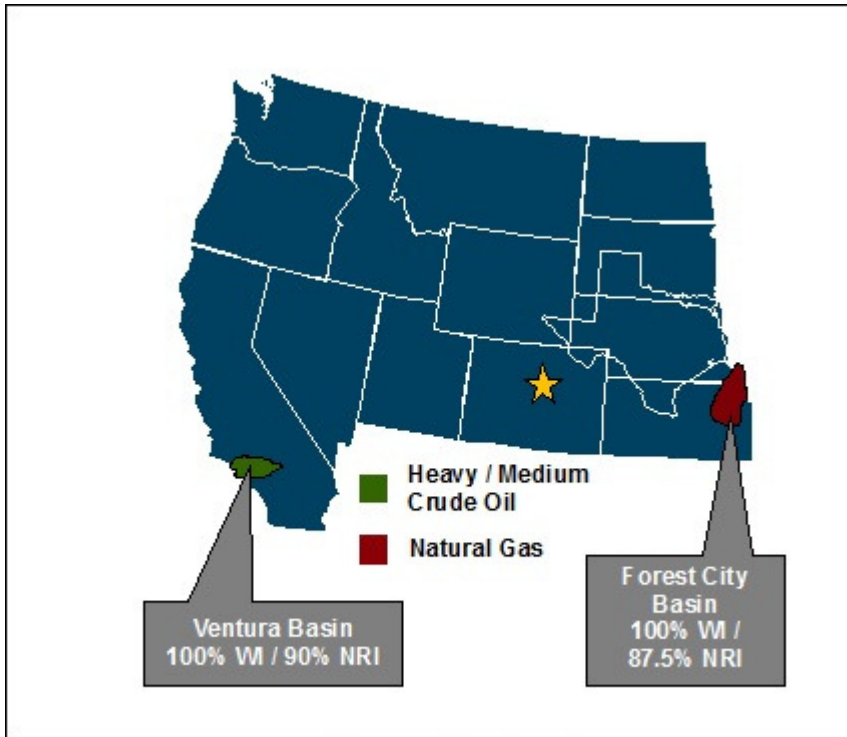
Sefton Resources is a British Virgin Island's holding company with two wholly owned operating subsidiaries - TEG Oil & Gas USA Inc and TEG MidContinent Inc. Headquartered in Denver Colorado, Sefton was founded by Jim Ellerton, Robert Mendes and Dennis Haugh in 1994, before listing on AIM in December 2000.

The company currently operates in the American States of California and Kansas, with oil production (Tapia and Eureka) in the former and Coal Bed Methane (CBM), conventional gas and infrastructure prospects (Anderson/Franklin and Leavenworth) in the latter.

The Tapia Canyon prospect was first discovered in 1957 when Texaco found oil and commenced production at the site. Subsequent owner Tenneco studied the possibility of using steam injection at Tapia in 1986, but was thwarted by falling oil prices and consequently divested of the field. Intervening owners have only used natural depletion and conventional pumping to generate recovery levels of 14%. Sefton acquired the Tapia licence in 1994 and has since implemented cyclical steaming to more than double these historical recovery rates.

Eureka Canyon was discovered in 1893 and has been more or less in continuous production ever since. Cumulative production to 2002 is estimated to have been 1.125 mmbbl (million barrels of oil), at an average gravity of 26° API. Sefton acquired the Eureka licence in 1996 but unlike Tapia, Eureka's oil does not need cyclical steaming.

Sefton began acquiring Kansas acreage in 2004, initially with the aim of developing conventional and CBM projects to diversify away from its oil position in California. The company has steadily increased its land position to 50,000 acres, and further diversified with the acquisition of infrastructure assets. Seeking to take advantage of prevailing depressed gas prices, and with infrastructure seen as a more cost effective way of capitalising on the expected recovery in gas prices, the Waverley project (gas processing facility in Anderson/Franklin Counties) was acquired in February 2009, the Vanguard pipeline (Leavenworth County) was acquired in August 2009 and the LAGGS pipeline (Leavenworth County) was acquired in March 2010.



Location of operations

## Operations

Despite its small size, Sefton has a reasonably diversified portfolio of production / exploration, upstream / midstream and oil / conventional gas / CBM assets. The company issued an updated reserves estimate in February 2011 from Reed W Ferrill & Associates detailing its hydrocarbon reserves as at 31st December 2010. In Tapia and Eureka oil fields, total proven reserves at year-end 2010 stood at 3.8 mmbbl, comprised of 1.6 mmbbl proven developed reserves and 2.2 mmbbl proven undeveloped reserves. At the year-end, the company had a Present Value of its proved reserves (PV10) of \$80.6 million (£50 million). In Kansas estimated possible gas reserves stood at 2.3 Bcf (billion cubic feet of gas).

### California – Ventura basin

Sefton's 100% owned subsidiary TEG Oil & Gas USA, Inc (Colorado) is the direct owner of its California assets.

*Tapia Canyon field* – oil assets. Covering 262 acres, Sefton holds a 100% Working Interest (WI) and 90% Net Revenue Interest (NRI) in the field, with the remaining NRI held by the landowner. Tapia is divided into four lease areas; Hartje, Lackie, Snow and Yule, and currently contributes the vast majority of Sefton's revenues through the production of heavy (17-19° API) oil. The implementation of a cyclic steam pilot in 2009 (the regular injection of steam into a heavy oil reservoir to improve its flow properties) has improved production rates across the 24 producing wells.



Oil production at Tapia Canyon, California

However, Sefton is now implementing a continuous steam pilot. Where the cyclical steam pilot has been able to recover up to 50% of the oil in place, continuous steam flooding can recover up to 80%, and thus its potential application not only opens up additional reserves from the existing portfolio, but also enhances the economics of the Tapia field. Sefton announced on the 1st of March that the continuous steam pilot had commenced on the Hartje lease as part of Dr Farouq Ali's ongoing study into its application to Tapia. Hartje #10 is the formerly idle well being used in the study and, surrounded by six producing wells, could offer production benefits beyond that immediate portion of the field.

Being heavy oil, Tapia receives a spot price equivalent to 95% of NYMEX. Operating costs are dependent on production levels and prevailing oil prices, but at a price of \$75 a barrel of oil and 150 bopd output, Tapia's lifting costs are \$11 /bbl (barrel). There is a 10% state revenue royalty and 6% production tax, while trucking costs are \$2.44 per bbl, but offset by a quality adjustment. Thus at an example NYMEX oil price of \$75 /bbl and output level of 150 bopd, general and administrative overheads work out at \$25 /bbl, leaving Sefton in a net position of \$24 /bbl, or \$3,600 per day.

*Eureka Canyon field* – oil assets. Covering 1,510 acres, Sefton holds a 100% Working Interest (WI) and 83.3% Net Revenue Interest (NRI) in the field, with the remaining NRI held by the landowner. Eureka is located 20 miles south west of Tapia and currently has 6 wells in operation. Total production across the field is between 8 and 15 bbl/d of medium (27° API) sweet crude. The oil at Eureka is light enough to flow sufficiently to avoid the need for steam flooding.

Sefton has only performed a limited amount of work on Eureka, but having recently acquired geochemical data, plans are in place for a drill programme once sufficient additional targets have been identified. This process will involve the amalgamation and interpretation of geochemical data with previous surface and sub-surface geological mapping.

### Kansas – Forest City basin

Sefton's 100% owned subsidiary TEG Mid-Continent, Inc (Colorado) is the owner of its Kansas assets.

*Anderson and Franklin Counties* – CBM, oil and processing / pipeline assets. Covering a total of 43,000 acres, Sefton holds a 100% WI and 87.5% NRI in the assets, with the remaining NRI held by the landowner. The company's primary target is conventional gas and CBM, while shallow reservoirs of underlying oil will also be targeted. Sefton has confirmed the presence of gas through the drilling of test wells and will now perform additional geological and engineering studies to properly delineate targets as part of a wider field development programme.

The Waverly facilities in Anderson county include 10 miles of pipeline, 15 well bore holes, 2 salt water disposal wells and a 10 MMcf/d (million cubic feet of gas per day) capacity dehydration facility. There is an inactive tap with interstate pipeline company Post Rock at the dehydration facility, which should be easy to reactivate at an appropriate time. This will provide Sefton with access to a wider market once testing and activation has occurred in late 2011/early 2012.



*Gas assets in Kansas*

*Leavenworth County* – Gas, pipeline and CBM assets. Covering a total of 7,000 acres, Sefton holds a 100% Working Interest and 87.5% Net Revenue Interest in the assets, with the remaining NRI held by the landowner. The company's primary target is conventional gas and midstream infrastructure, while CBM is another option. No preliminary tests have yet been performed to confirm the presence of commercial hydrocarbons however; there is substantial shut-in production in the immediate vicinity. To investors, this could signal the company's preference for infrastructure development.

This infrastructure is currently comprised of the Vanguard and LAGGS pipelines which offer Sefton the opportunity to create a looped pipeline system bounded by Southern Star's interstate pipeline and gas storage facility to the south. Such a loop would theoretically give Sefton more flexibility in allocating gas to the higher priced of two different gas markets.

Vanguard is approximately 26 miles in length and is currently being renovated to bring it up to commercial standard ahead of the anticipated commencement of third party gas transportation later in the year. Sefton is targeting a 1 MMcf/d (million cubic feet of gas per day) capacity floor, and capacity ceiling of up to 10 MMcf/d. Engineering advisor Dr Nafi Onat is currently compiling a report into the economics of Sefton's entire Kansas pipeline holding as well as its CBM opportunities. This report is due for publication in April/May and will answer the key operating and financial questions.

LAGGS is approximately 25 miles in length and Sefton is in the process of testing the line ahead of its activation in the first half of 2011. The company recently acquired approximately 1,200 net leasehold acres and 18 well bores with associated technical data along the LAGGS pipeline, and plans to recomplete the existing wells, in addition to exploring for new opportunities in the area.

## **Strategy**

Cash flow and profit is the driving factor behind Sefton, and to this end the company has achieved a degree of success having booked an operating profit each year since 2007 and positive achieved net cash flows from operations between 2006 and 2008. Results for the 6 months to 30th June 2010 were highly encouraging with an estimated operating profit of \$527,154, net profit of \$334,793 and cash flow from operations of \$599,344.

Sefton holds a \$10 million reserve-based revolving senior debt banking facility which was extended until January 2012 on the 1st of March 2011. The facility allows the company to borrow up to \$10 million at any one time based on its reserve base. The company's current reserve base entitles it to a current limit of \$6.8 million which is being reduced by \$100,000 per month in exchange for a lower service cost. Sefton's debt level is currently approximately \$6.7 million.

Joint venture partners and bolt-on acquisitions are sought at Eureka and in Kansas as the company looks to broaden its earnings base and accelerate development. Additions in Kansas are particularly advantageous as land is largely privately owned and thus typically more easily obtained at a lower cost, without excessive government regulation.

Sefton is hoping to double its output from 150 bopd to 300 bopd through the drilling of a further 6 wells at Tapia and the continued implementation of steam flooding. This work is expected to cost \$3.5 million and will be funded out of operating cash flows, debt and share placings. Dr Farouq Ali's study, due for delivery in April/May, will then play a big part in the next significant production uplift to 1,000 bopd. Such a step up is expected to require significant capital to achieve and thus the involvement of external financing is likely. This program will also have a positive impact on reserve bookings. Investor Relations will play a major role in helping to get the story out to investors.

## **SWOT Analysis**

### Strengths

100% ownership – owning its licences outright gives Sefton ultimate operational flexibility and complete control over their direction. While the company hopes to attract an earn-in partner or partners at Eureka and in Kansas, for now Sefton holds the cards.

Production – in 2010 Sefton posted estimated oil revenues of \$4.13 million, up from \$2.97 million in 2009. There is rarely a bad time to be producing oil, but with unrest in North Africa pushing the oil price higher, even modest production is desirable.

Diversification – owning oil, gas, CBM, pipeline and processing facility assets across two geographic locations significantly reduces the specific asset risk for such a small company. Small companies must be wary to not extend themselves too broadly or in to areas with which they are not familiar, but Sefton appears to be balancing this dichotomy well.

### Weaknesses

Financing capability – the increase in production to 300 bopd appears very achievable, but the next level of 1,000 bbl/d is expected to require significant investment. As a standalone entity, it is unlikely Sefton could raise such funds alone, thus the company will require the assistance of a more financially strong company.

Net debt – relative to its market capitalisation, Sefton's net debt position of approximately \$6.7 million is large, and while manageable with cash flows coming in from oil production, it could be a constraint on growth. Sefton's IR program will continue to address this issue with shareholders and investors.

### Opportunities

Licence development – Eureka has had little work done on it and Sefton is only getting started in Kansas. Tapia is anything but exhausted, so there are plenty of opportunities for extracting much more value from its current, let alone new, licences.

Pipeline income stability – broadening its operations from oil production into gas production and midstream pipeline ownership creates both an additional (diversifying) revenue stream but also a more stable source of income (pipeline), thus reducing the company's exposure to commodity prices. The reserves are also expected to rise as these assets are brought on line.

Steam flooding – the prospect of improving Tapia's recoveries from 40% to in excess of 70% is a valuable incentive, and a much more efficient way of increasing Sefton's oil reserves.

### Threats

Commodity prices – as the price of oil has demonstrated during the past 4 years, underlying fundamentals are becoming less relevant as speculators take over the market. Such volatility is an unwelcome phenomenon to many market participants and makes strategic planning more difficult.

Pipeline redundancy – while gas is becoming an ever more attractive commodity, once a field is depleted, its infrastructure becomes largely redundant. Sefton's risk here is that the upstream market that its pipelines serve ceases their supply. However, conventional and CBM reserves in Sefton's Kansas projects, typically have a 20 plus year life.

Recovery rates – the implementation of cyclical steaming has had a significant effect on existing recovery rates, and the implementation of steam flooding is expected to have a similarly considerable effect. However, each reservoir will react differently and, as the company has already experienced, enhanced recovery techniques may not work as expected and thus a reversion to primary production may be experienced.

## **Management / Directors**

**CEO and Acting Chairman**, Jim Ellerton. Co-founder of Sefton Resources in 1994, Ellerton is a geologist with in excess of 30 years experience in the development and evaluation of oil and gas prospects throughout many of the major basins in North America. A graduate of the University of Toronto with Honours in Science (Geology), his career prior to Sefton involved financing and developing smaller oil and gas companies. Ellerton is also president and founder of the Arctic Cultural Institute of The United States of America, a non-profit organisation that supports the art and culture of the Inuit.

**Non-Executive Director**, Karl Arleth. Current Managing Partner of Denver based exploration and development company Blue River Resources; Arleth is the ex-COO of Sefton after leaving to join Teton Energy Corporation in 2003 as President and CEO. Previous appointments have been as Non-Executive Director of Big Horn Resources and various international managerial positions with Amoco and BP. Having earned a Bachelor of Science degree with honours (Geology) from the University of California and a Master of Science (Geology) degree from San Diego State University, Arleth has also completed the Executive Development Program at the Wharton School of the University of Pennsylvania.

**Non-Executive Director**, Mark Smith. Smith has been involved in the energy industry for in excess of 20 years and currently runs his own law practice in Calgary, Alberta Canada, as well as holding board and sub-committee positions with, among others, Wolf Exploration, Destiny Resources, Welton Energy and Stone Mountain Resources. Earlier appointments include partnerships at Osler, Hoskin & Harcourt LLP and Burnet, Duckworth & Palmer LLP, Managing Director & CEO of Scimitar Hydrocarbons Inc, and co-founder of Infiniti Resources.

**President (TEG, Oil & Gas USA)**, Harry Barnum. Holding a Bachelors and Masters in Geology from the State University of New York at Buffalo, Barnam has in excess of 20 years oil and gas experience including 6 years with Chevron and several independents, the most recent of which was with Windsor Energy Corporation. Alongside his geological work, Barnam has also been involved with economic evaluations, planning, budgets and projections, and evaluating, hiring and negotiating with service contractors.

**President (TEG, Mid-Continent)**, Rick Wightman. With in excess of 32 years of oil industry experience, Wightman is a seasoned professional. During this time, Wightman has gained extensive experience in many facets of the industry including exploration, production operations, pipeline design and construction, pipeline operations, gas processing plant construction and operations and equipment procurement throughout the Eastern, Mid-Continent and Rocky Mountain Regions of the United States.

## Shareholders

Those shareholders with a significant interest in Sefton Resources' issued shares of 280,031,959 are as follows.

Name	Shares	Percentage (%)
JJ Ellerton	26,710,552	9.54%
Jewel Sires	9,162,720	3.27%
Karl Arleth	6,153,519	2.20%

## Valuation

GE&CR has used a discounted cash flow model to derive a valuation of Sefton, with Tapia and Eureka the contributors. A valuation of the company's assets in Kansas has been omitted due to the lack of guidance with regards to the economics of their operation. This will hopefully be rectified to some degree through the publication of Dr Nafi Onat's report due in April/May, but for now we limit our analysis to California.

Beginning with Tapia, we have conservatively estimated production output to average 150 bopd for the next 24 months, before more than doubling to an average of 380 bbl/d 2 years hence. Oil prices have been assumed to average \$90 during the next 12 months, \$80 between 12 and 24 months forward and then \$70 in the long run. Lifting costs have been assumed to remain flat at \$11 per bbl, although we would expect this to fall as production increases. Production tax and royalty are a flat 6% and 10% respectively of revenue, while general and administrative expenses have been estimated at \$1.7 million during the next 12 months, and to increase by 3% annually. Sefton has budgeted \$3.5 million for the drilling of 6 wells and implementing steam flooding, and we have also assumed \$500,000 in annual ongoing capital requirements (increasing by 2% each year).

The same parameters have been used for Eureka, but production here is a flat 15 bbl/d for 24 months then 30 bbl/d from 2 years onwards, and the general & administrative and CAPEX expenses are shared with Tapia. The benefits of a BVI incorporation show themselves in the absence of company tax and, using an annual discount rate of 10%, sees our valuation of Sefton (Tapia and Eureka) come out at 5p per share after using a USD/GBP exchange rate of 1.6 and dividing by the 255 million shares in issue.

Upside to our valuation clearly comes from the roll out of steam flooding in California and the monetisation of its assets in Kansas. Sefton has demonstrated an ability to operate both profitably and generate operational cash flows, but the challenge now is consistency and growth. Reports due from Drs Ali and Onat will reveal much about the future path of Sefton's assets in California and Kansas respectively, and provide an obvious rerating event for the company's shares. With existing production and both realistic and speculative operational elements in the pipeline, GEGR initiates coverage of Sefton with a 5p target price and **speculative buy** recommendation.



**Forecast Table:**

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