## Special Report August 2011

SEFTON RESOURCES

## Sefton Resources – Blue-Sky Vision built on a Sound Foundation

In the search for value, some investors are particularly drawn to stocks at the pre-discovery stage of development. And in the lifecycle of these stocks, it is the lead up to discovery which is often accompanied by highest levels of investor enthusiasm - only to tail off once the company has achieved its initial aims and then the more mundane work involved in the commercialisation of the discovery takes over.

Never is this truer than with Oil & Gas plays, where the market is crucially aware of the potential value creation on the discovery of commercial gas or oil.

There's an old market maxim which says "It's better to travel than to arrive", which in itself speaks volumes about certain investors' psychology. For many of us, the thrill is definitely in the chase, so when the market does eventually wake up to the potential we spotted from an early stage, we not only feel vindicated, but also enthused by the capital gains which accrue in the process.

For natural resources those gains can often look disproportionate to the risk averse, but are wholly proportionate to the amount of advance research and the level of risk we undertake.

Now the thrill seeking investor is not the only animal out there. After many early stage investors have achieved their ambitions and moved on, a different species commonly known the "longer term investor" may come along and pick up the reigns. He or she may be more comfortable with a substantially de-risked proposition, and happy with a more steady growth trajectory, and even the promise of a potential dividend.

One thing we have discovered however is that natural resource stocks where there is a balanced mix of thrill seeking investors and longer term holders can be an extremely sensible place to hold one's money (Range Resources is a good example of this).

That's because the company likely still holds the ability to surprise with short term developments and excitement, but has enough demonstrable value to attract those willing to hold for years, rather than weeks or months. So as the developments come you are not seeing a lumpy process of the entire free stock shifting from thrill seekers to more long term hands, but a proportion thereof (something we feel is inherently easier to achieve with continuing share price growth).

Listed natural resource companies combining short term excitement with demonstrable long term potential are few and far between, particularly in the oil and gas sector. But, we have recently started covering one such play which already has revenue generative assets, is profitable to the bottom line and yet still retains that real excitement and blue sky potential we all crave; and in Sefton Resources (LON:SER) we believe we may have uncovered just such an opportunity.

Upon visiting the company's website you are greeted with the message that Sefton's "*near-term tactical objective is to build a strong and stable platform of assets, generating sufficient cash flow to operate and grow the business*". This all sounds very positive, especially when considered against last financial year's operating profit of $691,393. Further investigation though, soon reveals just how meaningful this short-term tactical stability is to the business. For it is upon this foundation that a well-planned strategy has been laid for transforming the company's balance sheet and driving up its stock price.

## Company management and their involvement

Management biographies can be found here. Helpfully, information about the company's advisors is also included.

On 1st August 2011 Sefton announced they were splitting the roles of CEO and Chairman. Karl Arleth has taken over as CEO. He joined the board in August 2010 and also served as the company's Chief Operating Officer between 2001 and 2003. Mr Arleth's experience is consistent with the role he is now undertaking in stewarding Sefton to its next stage of growth.

Jim Ellison, the Chair, is co-founder of the business. He has overseen the implementation of the company's strategy – that of focusing on developing cash-flow first, which in turn has enabled Sefton to acquire undervalued capital assets.

Last year there were some other board changes. One director left to concentrate on other business interests, one retired and one, Harry Barnum, resigned from the board in order to concentrate on the day to day running of the California projects. In their place, Sefton also strengthened its board with another non-executive director, Mark Smith. As with Mr Arleth, Mr Smith brought additional expertise and experience to the company.

Sefton's share register, at the 31st of March, reveals that members and ex-members of the board retain 14.87% of the share capital. Of this group, Mr Ellerton, is the largest shareholder, owning 9.54%.

## Sefton's Core Operations

An integral part of Sefton's strategy has been to search for assets in the USA, looking for opportunities in close proximity to the world's largest market whilst taking advantage of the reliability trading the USA provides.  The core of Sefton's current operations, though not yet that expansive, is extremely strong.

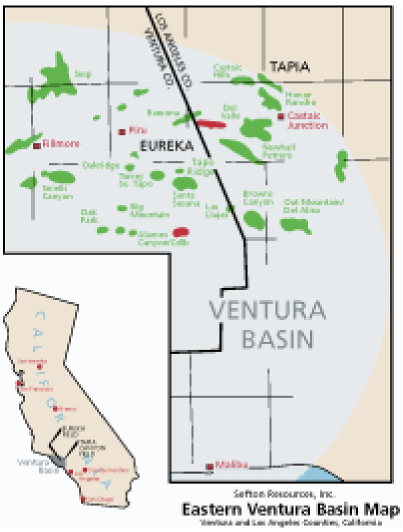
Sefton operates two projects;

1. California – owning a 100% of two oil fields, Tapia Canyon and Eureka Canyon, both of which have projected production lifespans of 20 years;
2. Kansas – owning 43,000 net acres in the Forest City Basin, targeting coal based methane gas ("CBM"), conventional oil and conventional gas deposits. Key assets of this project include the LAGGS and Vanguard pipelines. When operational, these pipelines will transport Sefton's gas as well as aggregating local third party gas supplies. This represents a substantial inter-state sales system.

Note: We have already conducted a detailed Q&A session with Sefton Chair Jim Ellerton as well as a podcast interview in early July.

## California; Tapia Canyon and Eureka Canyon

The Tapia and Eureka fields lie in the East Ventura Basin of Southern California.




Both fields have a long history of oil production; Tapia since 1957 and Eureka since 1893. Tapia contains heavy oil and Eureka contains medium gravity oil. Sefton is currently producing at both sites and this generates the company's current profits.  Sefton's current lifting costs at these sites are about $15 a barrel.

However, in both cases Sefton believes that potential recoverable oil can be significantly increased through the use of Thermal Oil Recovery techniques. Management has engaged Dr Farouq Ali to produce a report using the Continuous Steamflood Simulation method to assess the likely reserves at Tapia Canyon.

In very simple terms continuous steamflooding involves the plugging of an existing oil field and high-pressure steam is then pumped in. This heats the oil in the reservoir, softening it and allowing its easier extraction. Using such techniques has been demonstrated to allow recovery of up to 80% of heavy oil in place at sites such as Tapia.

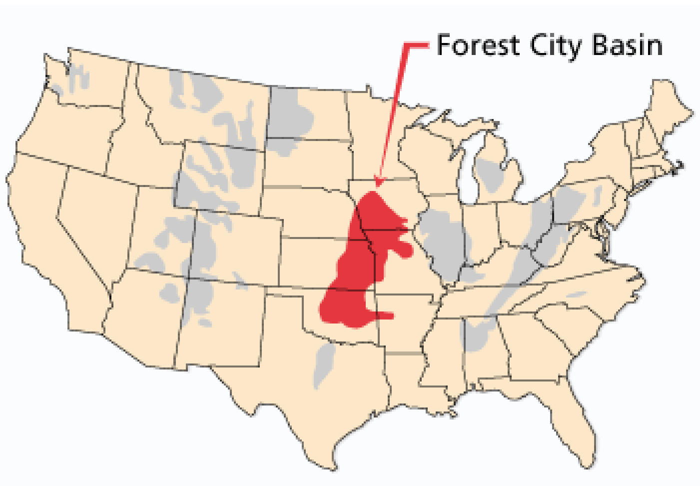
One of the previous owners of Tapia, Tenneco, studied the possibility of steam injection at this field in 1986. They found that the reservoir was suitable and were about to engage in this action. However a subsequent decline in the oil price made the economics of such a move unappealing and Tenneco disposed of Tapia without starting. Today's high oil price environment has transformed Tapia's economics and now provides Sefton with an excellent opportunity.

Pilot steamflood operations started in March this year at Tapia and Dr Ali's highly anticipated report is due out in the coming months. The historical indicator for likely success is favourable. If the assessment concludes that steamflooding is worthwhile, then Sefton's production capacity at Tapia will be dramatically increased.

In addition to this, Sefton also has a plan for geochemical field work at Eureka. Currently Sefton's lease covers 1550 gross acres here. Production is occurring in about 50 acres of this in the western portion. Management believes that there is scope for increasing this, but has so far prioritised developments at Tapia. A geo-survey of Eureka, from 2007, needs to be completed as well as the drilling of more exploratory wells.

## Kansas; the Forest City Basin

The Forest City Basin runs over the heartlands of America.




Sefton's concession covers 43,000 acres of this basin, in eastern Kansas.

Sefton's primary goal in this area is to evaluate the potential of Coal Bed Methane, but there is also the potential for oil in this development.

The background to this project is attention-grabbing and further highlights the skill of Sefton's management team. Management initially decided to engage in a lease acquisition programme for 7600 acres over 12 sections of the basin, based on their initial view that the geology of the area lent itself well to exploration. They formed an opinion that their project, in Anderson and Franklin County, was analogous to the prolific Bush City Field.

Management confirmed the viability of the project, by conducting an in-house geological survey. Once they were satisfied with what they had found they brought in Dr. Nafi Onat, of Sure Engineering LLC, to conduct a Competent Persons Report (CPR). In the meantime they increased the project's buy area to 40,000 acres. They went about this quietly, engaging two brokers to act on their behalf. They also started purchasing pipeline assets in the region, to give them control over their sales channel for any gas extracted.

When the CPR was released on May 12th 2011, this propelled Sefton's stock from 2p to 6p at close of trading.

The subtle manner in which management approached the Kansas venture is characteristic of the way they run the business. By having confidence in their internal ability and capacity to verify their geological assessment, they have been able to acquire significantly undervalued assets. With an eye to the future they crucially secured pipelines to transport the gas they find. Once these assets were secure, they then went about obtaining the CPR, verifying for the market what they already knew. Overall this has been a well planned and well executed campaign.

And listening to the MiningMaven podcast with Mr Ellerton, it sounds very much like the company has high expectations of making additional value generative transactions going forward.

## Company Funding

Sefton has in place project funding for both the near term development of the Tapia Canyon field and for the Kansas pipeline. This leaves financing decisions on the development of Eureka Canyon and the full field development of Tapia still to be made. However before committing to further financing, management has taken the good decision to await the next reports from Dr. Ali and Dr. Onat. If these reports are positive, as expected, then this will likely have a positive impact on Sefton's project funding requirements.

The accounts for the year ending December 31st 2010 reveal that Sefton had cash in the bank of $947,865 as well as trade and other receivables of $703,009. Current liabilities stood at $7.96m, of which $7.1m is the credit facility with Bank of the West. On March 31st Sefton announced that this loan has been reduced to $6.9m and that management has committed to reducing the balance by $100,000 each calendar month.

While we see the principle value in Sefton stemming from it exploration activities, it is worth remembering that Sefton is also a producer. As such, the current liabilities on Sefton's balance sheet are entirely reasonable. Management's healthy intent to reduce these through revenue generated in the manner described strikes us as both prudent and practical.

## Banking relationships

One aspect we noticed about Sefton, during our research, was the seeming strength of their banking relationships. The financial crisis hit the oil exploration industry hard. Companies that survived it did well, but Sefton's case goes one step further.

Sefton banks with Bank of the West who have twice reaffirmed its $10million credit facility. In the current climate, when extending credit, banks will typically impose strict eligibility criteria. That Sefton even has such a facility is a positive indicator, but when we consider Sefton's current market cap is £7.80m (roughly $12.7m) then clearly the bank must have confidence in Sefton's unrecognised value and ability to service their obligations.

## Investor relations

In the recent past, much of the Company's progress has been accomplished somewhat "under the radar". While this has not necessarily been great for the stock price in recent years, it has been excellent for the business. We like the fact that when needs must, management has been prudent enough to focus on the business end of operations and simply gotten on with the job. This reflects good practice and is reinforced by the fact that management themselves retain a notable portion of the stock. In the long run, their interests are nicely aligned with those of shareholders and the progress of the stock price. Importantly, they have taken sensible steps first to improve the likelihood of substantial capital appreciation.

However there was always going to come a point when the stock price would start to matter more. So with the fundamentals now in place, management recognised that the business had reached the stage where, going forward, its performance on AIM was going to be critical to the company's growth.

They resolved to raise the company's profile in the investment community and in February 2011 the Company announced the appointment a swathe of new advisors including, joint Brokers RSCF & Dowgate, Cadogan PR, and dedicated Investor Relations advisor Dr Michael Green. The trend for news flow has certainly improved over 2011, as the company has reappeared in publications and this trend looks set to continue.

Sefton's website also deserves mention. It provides comprehensive information about the Californian and Kansas projects as well as detail about the technology employed to extract oil and gas.

## Current stock price

Recently Sefton's share price has settled at about 2.8p valuing the business at around £7.80m. We believe this represents a substantial discount on the company's stated assets and also makes no allowance for future potential upside. Specifically we believe the market seems to have overlooked:

1. The £60 million plus of potential oil and gas in Kansas;
2. The Kansas gas pipeline;
3. The potential value of resource in California particularly when one considers the steamflood operations.

## Outlook for the rest of the year

So if we are right about the locked-in value in Sefton then the next six months looks to be quite important. Sefton's goals for the rest of the year include

1. Increasing production, improving cash flow
2. Activating the pipeline assets in Kansas, improving cash flow
3. Increasing proven/recognised reserves, growing the company's capital value

The reports from Dr. Ali in Tapia and Dr. Onat in Kansas will be released in the coming months. These both have the potential to give Sefton's stock a real boost. Beyond these there is also the longer-term possibility for positive reports from Eureka Canyon, once work starts there.

## Our final thoughts

We like Sefton and the way they do business. Management has patiently implemented a solid strategy for growth. They've navigated through the worst financial crisis in living memory and developed an asset through to production. They've focussed on what's been important for the business and can now look to build on the stability they've created. But this is not what excites us most. All of this having been achieved, yet the company still has the possibility for considerable capital growth. The changes at board level are not only general good practice, but are also indicative that they are taking their growth and development very seriously.

The leap in Sefton's share price on May 12$^{th}$ is a clear indicator that this stock has the potential for a potent response to progressive, perhaps even transformational news - and Sefton appears to have laid robust foundations for a good news story.

Sefton's management also exude a quiet confidence, drawn no doubt from their considerable experience in the industry and a deeper appreciation of the quality and real worth of the company's assets.

And if the positive developments from California and Kansas transpire as expected, then we would expect the market start the process of recognising that worth.

***Remember to go to the MiningMaven website for free subscription to all our latest updates.***

## About MiningMaven

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. All are welcome - mavens & novices! - be part of the MiningMaven network and watch our numbers grow!!

You can join Mining Maven and subscribe for updates (we never give out your email addresses to third parties) or join us on Twitter and our Facebook group where you can put forward and discuss value proposition of your own.

Please feel free to email us with your comments or suggestions. Likewise we are always keen to hear from companies operating in the resource sector with a value proposition for investors: info@miningmaven.com .