



Valeura Energy Inc.

Valeura Third Quarter 2019 Results Conference Call

TRANSCRIPT

Calgary, November 19, 2019: The following is a transcript of the Valeura Energy Inc. Third Quarter 2019 Results Conference Call, held on November 13, 2019. An audio replay of the meeting webcast is available with the link:

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Corporate Speakers:

Sean Guest, President & Chief Executive Officer
Steve Bjornson, Chief Finance Officer

Operator

Good morning, ladies and gentlemen, and welcome to the Valeura Energy Inc. Third Quarter 2019 Results Conference Call. At this time, all lines are in listen-only mode. Following the presentation, we will conduct a question-and-answer session. If at any time during this call you require immediate assistance, please press star zero for the operator. This call is being recorded on Wednesday, November 13, 2019.

I would like to turn the conference over to Dr. Sean Guest, President and CEO. Please go ahead.

Sean Guest — President & Chief Executive Officer, Valeura Energy Inc.

Thank you, operator. Welcome to Valeura Energy's third quarter results conference call. My name is Sean Guest, Chief Executive Officer, and joining me on the call today are Steve Bjornson, our CFO; Heather Campbell, our Controller; and Robin Martin, our IR Manager.

Before getting started, I'd like to draw your attention to our general disclaimer, which is provided on our corporate website, and the advisories on slide two of our updated corporate presentation, which is also on our website and available by link for those of you joining through the webcast. In particular, please take note of the advisories regarding forward-looking statements and non-GAAP measures used in this discussion.

As of this morning we filed our financial and operating results for Q3 2019. Everything is available on SEDAR, on our website. We've also posted a new corporate presentation to our website and it should be available for download.

I'm going to touch on some of the highlights from our press release and then hand over to Steve, who will take us through a financial review. After Steve, I'll provide a little more detail on operations and we'll then, with the help of the operator, take any questions you might have.

So, turning to the company's highlights from today's press release, first, our main focus as a company continues to be appraising the deep unconventional gas play that we're operating in Turkey. Q3 was very much a step change in our understanding of the play and largely as a result of the extensive stimulation and testing programme we conducted on Inanli-1.

Testing on Inanli was suspended in October and the biggest takeaway that I'd like to highlight is that we were able to successfully flow gas from all the four intervals that we tested. The data that we've gathered from those tests has helped to calibrate our models and define some important trends with regards to how these rocks are behaving at different depths. Counterintuitively, the best gas flows were seen in the deeper tests, and this has demonstrated to us it's not just about the reservoir rocks and their properties, it's important that we also understand the gas and the condensate properties and how these interact with the rock when they're flowing. We've left the well in the suspended state so that we have the ability to go back to it at some point in time for more work.

We've since moved the test equipment to Devepinar-1 well 20 kilometres to the west and have started the stimulation and testing programme there. Operations are progressing very much as planned, but we are not yet in a position to announce results from Devepinar. We expect that later this month.

Second, we continue to generate strong metrics from our conventional shallow gas business. Steve will go through the numbers in more detail, but let me just summarise by saying that we're generating positive cash flow on the back of very strong gas price realisations of nearly \$10. And our netbacks have come in this quarter at above \$33 per BOE.

Third, looking at our financial position, if we look at really the cash flow that we're getting, we're getting that cash flow increase due to the efficiency of our arrangements with Equinor so that we're able to appraise the deep while we're still generating cash flow, so we're in excellent financial position. We're debt free and we've actually seen our working capital increase slightly this quarter. As we move forward, we'll be paying 31.5%, our working interest of Devepinar-1, when we're doing that testing, but we still expect to exit the year with above \$45 million in working capital. This sets us up very well for further appraisal work in 2020.

Fourth, and very importantly, all of our operations have continued to be conducted with no lapses in health, safety, and environment, and while Turkey has been in the news recently given the events on the Syrian border, this is on the opposite end of the country from us, so we see absolutely no impact on our operations. We're in the European part of Turkey. We've been there a long time and we continue to operate without any issues.

So, I'm going to speak more in operations in a moment, but at this point I'll hand the call back to Steve to talk about the financials.

Steve Bjornson — Chief Financial Officer, Valeura Energy Inc.

Thanks, Sean. Hi, everyone.

Financial and operating results for Q3 are summarised in the table on page two of the press release we issued this morning. The headline from a finance standpoint remains the same. We are in excellent shape. We have no debt and working capital is sitting at a healthy \$52.8 million, which is actually a slight increase over last quarter. That's due to our cash position increasing slightly as a result of ongoing production operations, despite volumes being down quarter on quarter as a result of shutdowns by some of our customers during Turkish holidays.

Our activity in Q3 was funded almost entirely by Equinor. The main work programme item was the Inanli-1 stimulation and testing programme, where Equinor paid 100% of the cost as part of their earning obligations under our farm-out agreement with them. At this stage, we're just in the final steps of confirming that they've done everything they're required to before fully earning their 50% interest in the deep gas play.

Our net spending in Q3 was only about \$1.1 million, with over half of that associated with long lead items for the Devepinar-1 testing programme, which we're working on right now, so we expect to show more material spending in Q4. On Devepinar-1, all partners are paying their individual working interest share, meaning we're responsible for 31.5% of the cost. Nevertheless, we still expect to end the year with working capital of over \$45 million, still a very good financial position.

On a per-unit basis, our financial performance was very strong in Q3. Revenue was \$2.9 million, which was down a little in aggregate due to lower production volumes in the quarter, but realised prices were very strong at \$9.64 per Mcf. And today's referenced prices are higher yet at just over \$10 per Mcf based on current exchange rates. Netbacks have increased as well to \$33.04 per BOE. We continue to believe Turkey is an excellent place to have gas production on all fronts. Frankly, these are the sort of metrics our Canadian and US peers dream of.

I also want to touch briefly on exchange rates, as Turkish lira has remained relatively stable over the quarter. So, despite the US threatening to damage the Turkish economy, that idea seems to have been short lived, and with everything going at Turkey's southeast border, we see no adverse impact where we operate on the ground and we continue to turn out strong numbers.

We've announced today that we intend to move to US dollar reporting, so the idea here being that it puts us in line with common practice amongst our international peer group, so we feel it's an appropriate change to make. It also makes life a little easier for the analysts and institutional international investors, who generally run their models in US dollars. We're going to make the change along with our year end 2019 results, meaning the financials that we released today will be the last ones we do in Canadian dollars.

So, with that, I'll hand it back over to Sean.

Sean Guest

Thanks, Steve.

So, look, starting first with our deep unconventional gas play and our appraisal of that. I want to remind everyone that this is appraisal. This isn't in development mode. And even with all of the work that may be going on in the US in analogous and different basins, we are looking at these rocks, and testing these rocks for the first time. We need to understand how these rocks are going to behave at different depths, as well as across the whole area. We have a basin here, it's about half a million acres and we have a

reservoir section that is more than a kilometer thick vertically. We are testing the first three wells in this large area. Our goal of this testing campaign is to find zones in these three wells that can potentially offer further appraisal and finally ultimate development, so it's really demonstrating the commerciality, but this is early phases and we are learning.

When we started this campaign, we also cautioned people that this programme is about a suite of tests we're going to do in several wells. It's not about a single test. There are a number of zones of interest, each that we've seen with its own challenge, and we're talking about the wells that we're testing being more than 20 kilometres apart. So, as evaluation of a new play goes, we're moving as quickly as we can and we are learning and getting information. But it obviously does concern us to see drastic swings in share price on the back of an individual well test. So, where we're at, we're continuing with the testing campaign, we're onto the Devepinar well, and the results of flow from Yamalik and Inanli and Devepinar will then guide the appraisal programme as we go into 2020. And we'll be able to share more results on that in Q1 once we've finished up with this testing programme.

So, to look at a recap on Inanli flow results, we flowed gas at stable rates from every zone that we tested there. In fact, when I look across at the wells we've tested, every zone that we tested has flowed gas. We've learned a lot about some of the depth trends in this play and what we've seen is that the best flow has been occurring at the deepest tests, which, when we're looking at the rock, you know, the porosity and the permeability, this is counterintuitive. And following on from our last press release, we're starting to appreciate the impact of the condensate that comes with the gas on this play. We need to study whether this very high condensate yield that we saw in the shallow intervals are just inhibiting the gas flow or whether this actually presents an opportunity for us.

So, we've stopped work on Inanli in a way that ensures that we can get back to that well at a later date, as we do see potential for more work in that well. There are untested zones deeper in the section below where we actually had very good dry gas production. And further, there are shallower zones where we saw that the gas flow maybe inhibited, but with that very high condensate gas ratio. So, given the focus on the dry gas production, we are excited to move over to Devepinar-1, where we're currently operating. That'll allow us to really look at the correlation between these deep zones and how the rocks are behaving 20 kilometres away, out in the west of the basin. We're progressing on those operations very much as planned and, as I noted, we expect to be in a position to announce the first batch of results later this month.

We have explained to people in the past that we expect the test to take about four weeks. Moving from Inanli to Devepinar took about an additional one to two weeks with work that you have to do to prepare Devepinar, which gives you five to six weeks from our last result on October 20th. We're working towards that plan, but it is extremely important that we understand the flow from these wells before we actually release information to the market. We don't want to be releasing early information or information that could anyway misinform the market.

So, kind of reflecting on the current state of the company, we have over \$50 million in cash, which is effectively all of the money that we raised about 18 months ago. That puts us in a very strong position relative to many of our peers. While preserving that capital, since starting the appraisal of this deep unconventional play, we've gathered approximately \$100 million worth of data on the play. We've operated this programme and our partners picked up most of the cost through the commercial arrangements we've had with them. This is a very good proposition for our shareholders and, as we move forward into a phase where we're paying our own way, we present a very strong value proposition, which includes financial resources to fund an ongoing work programme into 2020, and possibly beyond.

So, we have the cash. We also have positive cash flow that we're getting from our current production, which is helping us out, and in the shallow conventional production we also have reserves that we are currently doing some work to look at whether we can increase the production there even further. So cash position, positive cash flow, reserve potential, and then finally, when we start to look at it, we have this unconventional play with upside that we are still, with our partner, appraising that can yield vast potential to our shareholders.

So with that, I'd like to thank everyone for calling in this morning and now turn the call back over to the operator to help us take any questions.

Operator

Thank you. Ladies and gentlemen, we will now begin the question-and-answer session. Should you have a question, please press the star followed by the one on your touchtone phone. You will hear a three-tone prompt acknowledging your request and your questions will be polled in the order they are received. Should you wish to decline from the polling process, please press the star followed by the two. If you are using a speakerphone, please lift the handset before pressing any keys and ensure your line is note muted. We'll also be accepting questions on Twitter @ValeuraEnergy.

Your first question comes from Colin Smith at Panmure Gordon. Please go ahead.

Colin Smith – Analyst, Panmure Gordon

Thanks. Hi, guys. I'm just wondered if you could talk a little bit about what the actual test programme at Devepinar is going to look like, because you had pre-announced an initial four tests at Inanli and I know there's been a little bit of flexibility around of what these programmes can be. So, if you could just talk a little bit about what the testing outlook for Devepinar is.

Sean Guest

Yes. Thanks, Colin. At Inanli, the tests were very limited. Three of the tests were a single frack in just one zone, except for one of the tests we did two. As we move over to Devepinar, we believe we've increased our understanding of where the dry gas is, where the wet gas is coming in, and we believe we can start to test more intervals together. So, the initial test is planned to be three fracks spread over approximately 100 metres, so opening up more section than we did do in Inanli.

The one thing to note is that we've dropped down right to the bottom of the well in Devepinar, so our first test is taking place at, you know, kind of from, I think, about 4,650 down to 4,750 metres, so significantly deeper than we have ever tested before. Now, we know that Devepinar had better porosities than we saw in Inanli or even in Yamalik but, again, we have moved 500 metres deeper, so we'll be seeing how that rock behaves down at that depth. So, the initial plan, three fracks in one zone down there that we would then test together in one comingled flow.

Colin Smith

Thank you.

Operator

Your next question comes from Charlie Sharp at Canaccord. Please go ahead.

Charlie Sharp – Analyst, Canaccord Genuity

Thanks for taking my question. Could I just ask, Sean, you said that this has been a step change in your understanding through Q3 in terms of how the rocks behave and the dry gas and the liquid contents and how it all works together. Are you in a position at the moment to give some sort of indication of how all that would inform the forward work programme, operational programme in 2020? Or is it still too early to it gives some, a little flesh to that?

Sean Guest

Thanks, Charlie. Maybe I'll comment first, you know, so we obviously acquired a lot of data while drilling these wells. We acquired core data, petrophysical data, over a very long section, and you work that up based on the equations you've got to understand it and then you feel you've got an understanding of the porosity of the rock, an indication of the permeability. And importantly, the gas saturations, what percentage of the pore space is full of gas. And what we've kind of seen is that you do up your numbers on that and then when you go to flow that you're surprised by the results. In other words, we expected down in the deep where the rock is much tighter, and from the resistivity is it looks like the saturations are actually quite low, it actually flowed gas with no water at all.

So, we then expect, as you move up the hole, porosities are better in that, but that's where we then saw the competing effects of more condensate coming out, and likely the combination of the condensate and some water in the pore space inhibiting the gas flow, because the flow that we got, it is counterintuitive to what some of the petrophysics might suggest. So, that's what's really pushed us towards going deep. And that's what we talked about, okay, we've moved over to Devepinar and it is about getting down to the bottom of the well again and seeing how these deep tones perform where we've seen the best performance.

Now, as we look at 2020, the options are, we've always believed that the horizontal well would be the next step, and what is the zone where you put that horizontal? And we still kind of believe that is the case, that you want to look for that zone. However, with some of the results we're seeing, it might be that actually a highly deviated or a vertical well that's then fracked over the whole area where the dry gas is your best solution. So, you can see these are issues that we're trying to address and, as we get the results from Devepinar, that's going to help us understand what are the next steps.

We would like to think what we're doing is a horizontal well into a best zone to get that good flow rate in a horizontal well, which will be much better, but we also see here that we have this whole basin with three wells in it. I find it hard to believe that we've drilled the best or the worst areas. It's about moving around to then try and find where could you be penetrating better sections, taking the learnings we've got in from this drilling campaign. So, we see a couple of wells in 2020 but, again, the exact state of those wells will be determined once we're done the testing.

Charlie Sharp

Okay. And could I just ask one follow-up? I think in a couple of the tests in Inanli you reported that there was a little bit of water production. Can you comment a bit further on that and how much of that might've been frack fluid versus formation water and whether or not it's an issue going forward?

Sean Guest

So, with the numbers we reported at the end of the test, those are just the water that's coming back, which then, as you say, is it formation water or is it still frack fluid? What we can see from getting the lab results back already on the deepest test down there, it's approximately, what was coming back we estimate near the end of the test to be maybe 50% formation water, and that's based on the salinity. So, the numbers that are reported of water flows for those lower zones, likely at most half of that could be attributed to the formations. At which point, as we kind of noted before, it's really, it's uninteresting. It just does not matter, that amount of flow.

When you come up to the shallower zones, we expect we'll see a similar amount there, but still, you know, a lot of that still being frack fluid that's flowing back. But what we believe is happening is a mixture of whether it's the water or the condensate could be inhibiting the gas flow. So, from our point of view, water management is not an issue. Water, if it is an issue, is going to affect your gas flow rate and it's the gas flow rate that becomes a much more important thing to understand. Water itself is just going to be a relative permeability effect on the rock.

Charlie Sharp

That's great. Thank you.

Operator

Ladies and gentlemen, as a reminder, should you have a question, please press the star followed by the one.

Your next question comes from Colin Smith with Panmure Gordon. Please go ahead.

Colin Smith

Hi. I'll have a couple of follow-ups, if I may. First one is just coming onto the flows and the question about the interaction between gas, water, and condensate, is your feeling that that is basically inherent in the nature of the rock or is it something that could be improved with the different fracking programme? In other words, can you get kind of much more commercial-looking flow rates if change the, if you actually change frack programme?

And then my second question is somewhat different, is just whether or not you can comment about how Equinor is potentially looking in terms of taking over operatorship, assuming it has or does complete all of what it needs to do under the Inanli programme to allow to it to exercise that option? Thank you.

Sean Guest

So, the first question was related to the flow and whether that could be improved with fracking. Yes, we definitely believe that we can improve the flow rates with improved fracking techniques. And, again, as we have stated here, we're really on fracking the first few wells in this basin. There is a lot of learning to do and this is like any basin. You figure, you know, what are the best angles to drill at, what is the best fracking method to access those? So, we in no way believe that we're doing optimal fracking at this point in time. We're just getting some fracks off. And, as we saw in the deep, actually, we had difficulty. It was challenging to get the fracks away in a couple of those cases. Again, learning will improve that.

You will always have, if you move up, though, into zones where you're getting that more water flow, there will be a relative permeability issue that will exist in the rock that will inhibit you. But, again, you can learn and there are other basins that people have seen, you know, when you start to look at North America where it took them a number of years to figure out how to effectively flow the condensate-rich gas out of those zones. And obviously being very important in North America, because that's where the value was. So that's on the first question.

The second one is with Equinor. Once Equinor have fully earned, which we expect shortly, once the work is completed on Inanli at some time in the future, Equinor will have the right to request operatorship at some point in time. That's obviously a decision for Equinor. They have set up an office in Ankara and have people in that office that are staff there, but at this point they recognise that we are the operator through this campaign and will be through at least the first half of next year. So, they'll have the right to make that decision, we expect, sometime in the new year, and that'll really be up to them.

Colin Smith

Understood. Thank you very much.

Sean Guest

Thanks, Colin.

Operator

Thank you. Your next question comes from Mark Wayne at IA Securities. Please go ahead.

Mark Wayne – Analyst, Industrial Alliance Securities

Hi. I was wondering if you're going to be doing a resource update or resource estimate update in the new year and, if so, do you have any sense as to how the results from this year might impact the numbers you've previously published?

Sean Guest

Thanks, Mark. So, two issues. One, what we were looking to do is obviously going through this campaign with sufficiently positive results from the testing. Our objective was not to be updating the prospective resource report, but to progress more to a contingent resource report, which really demonstrates the maturation of the project towards commerciality and, in our point of view, was an important step in that way. So, what we expect to do is, as we get into Q1 next year, to have looked at the test results, and we are going to work with our reserves auditor in that to then start to make an assessment on that contingent resource and reserves level.

So, in relation to your other question, just if I could say with the drilling and testing that we've done, you know, I can give you my indication of if we were to get D&M back in and say, look, let's update that prospective resource report. What we've seen is we've drilled deeper and we flowed gas deeper. And that's obviously very positive. However, we're now seeing more challenging flow up in the upper zones. So, I would have to expect that we would actually lose gas volumes in the upper part but gain some in the deep. And net wise, I think we would have to say that the numbers would decrease at this level. We still

expect it to be a very significant number, multi-Tcf type of number, but the numbers, you'd expect them likely to go down a bit.

To us, what's more important is how they would assess the probability of success. And from discussions we had with them last year, demonstrating the flow of intersecting gas and then demonstrating that you can flow that gas is very important in that prospective resource report. And while external reserves auditors will make their own assessment, they've had a 51% chance of commercial success on this, and I'm not sure that that number would decrease or whether it might even increase a bit given the ability to actually show flow of gas from all of these zones.

Mark Wayne

Okay, thanks. Can I just ask a follow-up to the previous question? Just whether do you have any sense of how Equinor is looking at this in terms of their level either enthusiasm or commitment to go forward? Like has it gone up or down or the same? Just any kind of comfort you can give to investors would be more than welcome.

Sean Guest

Yes. Obviously, they did the testing on Inanli. What they've seen now is that let's move over to Devepinar and let's test down in the deep there. So, they're committed to spending the money over there to test that. We do expect though that Equinor, given the size of the company, what they're looking for, they are looking for very large volumes of gas. And that they'll then kind of review that once we get into the testing at Devepinar to make their decision as to how much they want to invest, what's the next step of the programme, or what they decide to do as a company. So, we obviously just have to see how they'll play that out. But first step is we're over at Devepinar and we're testing those zones there.

Mark Wayne

Okay. Thank you.

Operator

Thank you. Your next question comes from Ben Firschein, Investor. Please go ahead.

Ben Firschein – Private Investor

Yes. Hi, Sean. Thank you for taking my call. I guess kind of adding on to what you spoke about earlier about the first test at Dev being scheduled for 4,650 to 4,750 metres in depth, are there any, I guess ultimately, in terms of the overall plan for that well, how many tests do you anticipate or are you going to make the determination after or depending on how the first test goes? Thank you.

Sean Guest

So, working with Equinor, our partner on this, there has been a review of all the different zones and how they look in the petrophysics and an assessment of what zones we would like to test throughout the well. But I do believe that we're looking at this bottom zone first to see how that zone behaves when we do the three separate fracks in it and then flow those to then make a determination on where we would go to next

in the well. So, while technically the guys have kind of sat down and identified where they would like to test, the testing programme is now very much focused on that deepest zone, and then we'll make the next determination after we have the results of that.

Ben Firshein

But is it fair to say that there will almost definitely be more than just this one initial test or are you going to decide depending on how this test goes?

Sean Guest

I think it will depend on how this test goes, but we see it extremely likely that there will be more testing in this well.

Ben Firshein

Great. Thank you.

Operator

Thank you. There are no further questions at this time. Please proceed.

Sean Guest

Thank you very much, everyone, for calling in today, and obviously it is an exciting time that we're at now and we look forward to getting these results out to you on the Devepinar first test in a few weeks.

Operator

Ladies and gentlemen, this concludes your conference call for today. We thank you for participating and ask that you please disconnect your lines.