



Aurelian Oil and Gas

Oil and Gas Producers
AUL.L (AIM)

Company Update

Buy

135%

What's Changed

2007E EPS	-1.0
2008E EPS	-2.75
Rating	BUY
Price Target	80p

Trezk Update

Aurelian has announced a positive short term test on Trezk-1; as it moves into an extended appraisal program we assess the potential upside.

Investment Case

- The Trezk-1 short term well test has had a successful outcome and longer term testing should commence in early 2008.
- The potential upside for Aurelian from this project alone could make it a major player in Central Europe.
- The 2008 Trezk appraisal program can be accommodated in the current cash budget but to maintain progress across its portfolio we feel a cash raise at some point in 2008 will be required.

Price **34p**
Target Price **80p**



Source: Proquote

Shares in issue	143m
Net Debt (Cash)	(€30mn Y/E 2007)
Market Cap	£44.5m
Enterp. Value	£16.6m
Next Event	Prelims March 2008

Forecasts	08/06A	08/07E	08/08E	08/09E
Turnover (€m)	0.3	3.1	1.8	1.6
EBITDA (€m)	(2.9)	(0.1)	(1.6)	(1.8)
DSC PBT (€m)	(2.2)	(1.7)	(5.1)	(4.7)
Tax (€m)	0.0	0.0	0.0	0.0
DSC EPS (p)	(1.4)	(1.0)	(2.8)	(2.6)
DPS (p)	n/a	n/a	n/a	n/a

Company Description

Aurelian Oil and Gas is an explorer and producer focused on Central Europe. It's major project is set to be the Trezk/Siekierki gas development in Poland



Testing Positive: Moves to Development

Trezk-1 well testing result is positive, indicating a company making asset could be in the offing.

Introduction

As discussed in our AiM Oil and Gas Review (Dec 07), Aurelian was identified as a company with good metric fundamentals including good cash, an EV/Cash ratio of 0.6x and a “required find”, a measure of its trading premium to its current NAV, of just 3mmbob.

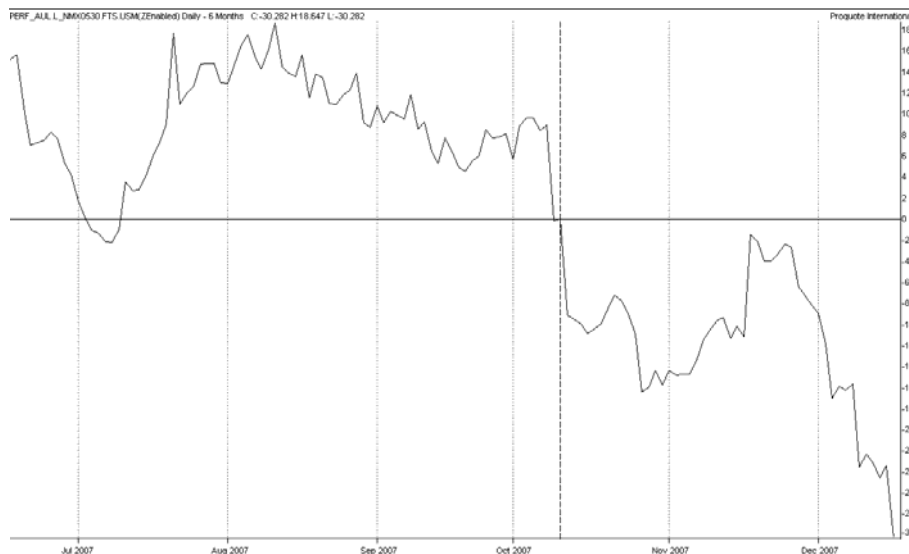
On these metrics Aurelian presents interesting upside and a good investment target. The one negative, even with the positive news it has generated since listing, is that the stock currently trades around 62% of its listing price, although this supports our buy recommendation.

In our initiation note we highlighted two near term events which we felt would drive the share price over the medium term. Firstly, a high impact but very high risk exploration well in Bulgaria, and secondly, the drilling and testing of the Trezk-1 well on the Siekierki trend in Western Poland, near the city of Poznan. Aurelian holds a 90% interest in the licence and is the operator.

The first prospect turned out dry; the second, however, was successful and recently Aurelian has announced the successful conclusion of the short term testing. However, Aurelian's share price has suffered of late; even with the positive news on Trezk.

Aurelian is undervalued for the potential upside it presents and provides an excellent buying opportunity

Figure 1: Aurelian Performance Relative to Oil and Gas sector



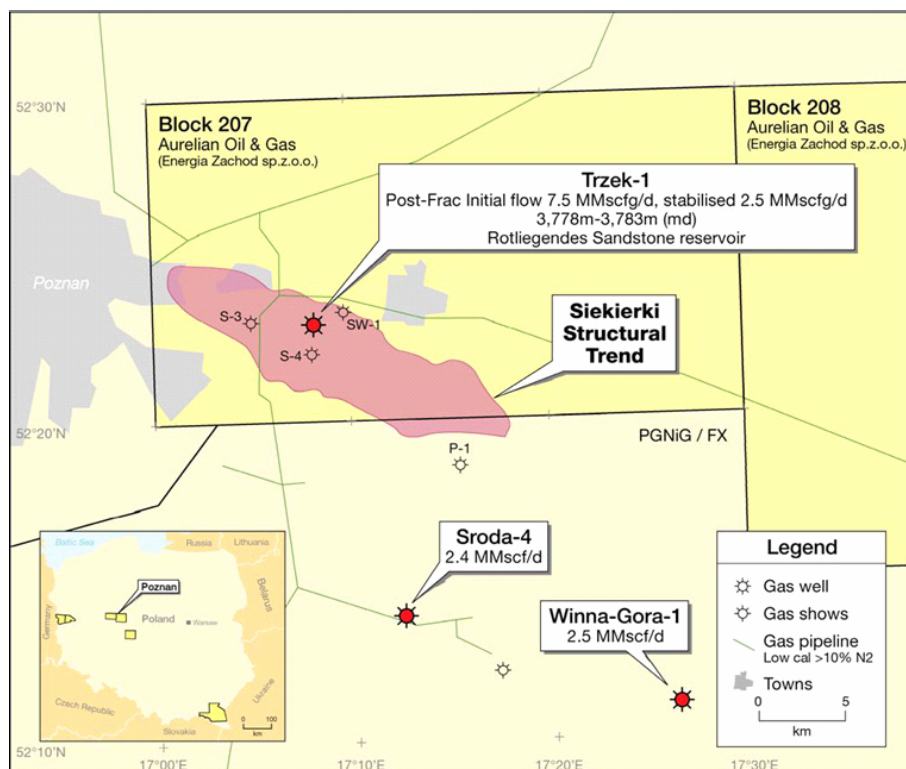
Source: Daniel Stewart

We feel this poor performance is principally driven by the illiquidity of the stock as well as a lack of appreciation within the market for the potential upside given the current positive status of being adequately funded for the initial appraisal process.

The Siekierki Structure

The Trezk-1 well lies on the large Siekierki structure that lies under and to the South East of the Western Polish city of Poznan.

Figure 2: Trezk-1/Siekierki Location



Source: Aurelian Oil and Gas

The tightly held, illiquid stock has slid on very positive news

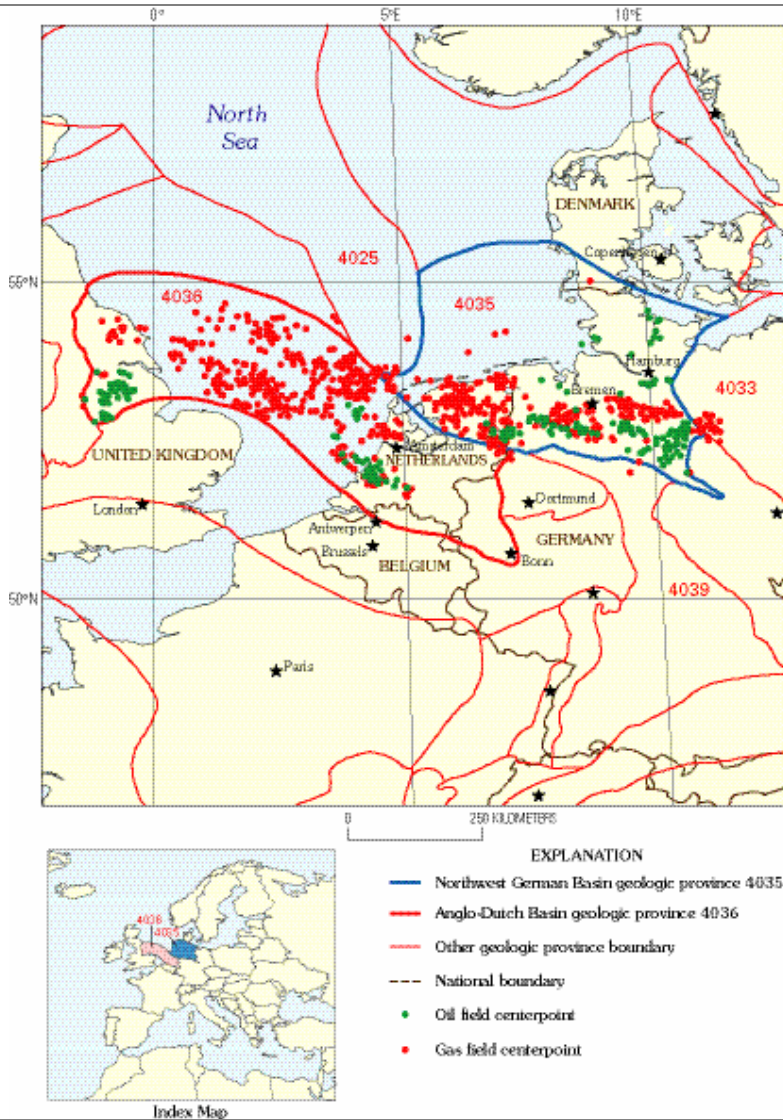
The block was originally drilled by the Polish Oil & Gas Corporation (POGC) in the 1970s who demonstrated the presence of gas. However, due to the adverse permeabilities and the available completion technology of the time coupled, with a limited gas market, there was no development undertaken.

The hydrocarbons in this region, as well as the contiguous region extending to the North West into Holland and the Southern North Sea, are centered on the Permian Rotliegende Formation; a prolific sub salt sandstone reservoir.

The Rotliegende sandstone reservoir was formed over 240ma principally by wind (aeolian) and associated Sabka (evaporate Salt Flats) deposition processes. These processes created high quality sandstones which are characterised by highly fluctuating reservoir properties; often over short distances, and as such, the majority of gas fields in the Rotliegende reservoir have to be artificially fractured by pressurised fluid injection. However, given the extensive exploration and production on this reservoir formation over the last 4 decades in the Netherlands and the Southern North Sea there exists extensive technical information on how to efficiently and economically extract gas. As such we see limited high level technical risk going forward for Aurelian.

Rotliegende Reservoir is a prolific producer across 5 countries

Figure 3: Rotliegendes Gas Fields



Source: USGS

Conclusion of testing and next steps

The Trezk-1 well was commenced on the 7th March with the target depth of 3,935m being reached in July. Within the top 89 meters of the Rotliegendes sandstone good gas shows were recorded and samples of the rock were taken. In addition logs were run indicating good continuation over this 89m segment. Porosities were declared by the company as being fair to moderate, possibly slightly better than had been forecast, and permeabilites as being 'in line with expectations'.

It is worth comparing permeabilites on Scholingen, a field relatively nearby, just outside Bremen in Germany. This field, operated by Exxon, has been in operation since 1980 and has been the subject of numerous technical papers due to its exceptionally tight permeabilites. A typically oil and gas reservoir will have permeabilites expressed in millidarcies (with a range from 5-500mD); where as the Scholingen has published permeabilites of microdarcies, a factor one thousand times worse than a typical oil and gas reservoir. However, with nearly 2tcf of recoverable gas, the field is economically produced and currently utilises 3 horizontal wells with multiple fractures along their horizontal legs, currently producing around 110mmscf/d from the field.

Short term testing very positive; longer term test and early appraisal planned for 2008

On the Trezk well, Aurelian contracted Halliburton to undertake the artificial fracturing of the rock around the well toe and gas was flowed on test between 6th November and 17th November. The well initially flowed at short term rates up to 215,000 cu.m/d (7.6 MMscf/d or 1,266 boe/d) but was then restricted to 71,000 m3/d (2.5 MMscf/d or 416 boe/d) at a wellhead pressure of 73 bar (1060 psi) to limit production of underlying water. As anticipated, the gas contains 12.8% nitrogen, a normal quantity for this region.

Since the completion of the test, the well has been shut in to allow monitoring of the pressure build up. On the 3rd December the pressure gauges were analysed and the results indicated the build up, and then steady state maintenance of bottom hole pressure. Thus it can be shown that the reservoir at this location has good communication and long term testing rates could be achieved.

In order to undertake a field development plan (FDP), full mapping of the structure needs to be carried out, such that the field can be developed as economically as possible. In our opinion, although an expensive option given the reservoir depths, the most likely development scenario will be horizontal wells. This type of well permits a greater area to be produced from one location, and given the likely faulted nature of the reservoir plus the field extending under the city of Poznan, will be a more cost effective option.

To this end a 340sq. km 3D seismic survey over the structural trend is to commence in January 2008, this will permit a complex model of the field to be created which should help identify fault locations for horizontal well placing and also help determine the size of fractures required to produce from the horizontal legs of these wells.

Although the testing is positive for Aurelian and the development of the Trezk/Siekierki field has been de-risked, with early indications that substantial recoverable gas volumes could be achieved from the field, it must be borne in mind that the development costs could be substantial. Many unknowns still exist across the rest of the structure and it could be a number of years before commercial production is achieved which we estimate to be 2010 at the earliest.

Early indications are that the Trezk/Siekierki structure could have substantial recoverable reserves.

Given the permeability issues it is unlikely swing supply will be achieved from the field and its operation will be limited to base load. Given the rising domestic demand in Poland; the field's location close to a major industrial centre and the need to diversify away from Russian imports we see no major obstacles to a long term gas off take contract being obtained.

Potential value

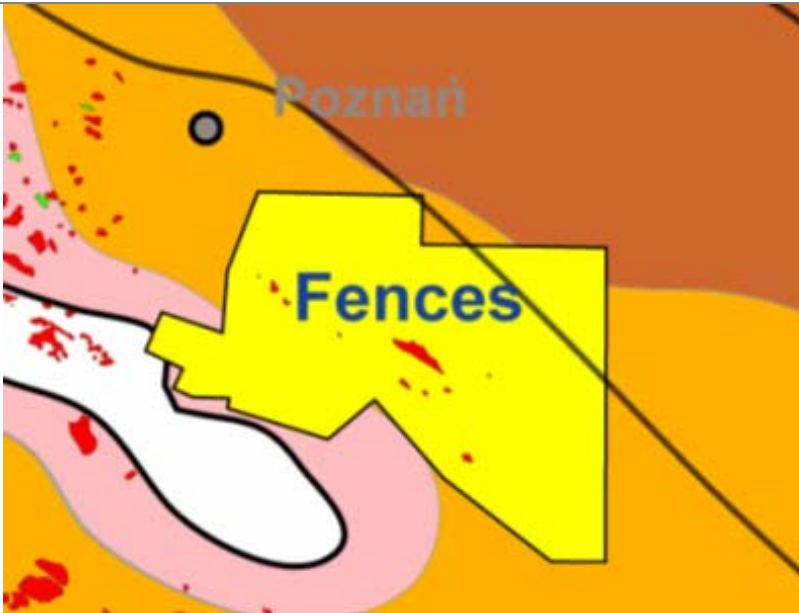
Although it is impossible for a firm value to be even considered at this stage given the huge number of unknowns and the development risks, we have tried to give an idea of the potential upside for Aurelian as the development expands.

Although we have consistently demonstrated comparators in oil and gas are very difficult and often misleading, in this case there is merit in looking at the progress made to date by FX Energy; a US listed company with operations close to Aurelian in Poland.

FX Energy Comparison

FX Energy's (NYSE:FXEN) main operating area, Fences, lies immediately to the South East of the Trezk/Siekierki prospect block.

Figure 4: FX Energy Fences Asset



Source: FX Energy

The following is extracted from FX Energy's latest investor presentation and filings and gives an indication of the value of the company as well as the potential for gas development and production in Poland.

At the beginning of November 2007, FX Energy had:

- A market cap of \$275mn (£138mn);
- Declared lifting costs of US\$0.6/mcf in 2007;
- Development and Exploration costs of US\$1.8/mcf;
- Sales price in 2006 of US\$3.88/mcf rising to US\$7.26/mcf in 2007;
- Average production in 2007 of 7.5mmscf/d (1,250boe/d);
- 1P reserves independently assessed of 39Bcf at US\$102mn NPV(10), \$2.6/mcf (\$15.6/boe);
- 2P reserves independently assessed of 62Bcf at US\$155mn NPV(10), \$2.5/mcf (\$15.0/boe);
- A market value, on a 2P reserve basis, of US\$4.4/mcf (\$26.4/boe) given an indication of how market values the potential upside in Poland from an exploration viewpoint but also incorporates further price rise potential.

FX Energy, a US listed company, has enjoyed success in Poland and is valued at a premium to its 2P Reserves.

Siekierki Development

Utilising the above as guidance figures we have utilised our tax/royalty model to run a scenario for Aurelian's potential development at Siekierki.

We have considered:

- 2P reserves of 500Bcf;
- Initial commercial production in 2010;
- 180mmcf/d initial production tailing to 15mmcf/d in 21 years;

- 1% gas royalty and 20% corporation tax and a 90% working interest;
- Flat gas sales price of \$6.0/mcf;
- Depreciation on rate of production method
- Capex of US\$1.65/mcf, Opex of US\$0.75/mcf escalating at 2.5% per annum;
- NPV(10) of US\$335m, US\$0.4/mcf (\$2.4/boe) or 117p per share on current issued capital.

The above is very simplistic, very conservative and is certainly not an indication of a target price. However it gives some indication of the potential value for Aurelian in the Siekierki structure.

On this comparative basis Aurelian is undervalued.

Going forward

Aurelian could mitigate risk by farming down at any stage going forward. Although the earlier they do this the less value the company will attract.

A farm down at some point is almost inevitable however we don't anticipate this until development begins in earnest and at least not before 2009. However, given the very high well costs, \$10m for a vertical and up to \$30m for a horizontal, the cash calls for Aurelian could be significant as it progresses the appraisal and development program.

On guidance from the company the 3D seismic is expected to cost around €3mn (\$11.50m) for the 340 sq km survey and processing; the long term test, together with a 4.5km pipeline, is expected to cost around €4mn and a further vertical appraisal well, which we estimate to cost of €3mn.

With an estimated 2007 year end cash balance of €30mn this program can be catered for; however, with other operations and commitments across its portfolio we feel Aurelian will have to raise cash at some point in 2008.

The 2008 appraisal program can be paid for by the current cash. However to keep progress across its portfolio we feel extra cash needs to be raised

There is of course the potential to part debt finance the long term test, however, in our experience this will most likely take the form of an expensive "quasi-equity" mezzanine package; most likely with dilutive warrants attached, to take a measure of the completion risk and short term nature of the financing.

In our opinion, it will be cheaper for Aurelian to focus on an equity fund raise at this juncture, and explore more senior debt options as the risk profile of the development is reduced.

One issue with an equity raise however, is the fact that Aurelian currently trades around 62% of its listing price. Any fund raise, at least in the near future given historic trading performance, will most likely be done at a discount to the IPO price immediately eroding the value of long term holders.

Although below its listing price we feel the upside for Aurelian is significant and increased liquidity will improve the position for all shareholders going forward

Although not an ideal situation for any company, it is our opinion, given the potential significance and extrinsic upside in the Siekierki/Trezk structure to Aurelian, that any discount issue should not detract any potential fund raise that would enable Aurelian to maximise its current upside, help derisk the Trezk project further and improve potential farm down terms; a fund raise would also have the benefit of improving liquidity in this tightly held stock.

We maintain our Buy recommendation and 80p target based on our justification in our initiation note.





Disclosure Checklist

Company	Code	Disclosure
Aurelian Oil and Gas	AUL.L	3

Source: Daniel Stewart

1. Within the past twelve months Daniel Stewart & Co plc and/or its affiliates has managed or co-managed a public offering for this Company, for which it received fees or the promise of fees
2. Daniel Stewart & Co plc and/or its affiliates act as corporate broker or nominated advisor to this Company
3. Daniel Stewart & Co plc and/or its affiliates regularly hold/may hold in future trading positions (which may include options) in this Company
4. Daniel Stewart & Co plc and/or its affiliates holds more than 5% of the securities of this Company
5. The Company holds more than 5% of the securities of Daniel Stewart & Co plc and/or its affiliates
6. Daniel Stewart & Co plc and/or its affiliates may currently be providing, expects to provide within the next three months or may have provided within the previous twelve months, investment banking services to this Company, which have given rise to payment or the promise of payment
7. The author and/or an individual responsible for production of this report has direct ownership of stock in this Company
8. The author and/or an individual responsible for production of this report received or purchased shares in the issuer prior to a public offering of shares
9. Daniel Stewart and Company is party to an agreement with this company for the publication of research on it
10. This research note has been disclosed to the Company, with resulting amendments, prior to its dissemination

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Key Assumptions

- Continued appraisal program and work on its existing portfolio indicates a fund raise may be necessary in 2008

Income	08/06A	08/07E	08/08E	08/09E
Sales (€m)	0.38	3.13	1.8	1.5
EBITDA (DSC)	(2.9)	(0.1)	(1.5)	(1.8)
EBIT (DSC)	(3.3)	(2.4)	(6.7)	(5.0)
PBT (DSC)	(2.2)	(1.7)	(5.5)	(5.1)
EPS (DSC)	2.14	(1.48)	(4.07)	(3.8)
DPS(p)	n/a	n/a	n/a	n/a

Cash Flows (€m)	08/06A	08/07E	08/08E	08/09E
Op. CF (€m)	(1.3)	4.1	(0.2)	(1.8)
FCF (€m)	(9.8)	(21.5)	(25.4)	(400.0)

Balance Sheet (€m)	08/06A	08/07E	08/08E	08/09E
Fixed Assets	15.1	39.8	62.1	465.0
Current Assets	56.5	35.0	9.6	(395.0)
Current Liabilities	1.1	6.5	0.37	0.3
Net Debt (Cash)	56.5	35.0	9.6	(395.8)

Recent News / Events

Successful short term test of Trezk-1

Management Team

Michael Seymour – CEO
Frank Jackson – Commercial Director
David Prior – Non Exec Chairman

Major Shareholders

Ospraie	12.6%
Millennium Intl	9.4%
Contessa Properties	6.6%
AXA Framlington	6.1%
Blue Ridge Limited Partnership	6.0%
Ospraie Special Opps	4.7%
RAB Capital	3.1%