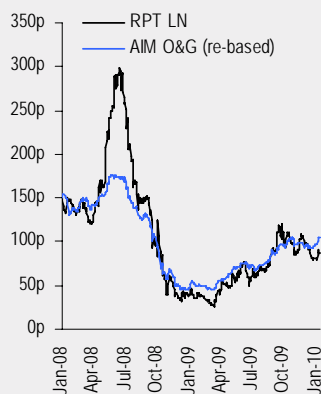


BUY

Bloomberg	RPT LN
Price (p)	83.75
Target Price (p)	130
Upside (%)	55
12mth high/low (p)	126 / 26
Shares out (mill)	315.6
Fully diluted (mill)	327.4
Mkt Cap (US\$m)	436
Enterprise Value (US\$m)	337



Source: Bloomberg

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Testing times

On Monday, Regal Petroleum released long-awaited test results from the SV-58 well in the GOL-MEX and SV field in Ukraine. After overcoming stabilisation issues, the well flowed at 395 boepd from two thin (2 metre) B-sand reservoir units, with the aid of a customised jet perforation technique. The new approach, which appears to be a major technical breakthrough, will now be applied to the remaining B-sand layers in SV-58. While this represents an important step forward for Regal, we believe that our original modelling assumptions for the field are too aggressive, particularly in terms of well productivity. As such, we have altered our model from a B sands only development to a combined B and T sands project, with the same reserve base but a higher risk factor. The valuation impact of this alteration is largely offset by our decision to use a more generous discount rate of 15% to reflect the stabilisation of Ukraine's macro-economic position. Overall, further successful test results are essential in the coming months, but Regal still offers compelling valuation upside, and progress on the technical front could represent a clear turning point. Hence, we maintain our BUY recommendation, with a trimmed 130p/shr price target.

Figure 1: Key financials

End-Dec	Production boepd	Revenue US\$m	Net profit US\$m	OCF* US\$m	FCF US\$m	P/E X	EV/OCF X
2007A	1,157	14.3	(22.0)	(8.0)	(16.8)	-	-
2008A	749	11.5	(50.8)	(8.3)	(63.7)	-	-
2009E	1,300	19.9	(8.9)	1.9	(107.8)	-	179.6x
2010E	4,490	88.7	37.5	46.5	(75.3)	11.6x	8.9x
2011E	8,171	186.5	90.7	107.1	(49.1)	4.8x	4.3x
2012E	13,355	313.8	163.0	189.8	21.5	2.7x	2.3x

Source: Mirabaud Securities estimates. *Operating cash after interest, tax & working cap.

Successful pilot test on SV-58 boosts field production over 2,000 boe/d.

In late November, Regal reported that SV-58 had been tied-back, perforated and flared to surface from the B-sands, ahead of testing. The subsequent test programme on the B-sands yielded mixed results initially, with difficulty obtaining a stabilised flow rate - due in part to higher than expected condensate production. The condensate content of the B sands increases with depth and SV-58 is currently the most down-dip test of this interval. Whereas gas condensate ratios are typically 500 to 1,500 barrels per million m³, in the SV-58 well the ratio was as high as 5,000 to 7,000 barrels which equates to almost 1 barrel of condensate per boe of gas. While this is clearly very encouraging from a value perspective, it has hampered the productivity of the well. Indeed, after flowing SV-58 at an instantaneous rate of more than 1,000 boe/d, the wellbore quickly filled with condensate which choked off production. Even producing the well at rates below 100 boe/d required the well to be periodically shut-in to allow pressure to build sufficiently to clear the condensate from the well bore. The paradox was that the very high formation pressures, which caused so many problems during drilling, now proved to be elusive.

A PLT (Production Logging Tool) run over the interval revealed that very few of the perforated zones were actually contributing to the flow, suggesting that perhaps the underlying problem was one of connectivity between the well bore and the reservoir formation. The narrow liner in this well limited the perforating gun size and it seems that in many cases the tool had insufficient oomph to blast its way through the liner, the cement and into the formation. One solution would be to use the much more powerful StimGun (there is a video clip of this in action online¹), but to bring this technology into the country requires a special licence which could take months to acquire. Regal therefore opted for a more home grown approach called hydro-jetting. This technique involves attaching a nozzle to the end of a coiled tubing unit which “fires” a high velocity (180 m/sec), sand rich fluid at the tubing wall. The sand then progressively cuts its way through the steel and cement into the formation, providing excellent connectivity between the reservoir and the wellbore and eliminating the reservoir damage associated with conventional perforation techniques. While this operation is cheap (at least by oilfield standards) the downside is that the nozzle needs to be replaced after each “perforation”, requiring a three-hour trip out of the hole and then another three-hour trip back in.

On SV-58, Regal has conducted 18 perforations over two 2 metre sandstone intervals and the results certainly appear impressive. Since 7 January the well has been on continuous production at an average rate of 395 boe/d, albeit with a much lower condensate ratio than that encountered in the earlier tests – the pilot perforation programme was targeted at the leanest intervals; the richer layers will be accessed later now that a higher velocity flow has been established in the wellbore. Encouraged by these results, the jet perforation technique will now be rolled out across the remaining 70 odd meters of reservoir in February, which should lift the flow rate to commercial levels. More importantly, the results from the pilot could indicate a systemic issue across the field – a theory that is being investigated by Regal ahead of a possible field-wide roll-out. After a couple of false starts, it looks as though Regal may finally be on the brink of delivering the long hoped for step up in production volumes.

Elsewhere, Regal has successfully removed part (8 out of 11 metres) of the obstruction in MEX-106 and will return to the well later this month to complete the job, before initiating a test programme on the T and D sands during Q1. In the meantime, the well has been returned to production at previous levels (517 boepd), which after including production from SV-58, takes total field output to more than 2,000 boepd. Meanwhile, SV-61 is drilling at 5,960 metres in the top of the T-sand reservoir, while SV-66 is already at 4,548 metres after drilling for little more than a month. Additionally, Regal noted that the reserve and resources assessment being carried out by Ryder Scott would not be completed until MEX-106, SV-58 and SV-61 have been successfully tested, without providing a specific timeframe.

Ukraine update: back from the brink

Ukraine took a pounding in last year’s economic storms, with industrial output shrinking and the currency plunging. However, the country avoided default and, since the worst of the crisis last spring, has taken important steps back from the brink, aided by over US\$10bn in IMF support. Relations between Kiev and the IMF have not always been easy, with a divided government reluctant to impose strict fiscal

¹ <http://www.youtube.com/watch?v=6opQGpgwXl0>

restraint. However, in late December the IMF made a key concession, allowing Ukraine to avoid its annual gas crisis with Gazprom. As part of the deal with the Russian gas giant, Ukraine has accepted higher gas import prices in 2010 – something which should benefit domestic gas producers. At the end of 2009 Ukraine’s five-year CDS narrowed to below 1,000 basis points, confirming reduced fears of default.

Figure 2: Ukraine CDS



Source: Bloomberg.

Further progress towards economic recovery will depend on the results of the upcoming presidential elections, with the first round of polling on 17 January and a second to follow on 7 February. Pro-Russian candidate Viktor Yanukovich is currently leading prime minister Yulia Tymoshenko, with the pro-western incumbent Viktor Yushchenko well behind. Western investors will be hoping for a quick outcome, allowing a strengthened government to push ahead with key economic reforms, while maintaining a strategic balance between a pro-European and pro-Russian orientation.

Maintaining BUY recommendation on trimmed core NAV of 130p/shr

We have revisited our key modelling assumptions to reflect our latest understanding of the GOL-MEX and SV project. Previously, our model was based on a 169 mmboe (B sands only) development, in line with Ryder Scott’s 2005 2P reserve report. However, following our conversations with management, we now understand that the recovery factor (75%) used in the Ryder Scott report is unlikely to be achieved, and that the T sands need to be included to some extent to hit the 169 mmboe number. As such, we have changed our model into a combined B and T sands development, with higher drilling costs to reflect the impact of deeper T sands development wells. In addition, we have lowered our “first year” productivity assumptions to c.1,100 boe/d per well (from c.1,500 boe/d) and increased the total number of wells to c.95 (from c.70).

We have also made a number of softer changes to our core valuation, including a lower discount rate (15% from 20%) to account for Ukraine’s improving outlook, a higher development risk factor (chance of success moves to 70% from 75%) to reflect the inclusion of the T sands in our model, and a revised DCF start date of 1 January 2010 (from 1 January 2009). The net result of all these changes is a small decrease in our risked core NAV from 133p/shr to 130p/shr.

Our core NAV offers more than 50% upside to the current share price, even after cutting back our well productivity assumptions and applying a more conservative risk factor. Should Regal achieve commercial flow rates from the T sands, we would envisage being able to de-risk the project and migrate some of the “possible” (57p/shr unrisks) upside into our core NAV. Given the potential for future valuation

upgrades and our belief that positive test results will emerge in the coming months, we are maintaining our BUY recommendation.

Figure 3: Valuation

US\$75/bbl LT; 15% discount rate										
Asset name	Interest	MMboe ¹	Unrisked				CoS ²	Risky		
			US\$/boe	US\$m	p/share	MMboe ¹		US\$m	p/share	
Ukraine base case (B-sands)	100%	169	4.7	803	149	70%	119	562	104	
ERB-A-1X base case	25%	1	11.5	9	2	90%	1	8	1	
Add: Net cash				100	18			100	18	
Add: Option & warrant proceeds				35	6			35	6	
Core NAV		170		946	175		119	704	130	
Ukraine upside (ex D-sands)	100%	87	3.6	309	57	25%	22	77	14	
ERB "A field" upside	25%	12	5.8	68	13	25%	3	17	3	
Suceava "Dornesti field"	50%	0.2	16.7	4	1	75%	0.2	3	0.5	
Core NAV + Upside		269		1327	246		144	801	148	

Source: Mirabaud Securities estimates; Ryder Scott. ¹Net 2P/3P reserves (core value) or P50 resources/possible reserves (upside). ²Chance of success.

RECOMMENDATIONS HISTORY

Market index	FTSE O&G				
Date	Market Index level	GDR Price (p)	Target Price (p)	Opinion	
15 May 2007	5162.49	162p	275p	BUY	
25 Jun. 2007	5470.78	225p	275p	BUY	
14 Sep. 2007	5323.25	214p	275p	BUY	
26 Sep. 2007	5390.49	180p	275p	BUY	
21 Nov. 2007	5239.88	176p	275p	BUY	
21 Jan. 2008	4581.79	147.5p	241p	BUY	
9 Jul. 2008	5417.03	224p	295p	BUY	
2 Oct. 2008	3339.43	87p	295p	BUY	
31 Mar. 2009	1964.72	39.5p	180p	BUY	
15 Jun. 2009	2664.58	66.5p	135p	BUY	
23 Sep. 2009	3404.51	102p	135p	BUY	
13 Jan. 2010	3686.70	83.75p	130p	BUY	

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- BUY:** The stock is expected to generate absolute positive price performance of over 20% during the next 12 months.
- ACCUMULATE:** The stock is expected to generate absolute positive price performance of 10-20% during the next 12 months
- NEUTRAL:** The stock is expected to generate absolute price performance of between 10% positive and 10% negative during the next 12 months.
- REDUCE:** The stock is expected to generate absolute negative price performance of 10-20% during the next 12 months
- SELL:** The stock is expected to generate absolute negative price performance of over 20% during the next 12 months.
- RISK Qualifier:** Speculative

Stocks bear significantly higher risk that typically cannot be valued by normal fundamental criteria. Investments in the stock may result in material loss.

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