

BULLETIN #5 – SEPTEMBER 19 2009

PETROMINERALES LTD. (PMG-TSX)

Petrominerales (PMG-TSX) is the only intermediate producer I have found that grew so fast in 2008 and 2009 that it actually increased its cash flow this year – despite energy prices collapsing. PMG has hit some big wells in their Corcel field in Colombia – with a lot more drilling to come in the next year. Low debt, big wells and a tight share structure (Petrobank owns 66% of the stock) should provide me with good capital gains with any exploration success.

Trading Symbols:	PMG-TSX
Share Price (Sep 18)	\$12.50
(My purchase price	\$11.30)
Current Production:	~25,000 bopd
Shares Outstanding:	97,843,881 (Petrobank owns 66%)
Fully Diluted	104,208,881
Market Cap:	\$1.17 billion
Net Debt:	\$104 M (includes \$87 M convertible debenture)
Enterprise Value:	\$1.21 billion

POSITIVES

- high growth company—production up 194% year over year
- high impact wells – 5000-8000 bopd IP rates
- drilling lots of wells in next 2-3 quarters
- all low cost oil—cash flow up 20% despite 52% decline in oil prices
- management has one of the best track records in creating value for shareholders
- several oil plays, even though most growth has come from one field
- low debt; should have big net cash position after selling their Orito field

NEGATIVES

- high declines from the initial rates they put in their press release—this can mean choppy quarterly production
- wells in their big Corcel field cannot yet be classified as low-risk development—while PMG has had good success there, (10/11) these are still *exploration* wells
- so if they miss on one big well, during the stock can still drop 20%
- share buyback - there is better ways to spend cash flow

HISTORY

CEO John Wright and CFO Corey Ruttan had worked for an oil company in nearby Ecuador, called Pacalta, which was bought out by Alberta Energy Company, now Encana, in 1999. Wright and Ruttan went back to AEC and bought Pacalta's Colombian assets. They steadily grew production through to 2004, when the Colombian government made new land available - and Wright & Ruttan were able to get 2 million acres. The acreage in Colombia was in known but undeveloped basins. And they have had great success.

PROPERTIES

CORCEL FIELD, LLANOS BASIN

This is the (oil) field of dreams for PMG. Located in the centre of the country, they started in drilling in 2007, and have hit 10 out of 11 wells, each with Initial Production (IP) rates ranging from 4500-8500 bopd. Production falls off steeply however – current productions levels of 15337 bopd from Corcel would indicate all the way down to 1500 bopd. PMG had Corcel at 21,000 bopd in February – this is what I mean by choppy production.

Over the next 15 months, through the end of 2010, management expects to drill eight wells at Corcel and another two wells just south of Corcel in the Llanos Basin, in their Guatiquia block. The company has completed a lot of 2D and 3D seismic this year, and added about 30 prospects to their drilling inventory at Guatiquia and Corcel.

PMG's oil has to be trucked 77 km away to get to a pipeline – the Monterrey offloading centre. PMG has invested heavily in this infrastructure, allowing them to keep operating costs low. PMG now is able to move 11,000 bopd of their production, but the facility is being ramped up so PMG's allotment will move up to 20,000 bopd in Q4 2009. *This should reduce costs by a further US\$3/bbl.*

DEEP LLANOS BASIN

PMG has two large concessions (over 500,000 acres) just north of Corcel, that go right up to the Monterrey offloading station. IP rates on these wells were about 1000 bopd, but have declined in less than a year to 550. It's not yet clear at what rate the wells will settle out – at what point the decline curve starts to flatten out. (Just like the big shale gas plays in North America, these Colombian oil wells produce much less after a year than the eye-popping IP rates in press releases)

Management has said they will drill five wells here in 2010, and extend their trend.

One analyst reported that there were less than 10,000 wells in the prolific Llanos basin, compared to over 400,000 wells in the Western Canadian Sedimentary Basin. So there is potentially **lots** of production to be discovered here. There are multiple producing zones in the Llanos Basin.

HEAVY OIL-Southern Llanos Basin

The market is waiting for the imminent results (late September 2009) of PMG's second heavy oil well. The first well was not successful, but PMG is casing the second one. While this play will take a couple years to develop, there is huge potential upside for PMG here. The company will drill 3 heavy oil wells in 2010 (I suspect more if there is good results.)

They have 800,000 acres of heavy oil exploration blocks. The oil is shallow, so drilling and operating costs are low. This management team would use their new THAI heavy oil process (Toe to Heel Air Injection) that they are pioneering in Canada with Petrobank, in Colombia. Simply put, this process creates a fire in the horizontal well, heating up the oil around it and making it flow better to the well.

The Llanos heavy oil belt extends along the southern and eastern edges of the Llanos Basin, sharing the same La Luna source rock as the Faja del Orinoco accumulations in Venezuela that are expected to produce approximately 600,000 bopd by the end of the decade. This region in Colombia currently produces approximately 100,000 barrels of heavy oil per day.

(Early subscribers will know that Pacific Rubiales, (PRE-TSX), is a fast growing heavy oil producer in Colombia that was the portfolio purchase in our premiere issue – it is up 40% since then.)

One of the first groups into Colombia earlier this decade, PMG is now surrounded by other foreign oil companies, including majors, who paid a lot more for their ground than PMG.

NIEVA

While not as high impact as the Llanos Basin, this play can produce some very profitable oil. PMG has an "Incremental Production Contract", or IPC, with Ecopetrol, where PMG gets a percentage of whatever extra production they can get out of this field. It used to be a 7000 bopd producer. This field is located south-west of the Llanos Basin.

All PMG is doing is transferring the Multi-Stage Fracing (MSF) they are using in Canada with Petrobank, in the Bakken play, down to the Colombian reservoirs. And they are having great success. Production at Nieva has gone from 500 bopd in November 2008 to over 2500 bopd now. Over 60 low risk prospects remain, and costs on this play are cheap. PMG has drilled 24 new wells and done 5 recompletions, with 15 more wells and 10 recompletions to go for 2009.

Production rates are increasing on new wells.

ORITO

PMG also has an IPC with Ecopetrol on this property; but PMG is interested in selling this asset. Located near the southwest coast, the Orito field (42,492 gross acres) is the largest oil discovery in southern Colombia's Putumayo basin. Current net production to PMG is just over 4000 bopd.

Canadian brokerage firm GMP Securities estimates the company will receive somewhere between US\$225 million – US\$450 million for Orito, or \$2.50 - \$5/share. This capital will most likely be redeployed to Corcel or their heavy oil play.

PERU

PMG has a 55% interest in a 2.6 million acre land position in Peru but won't be active until mid-late 2010 at the earliest. It is not part of the company's stock price now and I will update this play as it draws near.

FINANCIALS

This is a low cost, profitable oil company. Operating netbacks (the profit per barrel) in Q2 2009 was US\$36.90 when oil averaged \$60/bbl. Their latest quarterly shows PMG gets a 10% discount to WTI (West Texas Intermediate), presumably because even their Corcel light oil is only 19 API. (This barely meets pipeline spec in Canada – if it was a lower API number the oil would not flow well.)

Operating costs are under \$7/bbl (very good). All-in finding costs, as shown in their DD&A line item of their expenses (Depreciation, Depletion & Amortization – fancy accounting talk) are only \$20/bbl, which makes for recycle ratio of 1.84. The recycle ratio divides the profit per barrel over the cost of finding that barrel, and is a measure of profitability. Most energy producers only show a recycle ratio on partial costs; this DD&A figure throws every cost in and so is conservative.

PMG has three sets of debt – a bank loan for \$10 million, \$7.5 million on their line of credit and an \$87.1 million convertible debenture, which matures December 6, 2010, and is convertible into common shares at U.S. \$27.3485 per share and has an annual coupon of 3.375%, payable semi-annually in cash or common shares.

Colombian government royalties are fixed at a rate of eight percent until the Company's net production per field exceeds 5,000 bopd, and then increase by one percent for each incremental 10,000 bopd of production per field. In addition, there is an eight percent net profits interest ("NPI") applicable to the Corcel block.

With about a 50% success rate in exploration, I expect 2010 production to average about 30,000 bopd. (*This is at the high end of most analyst estimates.*) At US\$60 oil and the loonie at par with the greenback, 2010 cash flow would be just over \$400 million, or just over \$4/share. And if they sell Orito, they will be flush with cash.

VALUATION

There are a couple ways to value PMG. One of the easiest is to give it a value per flowing barrel. For example, if it averages 30,000 bopd in 2010, and I say that because of the company's low debt, high netbacks and good growth curve, it should trade at least \$65,000 per flowing barrel that would mean a market cap of roughly \$1.95 billion.

(Analysts use a company's *enterprise value* to come up with targets. The enterprise value is market cap + debt, or market cap – cash. Assuming PMG sells Orito for \$225 million, they will have close to zero net debt next year, so I will stick with \$1.95 billion.)

Dividing \$1.95 billion by 97 million shares out gives me a potential stock price next year of \$20.10.

Right now, international producers like PMG are trading about 5-8x enterprise value over cash flow. With \$400 million in estimated 2010 cash flow, my math comes up with a minimum \$2 billion market cap, or roughly \$21 share price.

WHAT THE ANALYSTS SAY

<u>Firm</u>	<u>Target Price</u>
BMO Nesbitt Burns	\$16
Dundee Securities	\$14.75
GMP Securities	\$18
Haywood	\$18

CONCLUSION

Few companies have the potential growth profile that PMG does. But the initial decline on these big wells is steep, and they are still higher risk exploration wells. (And regardless what press releases say the well is flowing at; history says 1500 bopd after the first big decline.)

The company has a large land position with many plays in Colombia, but the stock is still dependent on the one Corcel field for any major move up. Should they miss a couple wells in a row, the stock would take a big hit. Their choppy production makes for a volatile stock chart. (If they miss a couple in a row I will revisit this position.)

An active 2009 and 2010 drilling program should ensure steady news flow – and hopefully good production growth. I am very keen to see how the market responds to any success at the Chiguero Oeste-1 well in their heavy oil field. Management expects results to be made public by the end of September 2009 – within the next 2 weeks. Also expected soon is the result from the recompletion of Corcel A-2 well.

I own 1000 shares at \$11.25

POSTMORTEM- AUGUST 2010

Petrominerales TRIPLED in price to \$33 in nine months, which is where I sold my stock. I take profits regularly, guiding the subscriber portfolio to gains of 114% since March 2009. My current profit position on my open trades in the portfolio is 56%. Subscribe today for high potential junior oil and gas stock picks, and also receive a 60 day, 100% money back guarantee on annual subscriptions.

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