February 05, 2015

Cub Energy Inc.

Initiating Coverage

Emerging Gas Producer

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Investment summary

Having doubled production over the past two years, Cub Energy is steadily shedding its status as a junior E&P company and maturing into a real player on Ukraine's natural gas market. Demand prospects in Ukraine and high local gas prices offer the right conditions for the company to continue unlocking reserves.

The 85% slide in the company's share price over 2014 was mainly driven by investor concerns regarding Ukraine risk and the country's stability. Due to Ukraine's heightened military and economic risks we initiate coverage of Cub Energy with a HOLD recommendation, even though out 12-month target price of USD 0.052 per share implies 161% upside to the current price.

- The launch of production at seven new wells in 2013 and 2014 has boosted output to record highs. As of end-2014, the company's exit rate is up 16% yoy at 2,407 boe/d. In 11M14, Cub was the 7th largest independent gas producer in Ukraine with a 4% market share.
- Even though the average netback decreased 18% yoy in 9M14 due to both an increase in operational expenses and a hike in tax rates in Ukraine since August, it is still estimated at an attractive USD 30.4/boe in 2014. The tax rates will remain elevated in 2015 and as a result we see the average netback sliding to USD 15.9/boe in 2015E. Local gas prices are tied closely to import prices, which rose more than 30% over 2014 due to the gas dispute with Russia. However, the decline in global oil prices over the past couple of months implies gas prices will adjust accordingly, with a bit of lag.
- Cub is ramping up operations in Western Ukraine. Its 100%-owned RK field accounted for an estimated 17% of total production in 2014 (vs. 8% in 2013) after the launch of the new RK-22 and RK-21 wells. Additionally, the company launched a new RK-23 well in December 2014 and we see the share of gas produced in the west growing to 28% in 2015 and 2016. The greater focus on the western assets will mitigate the risks related to assets in Ukraine's east (E&P company KUB-Gaz in which Cub owns a 30% working interest).
- Ukraine's parliament approved abnormally high royalties for gas E&P companies for 2015. The tax rate has been set at 55% for gas extracted from wells up to 5,000m, which applies to all of Cub's wells. The rates were initially increased from 28% in August 2014 and the hike was to have been temporary. However, fiscal considerations have outweighed the economic arguments and the rate was not scaled back. Conservatively (for valuation purposes), we assume the 55% rate will remain through end-2016 and slashed to 28% from 2017. At the same time, we believe there is a good chance the tax will be reduced from 2016 because the current rate creates strong disincentives for exploration activities.
- Cub shares are trading at 2.1x EV/1P and 1.4x EV/2P, a 87-92% discount to international peers and a 37-56% discount to local E&Ps after losing 85% over 2014 and 34% since the beginning of 2015. We value Cub Energy using only core NAV and adjust the valuation of the company's assets in Eastern Ukraine by 70% to incorporate the risks and uncertainty caused by ongoing military conflict.
- Our valuation yields a target price of USD 0.052/share, which offers 161% upside to the current price. We initiate coverage with a HOLD recommendation.

Company and share data

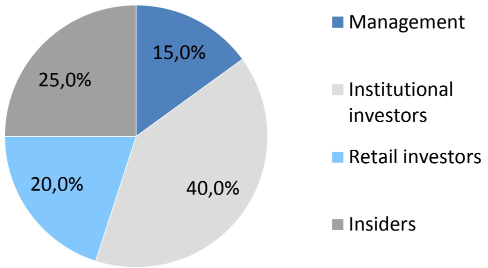
Share data*

Bloomberg ticker	KUB CN
Number of shares	315,419,927
Free float	20.0%
Share price	USD 0.020
MCap	USD 6.3 mln
MCap of free float	USD 1.3 mln

** data as of Feb. 04, 2015*

Source: Bloomberg, Company

Cub Energy shareholder structure

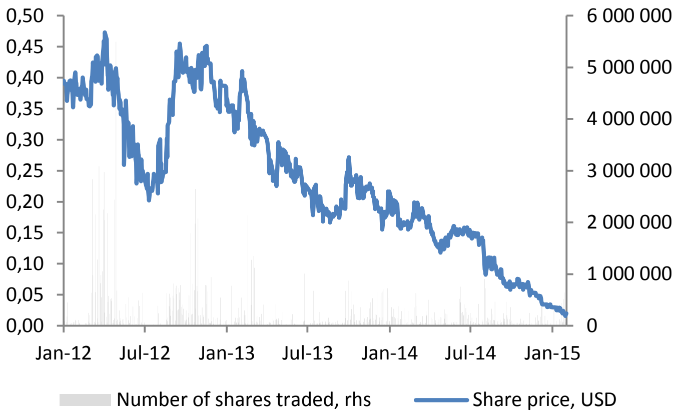


Key financials and multiples

	2013	2014E	2015E
Net revenue, USD '000	3,250	7,214	11,428
EBITDA, USD '000	4,058	5,800	1,170
Net income, USD '000	-3,013	-19,608	-2,398
Net margin	neg.	neg.	neg.
EPS, USD	-0.01	-0.06	-0.01
CFPS, USD	-0.03	0.00	0.01
Production, boe/d	1,542	2,016	2,161
Natural gas share	96%	97%	97%
EV/DACF	0.5	0.6	0.5
EV/(avg boe/d) '000	3.8	3.6	2.0

Sources: Company, SP Advisors

Cub Energy share price performance



Source: Bloomberg

Valuation summary

We value Cub Energy on the basis of core 2015 NAV given existing 2P reserves and using the following assumptions in our DCF model to arrive at a 2015E NAV estimate of USD 0.052/share.

- Separate economics for the two E&P companies in which Cub Energy has a working interest, namely Tysagaz in the west (100%) and KUB-Gaz in the east (30%).
- Exploration assets with no proven reserves in which Cub has a 100% working interest – three fields in the west and three in the east – are excluded.
- We discount the NAV for KUB-Gaz by 70% to account for the risks related to the military conflict in Eastern Ukraine.
- We assume the RK-23 well launched in late 2014 will generate average output of 100 boe/d in 2015.
- We model a delay to development operations at KUB-Gaz and Tysagaz until 2016 based on economic uncertainty, the military conflict in the east, and a hike in royalty rates.
- Decline rates vary by field and range between 20% and 30%.
- Average drilling and completion cost of USD 2.5 mln per well.
- Dividends from 30% in KUB-Gaz at USD 7.6 mln in 2014 and USD 6.6 mln in 2015.

Our valuation suggests 161% upside to the current KUB price. Nevertheless, we initiate coverage of CUB Energy with a HOLD recommendation due to the military and economic risks in Ukraine at the moment.

Target price derivation, USD

2015E NAV

	Mmboe	NPV (USD/boe)	USD mln
Tysagaz (@100% WI)			
- Proven	0.9	6.2	5.4
- Probable	1.2	2.9	3.5
KUB-Gaz (@30% WI)			
- Proven	1.8	10.6	19.1
- Probable	1.5	10.9	16.1
NPV, USD mln			44.0
- Debt			-2.0
+ Working capital			-1.0
- KUB-Gaz discount			-24.6
Core NAV			**16.4**
Base NAV per share, USD			**0.052**
Upside, %			161%

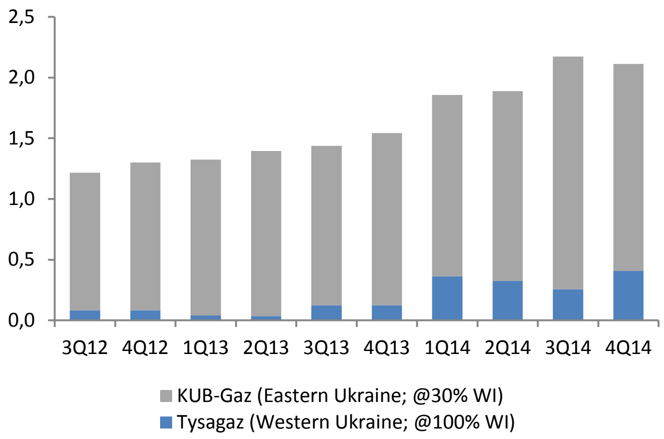
Sources: Company, SP Advisors

Cub Energy: Unlocking reserves

Cub Energy is a natural gas producer with exploration and development assets in Ukraine. An aggressive development strategy has driven significant growth over the past few years – gas output has more than quadrupled from 450 boe/d in 2011 to 2,016 boe/d in 2014.

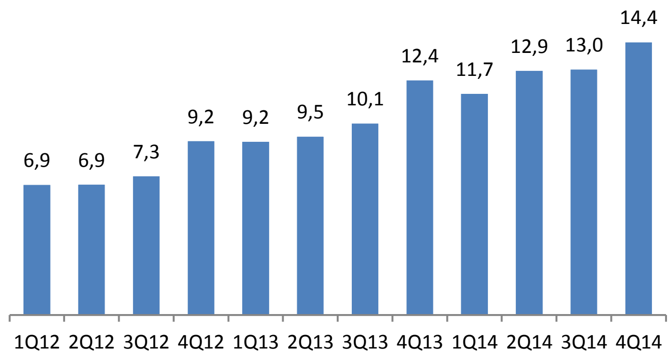
Owing to the successful launch of new wells in 2011-2014, including 3 wells in 2014, Cub Energy doubled its exit rate from 6.5 mmcf/d at end-2011 to 14.4 mmcf/d at end-2014.

Average Oil & NGL production, '000 boe/d



Source: Company

Exit rates, mmcf/d

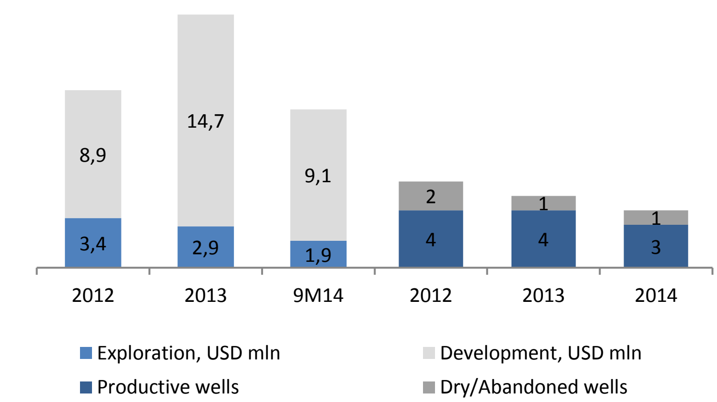


Source: Company

Pumping up CAPEX

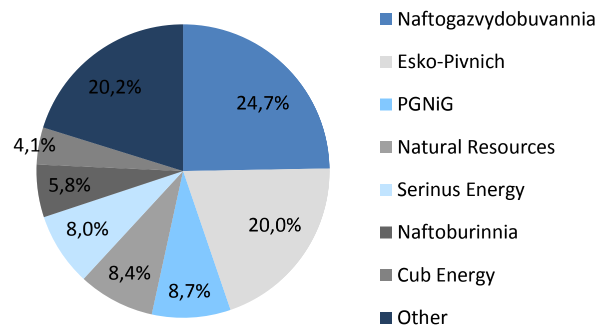
Natural gas accounts for c. 96% of total production. Having invested over USD 30 mln on development and exploration CAPEX in 2011-2014, the company became the 7th largest gas producer in Ukraine in 11M14 (with the 30% WI in KUB-Gaz).

CAPEX spending and commencement of new wells



Sources: Company, SP Advisors

Ukraine's largest independent gas producers, 11M14



Source: Energy Ministry

Strong 9M14 financials on a hike in production

Significant growth in gas production allowed Cub Energy to report impressive financials in 9M14 despite a deterioration of the legal environment and related decline in netbacks: cash from operations surged 44% yoy, while the bottom line added 82%.

Operational results – Western assets

	9M14	9M13	Chg, yoy
Production, '000 boe	82.5	34.1	142%
Revenue, USD mln	4.8	2.5	93%
Funds from operations, USD mln	5.3	1.8	193%
Net income, USD mln*	2.6	1.5	82%
CAPEX, USD mln	6.8	6.1	12%
Netback, USD/boe	19.2	17.7	8%

Sources: Company, SP Advisors

Operational results – pro-rata**

	9M14	9M13	Chg, yoy
Production, '000 boe	542.0	409.0	32%
Revenue, USD mln	31.5	28.8	9%
Funds from operations, USD mln	11.1	7.7	44%
Net income, USD mln*	2.6	1.5	82%
CAPEX, USD mln	11.0	13.0	-15%
Netback, USD/boe	33.6	40.9	-18%

**Excluding non-cash impairment of exploration and evaluation assets of USD 20.7 mln in 3Q14*

***Accounting for 30% WI in KUB-Gaz*

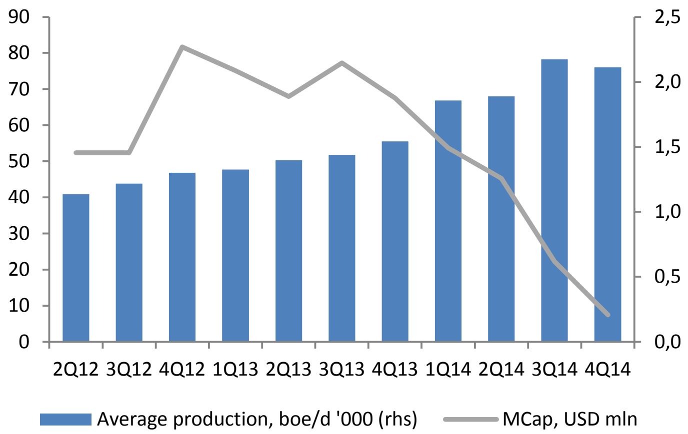
Sources: Company, SP Advisors

Share selloff on war concerns and country risks is unjustified

Despite the upbeat financials, the company's shares shed 85% of their value over 2014. In our view, the military conflict in the east coupled with macroeconomic instability and heightened country risks are the main reasons for the sell-off. The company currently generates two-thirds of its cash from the 30% WI in KUB-Gaz, whose fields are close to the conflict zone. The government's hike in royalties only served to reinforce the negative sentiment over the past couple of months.

We believe the sell-off in light of those negative factors was excessive. The company has mitigated war-related risks by successfully re-focusing development efforts to its Western assets and bringing three wells in the RK field on-stream in the last 14 months. The unjustifiably high royalty rates are not sustainable, in our view, and should be cut considerably already next year after Ukraine resolves its acute fiscal issues.

Cub Energy production vs. MCap



Sources: Company, Bloomberg, SP Advisors

The Ukrainian reality: Military turmoil clouds strong fundamentals

Traditionally an attractive locale for gas E&P companies due to strong demand and lucrative pricing, Ukraine is now facing serious challenges as a result of the military conflict with terrorists and Russia's Armed Forces in the east (the Donbas region).

The active phase of the conflict began in May and escalated in August, when the Russian Army (up to 10,000 troops) directly invaded Ukraine. In late August, Ukrainian President Petro Poroshenko announced the signing of a ceasefire with representatives of the unrecognized Donetsk and Luhansk People's Republics. Despite the peace plan, the attacks on Ukraine's Armed Forces by Russia and the terrorists continued. Over the past couple of months NATO has provided evidence that Russia's Armed Forces are based on the territory of Ukraine.

Since mid-January fighting along the line dividing Ukrainian and Russia-backed forces has intensified significantly. Terrorist armed forces have tried to expand the territories under their control and have attempted to fight the Ukrainian army off their block posts, with limited and temporary success. Regular witness reports in social networks point to numerous soldier and civilian deaths. The renewed large-scale hostilities of late suggest Russia is trying to re-escalate the conflict to provoke Ukraine into restarting a full-fledged military campaign. Nevertheless, we continue to believe Ukraine will not attempt to return the occupied territories by force at this time.

Military conflict territory in Ukraine*

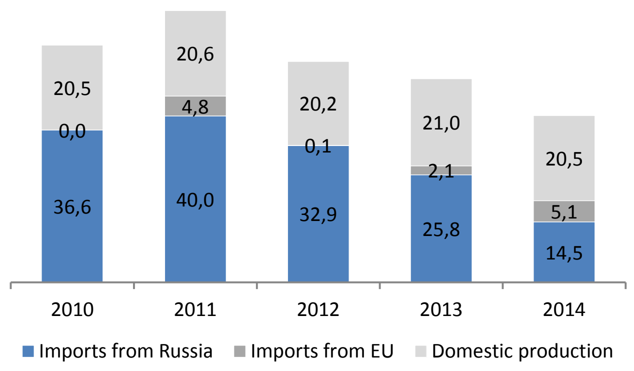
** as of January, 2015*
Source: National Security and Defense Council of Ukraine

Eastern development partly suspended

Only one of the gas producing fields in which Cub Energy has a working interest is located directly in the war zone. The Vergunskoe field (30% WI) is situated close to Luhansk, a city controlled by terrorists. Cub's other operating fields in the east continue to produce and sell gas and gas liquids, although exploration and development activities at all of Cub's eastern fields were suspended in late June for safety precautions. In early October, the company announced it resumed drilling works on the Makeevskoe field (30% WI) after the security situation improved.

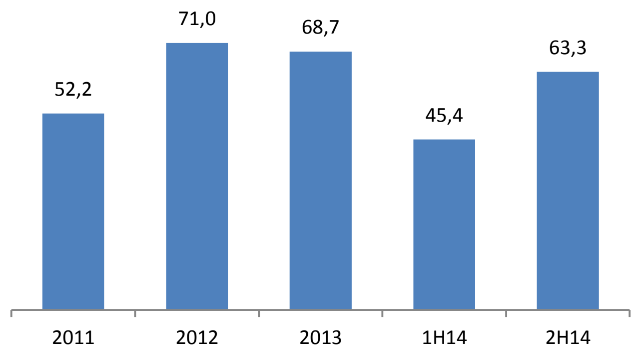
Dependence on imports favors pricing
The main feature of Ukraine's gas market is the misbalance of demand and internal gas consumption. Ukraine has traditionally produced about 2/5 of the gas required by industry and households. This results in:
- A heavy reliance on gas purchases from Russia
- High local gas prices for industrial consumers, which are indirectly subsidizing households (the latter buy gas for prices 4-5x below market)

Domestic production and import of gas in Ukraine, bcm



Sources: Energy Ministry, SP Advisors

Import gas price for Ukraine, net, USD/boe

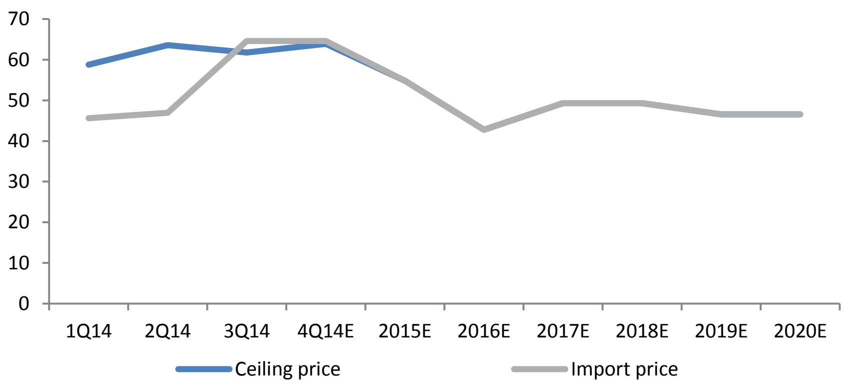


Sources: Energy Ministry, SP Advisors

Prices will remain high in the near-term but may decline materially by end-2015
Cub Energy operates on the free gas market, selling gas primarily to industrial consumers. Domestic gas prices in Ukraine are tied to import prices, which are usually equal to "ceiling gas prices" set by the National Utilities and Energy Commission on the basis of the price for gas imports from Russia. In December 2014 and January 2015 the ceiling price was set at UAH 5,900/tcm (USD 378/tcm and USD 375/tcm, respectively, based on the monthly average official exchange rates), in-line with the gas price agreed with Russia. For February, the ceiling price was reduced to UAH 5,700/tcm (USD 351/bcm at the official FX rate), above the USD 239/bcm Ukraine's 1Q15 price to Gazprom. However, given the difference between the official and market exchange rates, the USD equivalent of the ceiling price is some 18-22% lower.

Following a material decrease in the oil price (the price of Brent slumped from USD 110/bbl in June to below USD 50/bbl in January, but has since bounced back slightly to above USD 55/bbl) gas prices are also expected to adjust materially. Under the current contract with Russia (which is being disputed in international court on discrimination grounds), gas prices lag global oil prices by 9 months. This lag would bring a substantial decline in gas prices in Ukraine by end-2015. We assume gas prices will track oil price trends with a respective lag and we use Bloomberg consensus long-term Brent price forecasts in our model.

Gas prices in Ukraine, USD/boe



Sources: Energy Ministry, Bloomberg, SP Advisors

Cub Energy background

Cub Energy operates in two natural gas basins – the Trans Carpathian Basin in Western Ukraine and the Dnipro-Donets Basin in Eastern Ukraine.

In the west, Cub is the 100% owner of Tysagaz E&P, which produces natural gas from the Rusko-Komarivske (RK) field and holds exploration licenses for 3 other fields, Stanivske, Uzhgorod, and Korolevskoe with a gross area of 80,000 acres.

In the east, the company holds a 30% working interest in KUB-Gaz, one of the largest independent natural gas producers in Ukraine, as well as a 100% interest in Technogasindustria (TGI), which holds exploration licenses for 3 fields with a gross area of 70,000 acres.

While most of the company's production assets are located in Luhansk Oblast, only one falls directly into the military zone – the Vergunske field, which accounted for less than 1% of Cub Energy's output in 2013-9M14. The key producing fields – Makeevskoe and Olgovskoe – are located 70 km from the territory controlled by the terrorists and Russia. However, the risk of re-escalation and a related negative impact on production in those fields cannot be definitively ruled out.

Location of Cub Energy's assets

Sources: Company, SP Advisors

Cub Energy license summary

Western fields	Interest	License type	Gross area, acres
Rusko-Komarivske (RK)	100%	Production	2,000
Stanivske	100%	Exploration	22,000
Korolevskoye	100%	Exploration	8,000
Uzhgorod	100%	Exploration	50,000

Eastern fields	Interest	License type	Gross area, acres
Olgovskoye	30%	Production	22,000
Makeevskoye	30%	Production	18,000
Vergunskoye	30%	Production	2,000
Krutogorovskoye	30%	Production	3,000
North Makeevskoye	30%	Exploration	47,000
East Vergunskaya	100%	Exploration	11,000
Kryakovskaya	100%	Exploration	22,000
Oskolonovskaya	100%	Exploration	37,000

Sources: Company, SP Advisors

Hefty reserves, strong potential to convert reserves into production

The company's total 2P reserves stood at 6.1 mmboe as of end-2013. Nearly two-thirds of those reserves are at KUB-Gaz (30% WI), with the balance at the RK field at Tysagaz in the west. The other fields for which the company holds exploration licenses had no proven or probable reserves at end-1H14.

Cub Energy reserves summary

	Natural gas		Natural gas liquids		BOE Equivalents	
	Gross, MMcf	Net, MMcf	Gross, Mbbl	Net, Mbbl	Gross, mmboe	Net, mmboe
Developed producing	8,980	6,736	32	20	1,529	1,143
Developed non-producing	1,516	1,137	11	7	264	197
Undeveloped	7,355	5,517	14	9	1,240	929
Total proven	17,851	13,390	57	36	3,031	2,268
Probable	17,743	13,307	100	61	3,057	2,279
Total proven plus probable	**35,592**	**26,697**	**157**	**97**	**6,088**	**4,545**

Source: Company

Eastern assets at gunpoint

Cub Energy holds a 30% working interest in KUB-Gaz (purchased in 2012), one of the largest independent (private) E&P companies in Ukraine. In 2013, the company produced 291 mcm of gas (+40% yoy), 4th among local independent gas producers. The robust growth continued in 11M14; the company produced 307 mcm (+20% yoy), with two new wells having come on-stream in 2013-14. The growth allowed KUB-Gaz to become the third largest private producer of gas.

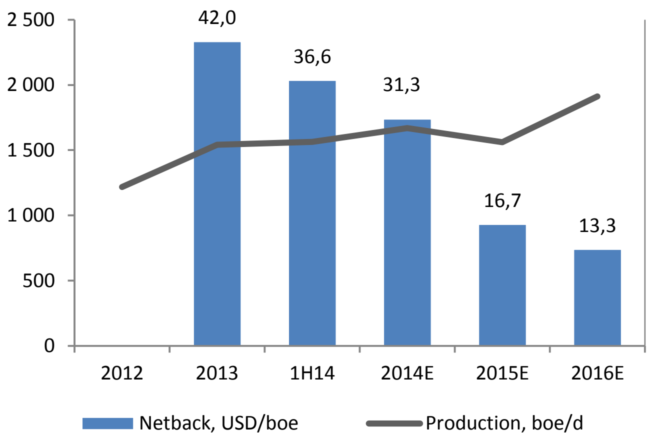
KUB-Gaz currently operates the Olgovskoe and Makeevskoe gas fields, both with average 20% decline rates, and holds an exploration license for the North Makeevskoe field. All of the assets are located in Luhansk Oblast, approximately 70 km northwest of the city of Luhansk. The company also holds production licenses for two fields, Vergunskoe and Krutogorovskoe, located near Luhansk.

For reporting purposes, Cub reports its 30% stake in KUB-Gaz as an equity investment. KUB-Gaz has since March 2013 consistently paid dividends to shareholders, and Cub Energy received USD 9.8 mln in dividends in 2013 and USD 7.6 mln in 9M14. The dividends are a primary source of development financing.

The other 70% in KUB-Gaz belongs to Serinus Energy (formerly Kulczyk Oil Ventures), listed in Warsaw and Toronto, with an end-2014 MCap of USD 89 mln. After being acquired by Kulczyk Oil in mid-2010, KUB-Gaz increased production 6x to 6,390 boe/d in 3Q14, but then saw output fall to 5,650 boe/d in 4Q14. Following the successful launch of a gas processing facility in March 2014, the company more than doubled production capacity from 30 to 68 MMcf/d. In its latest press release KUB noted it is having difficulty meeting gas dew point specifications, which, along with other factors, drove a decline in gas production in the 4Q and further in January 2015. The company will install a new compression in May to address the problem.

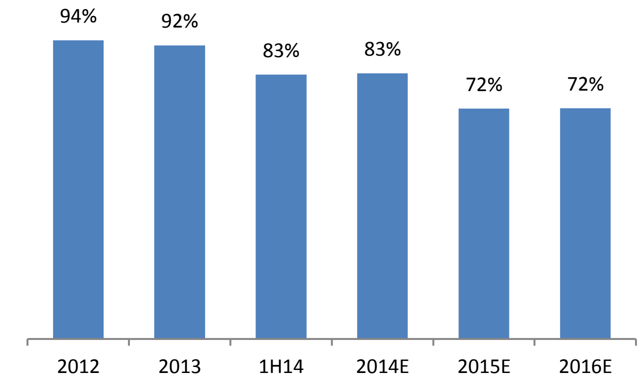
Aside from the KUB-Gaz stake, Cub is also the 100% owner of TGI, which holds exploration licenses for 3 fields with an area of 70,000 acres in Luhansk Oblast. Cub acquired TGI in 2013 in exchange for 55.6 mln Cub shares, valued at USD 12 mln.

KUB-Gaz production and netbacks (pro-rata to Cub)



Sources: Company, SP Advisors

KUB-Gaz's share of total production (pro-rata to Cub)



Sources: Company, SP Advisors

Production continues, exploration paused

The development of the eastern assets, however, has been impeded by the military conflict in the Donbas since May 2014. In June, Serinus and Cub Energy decided to suspend development operations, including drilling and workover activities, on the eastern fields. However, there are significant risks to these operations given their proximity to the war zone. KUB-Gaz is continuing to produce gas at a rate of approximately 5,060 boe/d (in the first 23 days of 2015), or 1,518 boe/d pro-rata to Cub. The company also recently completed drilling a well in the Makeevskoe field and in the coming months plans to test it and tie it in.

One-year delay in exploration on the eastern fields

Given the recent re-escalation, we believe a full resumption of development activities at the eastern fields is impossible in 2015. We expect gas production at the O and M fields will continue at the current decline rates, but there is a risk that KUB-Gaz will not be able to operate at all if the situation deteriorates drastically. We therefore believe development and production at the eastern assets may slow in the coming years; we see their share of production falling from an estimated 83% in 2014 to 72% in 2015 and 2016.

As for TGI, whose fields are currently in the military conflict zone, Cub estimates that it cannot commit any material capital to those assets over the next 12 months. As a result, the company recorded an impairment of USD 9.6 mln in 3Q14.

KUB-Gaz reserves summary (net to Cub)

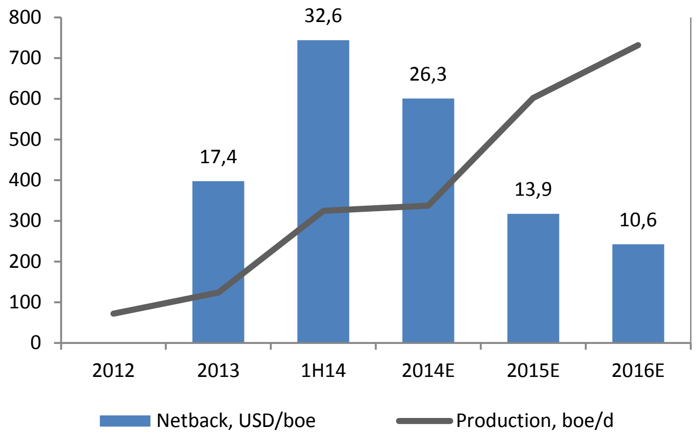
	Natural gas		Natural gas liquids		BOE Equivalents	
	Gross, MMcf	Net, MMcf	Gross, Mbbl	Net, Mbbl	Gross, mmboe	Net, mmboe
Developed producing	7,326	5,495	32	20	1,253	936
Developed non-producing	1,516	1,137	11	7	264	197
Undeveloped	3,066	2,300	14	9	525	392
Total proven	11,908	8,932	57	36	2,042	1,525
Probable	10,462	7,846	100	61	1,844	1,369
Total proven plus probable	**22 370**	**16 778**	**157**	**97**	**3 885**	**2 893**

Source: Company

Western fields – Safe heavens on a growth path

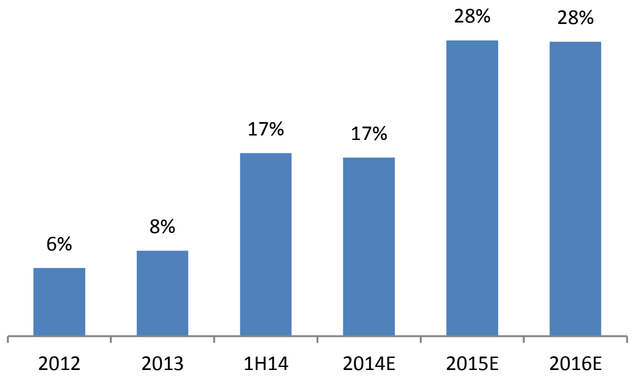
In 2011, Cub Energy acquired Tysagaz, an E&P company, for USD 17 mln. Since then, the company has spudded three new wells on the RK field: RK-22 (production launched in December 2013), RK-21 (production launched in June 2014) and RK-23 (production launched in December 2014). As a result, average gas output at the RK field increased more than 5x from 82 boe/d in 1Q12 to 325 boe/d in 1H14. Following a hike in royalty rates in August the company temporarily slowed production to 257 boe/d in the 3Q but then brought the rate back up to an estimated 406 boe/d in the 4Q. Tysagaz now operates 5 wells, including three new (RK-21, RK-22 and RK-23) and two 13 year-old wells (RK-2 &RK-6), leased from a 3rd party until 2017. The near-term development pipeline includes two additional wells, RK-24 and RK-25.

Tysagaz production and netbacks



Sources: Company, SP Advisors

Tysagaz's share of total production, %



Sources: Company, SP Advisors

Mid-term development strategy: Focusing on RK, Stanivske

Cub is continuing development works at its western assets; in December 2014 the company put the RK-23 well into production. The well was tested at 2.3mmcf/day and we expect an average operating rate of 100 boe/d in 2015.

The priority pipeline for the mid-term includes re-entering the old RK-1 well and drilling 2 more wells, RK-24 and RK-25. However, Cub's capex program in 2015 will be limited due to the hike in royalty rates and an expected decline in gas prices. Cub is planning up to two workovers to enhance production at existing wells.

Going forward, the company plans to continue developing its western assets and converting its current exploration license for the Stanivske field into a production license. However, taking into account the expected capital shortage, Cub recorded an USD 11.2 mln impairment in 3Q14 from the carrying value of exploration assets, noting it is unsure when it will have sufficient funds to continue exploring and evaluating the assets.

Summary of Tysagaz's reserves

	Natural gas		Natural gas liquids		BOE Equivalents	
	Gross, MMcf	Net, MMcf	Gross, Mbbl	Net, Mbbl	Gross, mmboe	Net, mmboe
Developed producing	1,654	1,241	0	0	276	207
Developed non-producing	0	0	0	0	0	0
Undeveloped	4,289	3,217	0	0	715	536
Total proven	5,943	4,458	0	0	991	743
Probable	7,281	5,461	0	0	1,214	910
Total proved plus probable	**13,224**	**9,919**	**0**	**0**	**2,204**	**1,653**

Source: Company

Dividend regulation complicates cash flow management

Cub Energy funds the development of its western assets mostly from dividends paid by KUB-Gaz. Cub has been receiving hefty dividends since it acquired a 30% WI in KUB-Gaz. The company received USD 9.8 mln in 2013 and USD 7.6 mln in 9M14.

Since September 2014, however, receiving dividends has become problematic for Cub as the National Bank of Ukraine (NBU) adopted a resolution temporarily prohibiting certain foreign exchange transactions. That resolution restricts local companies (incl. KUB-Gaz) from purchasing FX for further repatriation of profits to foreign shareholders. The resolution expired on December 2, but the NBU extended the restrictions until March 3, 2015. The regulation inevitably leads to FX losses for Cub Energy due to the ongoing hryvnia depreciation since its subsidiaries can't convert hryvnia into USD immediately upon the receipt of cash from customers.

Prior to the NBU decree, Cub projected FY14E dividends at USD 9.5 mln. We now assume the company did not receive dividends in 4Q14 and that they were postponed to 2015. We don't rule out the possibility that the NBU may prolong the resolution another few months until the local FX market stabilizes, but the restrictions should ultimately be abolished in 2H15. We therefore expect Cub to receive USD 6.6 mln in dividends in 2015 – USD 1.9 mln in arrears for 4Q14 and USD 4.7 mln for 2015.

New tax legislation impedes development

Ukraine's parliament last year approved abnormally high royalties for gas E&P companies for 2015. The tax rate has been set at 55% for gas extracted from wells up to 5,000m (applies to all of Cub Energy's wells) and at 28% for gas extracted from wells deeper than 5,000m. The rates were initially hiked (from 28% and 15%, respectively) in August 2014 and the hike was to have been temporary. However, fiscal considerations have outweighed economic arguments and the 55% rate was retained.

The new tax law also abolishes a discount in the royalty rate for gas extracted from new wells during the first two years of operation. The 0.55x multiplier that was set in August is no longer applicable.

In addition, the benchmark for calculating the base for royalties was amended in August 2014. Previously, taxes were charged based on the average price of imported gas, which was set monthly by the Economy Ministry. Now, taxes are based on the gas ceiling price for industrial consumers. The ceiling price has historically been higher than the import price (USD 363/bcm vs. USD 272/bcm in 2Q), but the prices have converged recently and we assume they will be equal in the long run.

In light of the above, a number of Ukraine's independent gas producers, including Cub Energy, have revised development plans to take into account the effective royalties of 55-65%. Also recently, some private gas E&P companies announced they will halt or delay exploration and development activities given the unjustifiably high royalty rates. CUB's management also reported that "development drilling will be marginally economic in 2015 and exploration drilling not economically viable", mainly due to the unfavorable fiscal regime.

We conservatively assume the 55% royalty rate will remain in place though end-2016 and will be slashed to 28% from 2017. If Ukraine were to keep royalties elevated for another couple of years, it would negatively affect oil & gas companies' financials and create negative investor sentiment.

Peer comparison

Cub Energy trades with a hefty 87-92% discount to international peers and with a 37-56% discount to local peers. This supports our view that the stock is being overlooked.

	Ticker	MCap, USD mln	EV/Reserves, 2014E 1P	2P	EV/Production (boe) 2014E
JKX Oil & Gas	JKX LN	48.3	2.1	0.6	14.9
Cadogan Petroleum	CAD LN	36.4	na	na	na
Serinus Energy	SEN CN	68.9	7	3.7	42.2
Regal Petroleum	RPT LN	20.7	na	na	na
Median			4.7	2.1	28.6
Trap Oil Group	TRAP LN	4.7	na	na	na
Noreco	NOR NO	9.5	53.0	26.9	164.3
San Leon Energy	SLE LN	38.2	na	na	na
FX Energy	FXEN US	73.5	31.3	10.6	na
Valeura Energy	VLE CN	26.7	11.3	3.5	47.5
Transatlantic Petroleum	TAT US	200.3	21.5	10.8	153.4
Median			26.4	10.7	153.4
Cub Energy	KUB CN	6.3	2.1	1.4	12.9
Premium/(discount) to peers					
local			-56%	-37%	-55%
international			-92%	-87%	-92%

As of Feb. 4, 2015
Sources: Bloomberg, SP Advisors

Model assumptions

	2013	2014E	Chg, yoy	2015E	Chg, yoy	2016E	Chg, yoy
Production, '000 boe							
Total	563	733	30%	789	8%	965	22%
Tysagaz	45	123	172%	220	78%	267	22%
KUB-Gaz	518	610	18%	569	-7%	698	22%
Price, USD/boe							
Weighted average	68.4	61.8	-15%	52.8	-10%	44.9	-15%
Tysagaz	70.0	58.6	-18%	52.1	-9%	44.2	-15%
KUB-Gaz	68.3	62.4	-14%	53.2	-9%	45.2	-15%
Royalties, USD/boe							
Weighted average	17.5	23.8	36%	30.1	26%	25.6	-15%
Tysagaz	17.5	21.5	23%	30.1	40%	25.6	-15%
KUB-Gaz	17.5	24.3	39%	30.1	24%	25.6	-15%
Production expenses, USD/boe							
Weighted average	10.9	7.5	-31%	6.8	-10%	6.8	0%
Tysagaz	35.1	10.9	-69%	8.0	-27%	8.0	0%
KUB-Gaz	8.8	6.8	-22%	6.3	-8%	6.3	0%
Netbacks, USD/boe							
Weighted average	40.0	30.4	-32%	15.9	-41%	12.5	-21%
Tysagaz	17.4	26.3	44%	13.9	-45%	10.6	-24%
KUB-Gaz	42.0	31.3	-34%	16.7	-39%	13.3	-21%

Sources: Company, SP Advisors

Company financials

Balance sheet, USD '000

	2012	2013	2014E	2015E
Current assets	10,660	3,276	1,885	7,016
Cash	10,116	1,617	1,034	3,849
Trade & other receivables & prepaids	231	1,062	830	3,106
Inventory	11	23	21	62
Restricted cash & other	302	574	0	0
Non-current assets	68,606	89,803	57,982	42,317
Exploration and evaluation assets	16,616	33,510	18,539	11,522
Equity investments	29,740	30,518	19,590	14,692
PPE	22,212	25,174	19,420	15,669
Other non-current assets	38	601	433	433
Total assets	**79,266**	**93,079**	**59,867**	**49,333**
Current liabilities	1,083	2,334	2,873	3,471
ST debt	0	0	0	0
Trade &other payables	1,083	2,334	2,873	3,471
Non-current liabilities	6,114	5,091	5,160	5,160
LT debt	0	0	2,000	2,000
Deferred income taxes	5,738	4,959	3,032	3,032
Provisions	376	132	128	128
Total liabilities	7,197	7,425	8,033	8,631
Share capital	45,714	62,133	62,133	62,133
Warrants	0	281	281	281
Contributed surplus	2,126	3,521	4,188	4,188
Accumulated other comprehensive loss	630	-867	-15,746	-24,480
Retained earnings	23,599	20,586	978	-1,420
Total equity	72,069	85,654	51,834	40,702
Total equity and liabilities	**79,266**	**93,079**	**59,867**	**49,333**

Sources: Company, SP Advisors

Income statement, USD ‘000

	2012	2013	2014E	2015E
Revenue	**1,666**	**3,250**	**7,214**	**11,428**
Cost of sales	-784	-1,744	-3,477	-8,373
Gross profit	**882**	**1,506**	**3,737**	**3,056**
Operating expenses	-6,691	-16,300	-10,234	-10,645
SG&A	-5,114	-8,604	-7,472	-6,586
Share-based payments	-837	-1,395	-1,067	-1,067
Depletion and depreciation	-709	-1,033	-1,666	-2,978
Impairment of exploration & evaluation assets	0	-5,216	-20,761	0
Accretion of decommissioning obligations	-20	-28	-15	0
Finance cost/income	-11	-24	-14	-14
Income from equity investment	7,787	11,156	9,535	4,700
Other income/expenses	401	0	0	0
Profit before tax	2,379	-3,638	-19,623	-2,890
Income tax expense/recovery	-89	625	15	491
Net income	**2,290**	**-3,013**	**-19,608**	**-2,398**
Foreign currency translation income/loss	289	-1,497	-34,309	-16,687
Comprehensive income	**2,579**	**-4,510**	**-53,917**	**-19,086**

Cash flow statement, USD ‘000

	2012	2013	2014E	2015E
Net income	2,290	-3,013	-19,608	-2,398
Income from equity investment	-7,787	-11,156	-7,635	-4,700
Dividends from equity investment	0	9,750	7,635	6,600
Share-based payments	837	1,395	1,067	1,067
Depletion and depreciation	709	1,033	1,666	2,978
Accretion	20	28	15	0
Impairment of exploration & evaluation assets	0	5,216	20,761	0
Income tax expense (recovery)	0	-779	-15	-491
WC changes	-1073	-931	460	1,718
Changes in non-current receivables	0	-428	0	0
Changes in provisions	-45	-272	23	0
Operating cash flow	-5,049	843	4,370	4,773
Additions to PPE	-1,016	-3,669	-6,537	-1,700
Addition to exploration & evaluation assets	-827	-5,182	-641	0
Restricted cash	0	701	574	0
Acquisition cash & costs	4716	-921	0	0
Investing cash flow	2,873	-9,071	-6,604	-1,700
Proceeds from share issuance	11933	0	0	0
Proceeds from loans	0	0	2,000	0
Financing cash flow	11,933	0	2,000	0
Net increase in cash	**9,757**	**-8,228**	**-234**	**3,073**
Effect of exchange rates	353	-271	-349	-258
Cash at the beginning of period	**6**	**10,116**	**1,617**	**1,034**
Cash, period-end	**10,116**	**1,617**	**1,034**	**3,849**

Per share, USD

	2012	2013	2014E	2015E
Book value per share	0.23	0.27	0.17	0.13
Earnings per share	0.01	-0.01	-0.06	-0.01
Dividends per share	0.00	0.00	0.00	0.00
DACF per share	0.01	0.04	0.04	0.03

Sources: Company, SP Advisors

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