Epstein Interviews CEO Bob Lamond of Tuscany Energy

Tuscany Energy (TSXV: TUS) is a Calgary based, oil focused company developing heavy oil pools in Saskatchewan through horizontal drilling.

The following interview of Chairman & CEO Mr. Robert W. Lamond, took place by phone and email on August 6-8, 2014.

Tuscany has a number of existing drilling locations and drill targets. Please list them in order of importance with a brief description of each.

Lamond: The First is our Macklin structural play with heavy oil bearing sands in the Dina oil fairway, Second is a similar structural play with heavy oil bearing sands at Evesham, we have approximately 10 wells in each of these areas. The key to minimizing the risk is 50 meter spacing. As a result, there is minimal risk once the initial discovery is made. Third is our Winter play based on seismic and 2 abandoned wells which penetrate a heavy oil column. Fourth is our Morgan prospect, with planed horizontal wells adjacent to vertical wells drilled by Husky due west of us.

We are drilling as close as we can to Husky’s wells to reduce the risk. Several years ago we thought heavy oil would turn, so we bought leases. All had by passed oil or were close to offset wells. Why could we buy cheaply? The differential was high, and the oil price low. Timing is everything, we were buying and leasing 3 years ago. Every 3 months we acquire a new prospect, but competition for acquisitions is getting tougher. Why hasn't Husky been doing horizontal wells elsewhere, we bought a lease that Husky missed. We think our location is better. It has 5-6 drill locations and a substantial number of additional locations to the east.

What % of Tuscany's drilling over the next 12 months will be exploration vs. development?

Lamond: 90% development and 10% exploration.

You characterize your heavy oil development drilling as low-risk, can you explain why it's low risk?

Lamond: Once you've proven the field, 50 meter offsets make it low risk. It's a simple as that. One reason why we can drill so closely is that we typically have 25 feet pay zones, 33% porosity. 13 degree API oil with good viscosity, therefore tight spacing is quite economic for us.

What is a typical decline curve on a Tuscany heavy oil well?

Lamond: Heavy oil wells have very rapid declines, some IP at 120 bopd, are at 60 bopd in six months then 20 bopd in 12 months. But, we're using a different pumping technique, pumping at a higher rate initially, oil is flowing quicker. We can get 15-20 barrels for many years- some of our current payouts are 3-6 months. These are the cheapest to drill in Western Canada, 2,000 feet down 2,000 horizontal for C$800k all-in. The first wells are more expensive than that, I'm referring to subsequent wells.

Tuscany recently raised equity capital to fund a new drilling campaign, how long will that capital last?

Lamond: We recently announced a 5 well drilling program which will use the bulk of the funds we raised. Then we can self-fund and go after our Macklin Sparky play. We recently acquired a 100% interest in 567 acres adjacent to our Macklin heavy oil pool, comprised of a producing natural gas well and rights to the Sparky formation. The significance of this acquisition is that it increases Tuscany’s holdings in the Macklin area to a 100% interest in approximately 1,400 acres of prospective oil bearing Sparky lands. We will probably do an equity raise in the fall to fund that. We use a measured approach to drilling, we are very careful about using debt. We have a rule of thumb that we have to be able to pay off all our debt with less than 1 year of cash flow. For example, we recently delivered C$8.5mm in cash flow and we have C$3.9mm drawn on our debt facility.

You mentioned that the company was always looking at distressed asset purchases. In a strong pricing environment how many distressed assets are there?

Lamond: That’s a good question. We are looking at land purchases from the crown and from individuals, the crown land is extraordinary expensive at this time. A lot of people are now looking at heavy oil. So, we’re looking at farm-ins or acquisitions from individuals, we’re looking at least 10 deals at any given time, typically we get 1 deal done every 3 months.

Tuscany lists an inventory of drill targets of low case of 74 to a high case of 192 locations. How long would it take to address all of these targets? Are these net working interest figures?

Lamond: Using mostly internally generated cash flow and only a prudent amount of debt, 74 wells would to take us several years. For example we have 8 wells planed for the 2nd half of 2014. On average we hold about an 80% WI in all those prospective locations. We will drill the low risk wells or take on partners for some of the higher risk wells.

Heavy oil wells are known to be prone to sand and water challenges. How would you describe your wells compared to industry peers in this regard?

Lamond: Yes, that’s the key, the sand issue is no problem because once we drill the wells we use slotted liner. Slotted liner is narrow enough to let water and oil flow, but no sand gets through. Water is an issue, these wells start up at 10% water, then go to 98% water, then we pump more and more water and have to pump it back into a reservoir. We have water disposal facilities of our own so that we are able to avoid paying high water disposal trucking fees. We will tie in additional wells this summer into existing water disposal facilities.

How much does a vertical well cost and then how much more to drill horizontally and complete the wells?

Lamond: We don’t drill vertical with 13% API oil, our best well has a cumulative 40k boe horizontal vs 3k boe for a vertical, the cost is $850k tied in.

Please describe the recent favorable movement in the heavy-lite differential. How does that differential stand by historical standards?

Lamond: How sustainable is this recent move? The latest revenue we got was $87 per barrel, the highest ever at the well head. That was with WTI Crude, around $100 per barrel. We are benefitting from lower differentials due to higher demand in the U.S. for heavy oil. Not sure how long this will last. I’m not in the projection business.

Tuscany just announced 2nd quarter production of 750 boepd, an excellent outcome. What were the main factors that allowed you to reach that elevated level? Could you possibly exit 2014 at 1,000 boepd?

Lamond: Yes, that’s our target, if the next 5 wells are successful, that’s certainly achievable.

What type of valuations do you see on companies that have meaningful heavy oil production (say over 1,000 boepd) on a common metric such as Enterprise Value / daily flowing barrel?
Lamond: That’s a good question, the way I would answer, we had a nickel per share of cash flow in the first quarter. So, we’re trading at 2x cash flow, which is way too cheap. That’s why we’re working on achieving better public recognition of our company. We put in our corporate presentation, the NPV of 2P reserves at C$ 0.80 per share. And, a July 30th Industrial Alliance report raised its price target on Tuscany from C$ 0.40 to C$ 0.75 per share.
Which intermediate and major E&P companies are active in Saskatchewan and Alberta?
Lamond: Husky is all around us. We pooled on field with Husky, Canadian Natural, Cenovous and other household names are in the area as well. Juniors close to us are Surge and Twin Butte, and a few others of that type. I only mentioned the few that are predominately heavy oil in our areas. I thank my lucky starts I moved away from gas. Heavy oil has been very good for us.
What % of fully-diluted shares is held by management and directors?
Lamond: 37%. Does that large percentage depress the trading volume of our stock? Yes and no. Some don’t like that large holdings, but I think 30% would be ideal. Tuscany Energy remains virtually unknown. It took us 2.5 years to get to the position that we’re in now. We’re well recognized in Calgary. We now appear in peer evaluations among sell-side analysts. We think trading volume will increase.
What is the exit strategy for Tuscany? Are you looking to sell once you reach a critical mass?

Lamond: Yes. Our exit is to expand over next year and then sell the company. For several reasons we would be an ideal bolt on acquisition to a larger company with a lower cost of capital and greater debt capacity. Recall that I said we use very little debt. A larger company could produce low-risk oil from our inventory of projects faster than us, therefore increasing the project economics for them. Next year we will be at a point six years into the business cycle. It’s always nice to buy low and sell high. A number of U.S. refiners went and spent hundreds of millions switching form light to heavy on the assumption that they would be flooded with heavy oil, but the oil shale revolution changed that dynamic.