



# Pacific Energy Resources Ltd.

PFE-TSX: \$2.15

Target Price: \$3.00 (was \$5.50)

Recommendation: **BUY**

## BUY: Pacific Energy Resources Ltd. 1,2,3,4

November 29, 2007

### Overview

- Pacific Energy's activities ramp up in 2008 as it exploits its two acquisitions and drills on two exploration plays.
- We expect the Company to develop meaningful cash flow by year-end 2008.
- We are maintaining our **BUY** recommendation, but reducing our target price to \$3.00.

Price	\$2.15	Market cap. (\$mm)	\$ 393.9
Shares O/S Diluted (mm)	183.2	Net debt	497.3
Avg. daily vol.	100,000	Enterprise Value	\$ 891.2

	2005	2006	2007e	2008e
EPS	-0.05	-0.19	-0.20	0.02
CFPS	0.01	-0.05	-0.04	0.19
Production/mm shares	11.1	9.9	23.5	41.6
P/CF	n/a	n/a	(55.6)	11.2
EV/DACF	n/a	n/a	(107.5)	15.6
Revenues (mm)	\$7.4	\$13.0	\$132.0	\$281.4
Cash Flow	0.2	(3.7)	(8.3)	57.0
Net earnings	(1.7)	(13.6)	(41.8)	4.8
Oil & NGLs (bpd)	347	705	4,535	10,961
Natural gas (mmcf/d)	0.4	0.0	3.0	8.1
Equivalent (6:1 boed)	405	705	5,039	12,311

Quarterly CFPS (diluted)				
Q1	\$0.01	\$0.01	-\$0.03	\$0.04
Q2	\$0.01	\$0.01	\$0.00	\$0.02
Q3	\$0.02	\$0.00	\$0.00	\$0.05
Q4	\$0.01	\$0.00	\$0.02	\$0.09

Changes to Estimates	Previous Estimates Q4/07	Previous Estimates FY07	Current Estimates Q4/07	Current Estimates FY07
Revenue			\$69.4	\$132.0
Cash Flow			\$5.1	-\$8.3
Net Earnings			(\$4.3)	(\$41.8)
CFPS (diluted)			\$0.02	-\$0.04



### Major Changes Underway:

- Alaska Acquisition Adds Over 6,000 bd
- California Offshore to Add 5,000 bd
- Two Exploration Plays

(Pacific Energy reports in US dollars; all figures have been converted to Canadian dollars, except as noted. All per share numbers are on a diluted basis.)

Pacific Energy has undergone significant changes during the past year, with fundamentals changing more dramatically than almost any other company. After having undertaken two major acquisitions, the Company's diversified base offers several growth opportunities.

### Investment Conclusion

Although the market penalized the Company for its balance sheet, a reduction of debt and lower cost, longer-term financing is underway.

Management are pursuing several options to reduce the level of debt, which would be beneficial to the stock price.

The high debt level undermines support the asset value would provide. As the benefits of the Company's two acquisitions are realized, the stock price should move closer to its asset value (\$5.27), a process that would be accelerated if there is exploration success in Alaska or Wyoming, thereby increasing the asset value.

Our previous target was based on the prior asset value of the Company with a premium for its exploration prospects at Pacific Creek Wyoming. Since commerciality of the play has not yet been established, and results of the second location are not expected for about another year, **we are giving no value to the Wyoming assets**. Similarly, until a rig is booked for the Corsair prospect in Alaska, **we are not assigning an exploration premium to the target price**.

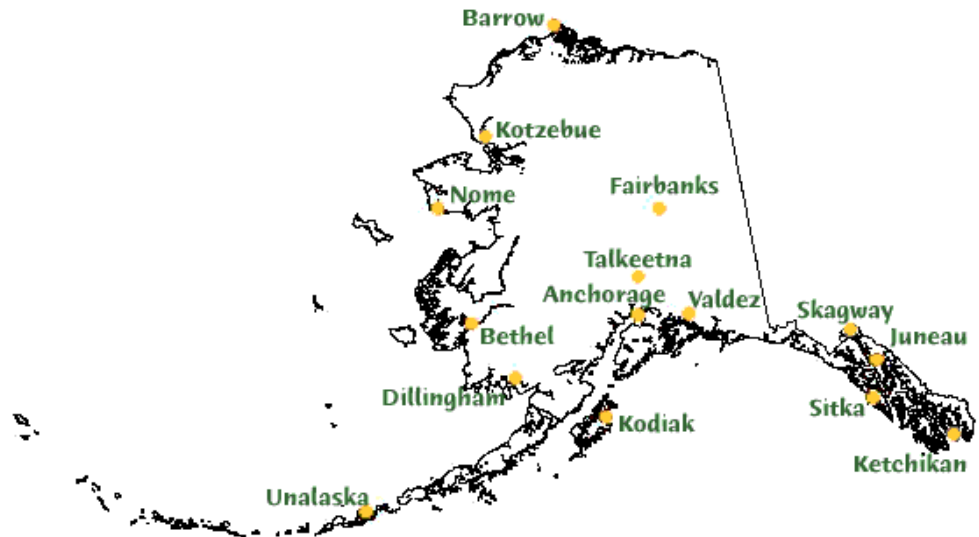
The current asset value reflects the increase in debt from \$42.8 million in Q1 to the current level of \$487.0 million. Current debt to next year's cash flow estimate of \$57 million is 8.5x, a fundamental that will likely constrain the share price in the near term. (The debt level is less than half of the Company's 2P reserve value, keeping it within normal lending guidelines.)

To reflect the impact of this level of debt on the share price, we are lowering our target to \$3.00 (from \$5.50). We are maintaining our **BUY** recommendation as the debt and debt charges are in the process of being reduced, and there is sufficient value in the reserves to justify a higher stock price.

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## Forest Alaska Oil Acquisition

Pacific Energy's purchase of Forest Oil Corp.'s (FST-NYSE) Alaskan assets adds a third operating area, in addition to California and Wyoming, and brings production from 3,000 boed to almost 8,900 boed. The assets are located near Anchorage in the Cook Inlet in the southern part of the state.



A majority of Pacific Energy's Alaska production is offshore in water depths of 20-40 metres.

Future drilling is planned both offshore in the Inlet and onshore near Anchorage. All the production is marketed locally around the Inlet.

### The Cook Inlet

The Cook Inlet was first drilled in the 1960s, leading to 25 commercial gas fields with gas reserves of about 8.5 tcf peaking in 1968. An LNG gasification facility was built in the Inlet to supply Japan. After oil was discovered on Alaska's North Slope, most activity moved north to Prudhoe Bay.

With improving commodity prices, a renewal of activity is underway for both oil and gas. Oil is sold to local refineries and is referenced to world prices. Gas prices have, until recently, tended to trade at a discount to Henry Hub levels. However, during the last few years, gas supplies have been unable to meet demand, resulting in industrial closures and blackouts in Anchorage, and this led to improved market fundamentals whereby gas prices are comparable to Henry Hub levels.

As elsewhere in the world, major oil companies dominated the first wave of activity, leaving smaller sized targets ideal for junior companies like Pacific Energy to explore and develop in subsequent cycles.

The Department of Energy estimates there are 13-17 tcf of undiscovered gas in the Cook Inlet. To date, approximately 10 tcf of gas has been produced in the Inlet, with an estimated 2 tcf of remaining reserves. Area production has been holding steady at 200 bcf per year, but has started what is expected to be a steep decline and an inability to meet peak winter demand, thereby reviving interest in exploration for new reserves.



Royalties in Alaska are among the lowest in the world, at 12.5%, although the costs of operating in a remote and harsh environment are somewhat higher. Income taxes have recently been increased to 25% from 22.5%, part of a world-wide trend of governments to increase their share of higher commodity prices. Natural gas sold within Alaska is taxed at 5%, if exported it is taxed at 25%.

### The Transaction

The value of the transaction was slightly under \$500 million based on reserves of \$451.9 million (see the following table for details). This compares favourably to the reserve report values of \$437.5 million for the proven reserves (using a price forecast that would have increased since preparation of the report), and the \$1.0 billion value of the proven plus probable reserves. There is an additional \$97.3 million of possible reserves. The proven reserve life index of 11.4 years is higher than normal, indicative of the potential for increased production as the reserves are exploited and explains the \$72,207 paid per flowing barrel equivalent, which otherwise would be high.

<b>Acquisition Metrics</b>	US\$ millions
Cash	\$400.0
Value of 10 million shares @ \$2.75/s	\$27.5
0% Coupon Note due 2014	<u>\$60.8</u>
Cost of Acquisition	\$488.3
Less Adjustments:	
Pipeline, book value	\$8.6
Working Capital	\$18.4
Undeveloped Onshore Land 938,000 acres	<u>\$9.4</u>
	\$36.4
Cost of Reserves	\$451.9
Production, boed	6,258
Purchase Price of Production, US\$/boed	\$72,207
Proven Reserves, millions of barrels	26.1
Probable Reserves, millions of barrels	<u>27.8</u>
Total Reserves, millions of barrels	53.9
Purchase Price of Reserves, US\$/boe	\$8.38
Proven Reserve Life Index, years	11.4
DeGolyer, McNaughton Reserve Report, 1/1/07	
Proven Reserves, PV 10%, US\$ millions	\$437.5
Probable Reserves, PV 10%, US\$ millions	<u>\$564.5</u>
PV 10%, P+P, US\$ millions	\$1,002.0
Cost of Reserves / PV 10% of Reserves	45.1%
Possible Reserves, PV 10%, US\$ millions	\$97.3

Source: Pacific Energy and Octagon Capital

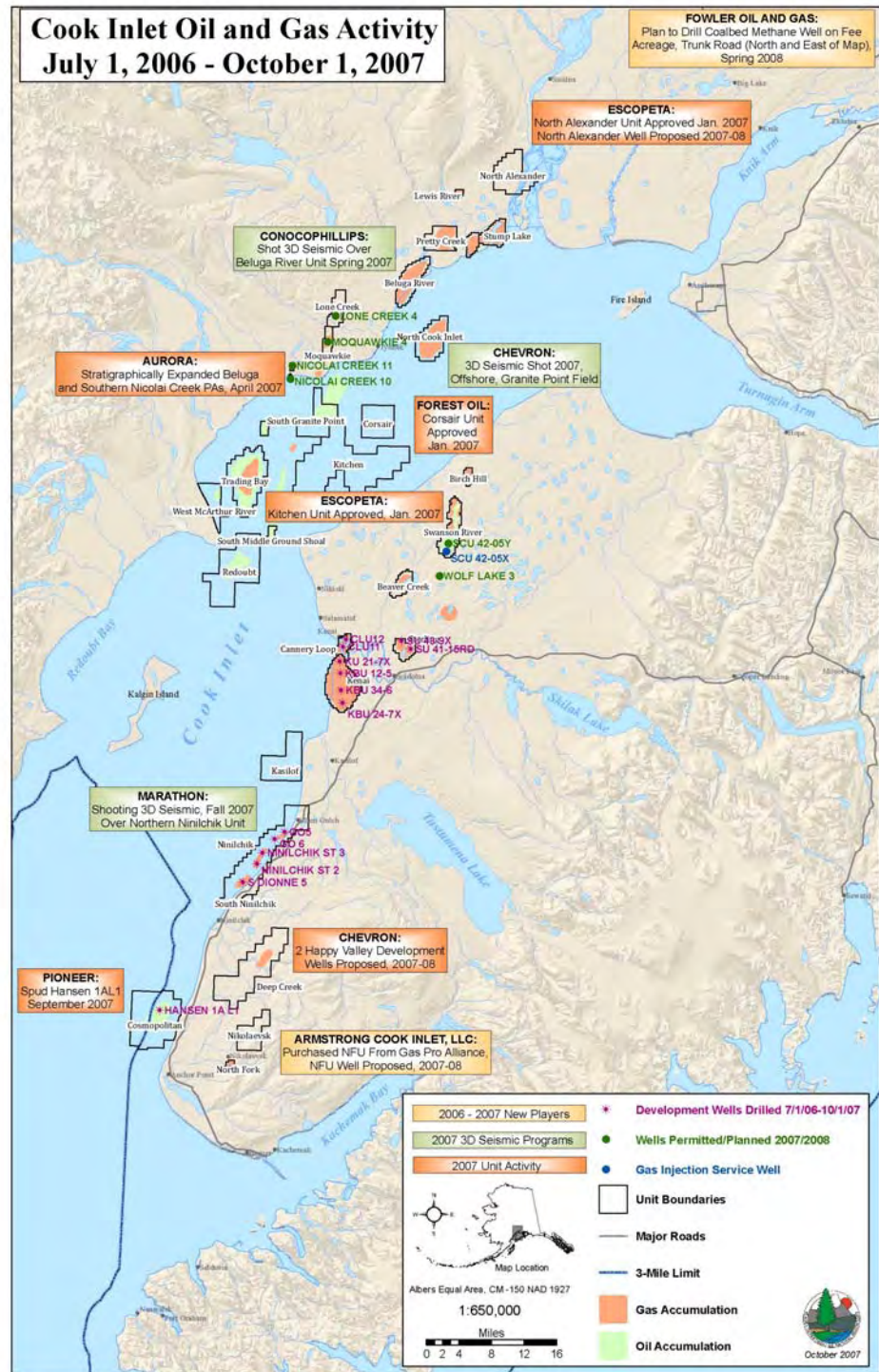
### Current Production

Pacific's Alaska production at the time of the transaction was 6,258 boed. Two-thirds of the production (4,179 boed) is operated by Chevron Corp. at Trading Bay and McArthur River, in which Pacific has a 46.8% interest. Chevron acquired these assets approximately two years ago as part of its takeover of Unocal Corp. Chevron has proposed a multi-year capital expenditure program that would envisage the drilling of up to 10 locations – general redevelopment



expenditures to alleviate declines at offshore platforms, and is part of what is possibly the most aggressive stance taken by any operator in the area. Since there are no drilling rigs in the Inlet, other than platform-mounted rigs, having the platforms in place is a key advantage; Chevron operates 5 platforms in joint partnership with Pacific.

Forest operates 2,000 boed of production at West Foreland, Redoubt Shoal, and Kustatan with 100% interest. The Osprey platform on Redoubt Shoal has drilling capability. A remaining 70 boed of Pacific's production is operated by a partner.



## Exploration Potential

There are a total of 18 prospects and leads on the Alaska acreage, of which two are at the drillable stage. The most likely target to be drilled first is the offshore Corsair prospect (Pacific 100%), with a resource estimate of up to 480 bcf of gas. A well tested 300 bd in 1963, and there is potential for 137 million barrels of oil, but gas is the primary target. Two drilling locations have been picked on the geologically complex play of channel sands, and if successful, up to six wells may be required to develop any discovery. Pacific is in the early stages of contracting a rig to bring it into the Inlet next spring after the ice is out, to drill the first location on the target.

The second exploration target is Middle Lake, which is across the inlet from Anchorage with road access. Potentially, up to 90 bcf of gas could be recoverable. If successful, the well could be expected to produce at 10 mmcf with the potential for two follow-up locations. The play is a seven-mile tie-in to the distribution system for Anchorage.

Although test results of the first well of a two-well program at Pacific Creek Wyoming are inconclusive, the second location is expected to begin drilling during the third quarter of 2008.

Pacific Energy's exploration program over the next year – including the Pacific Creek gas play in Wyoming – totals 137 million barrels and 1.37 tcf of recoverable resource potential. If it were all successful, this would add \$11.60 per share of asset value and, on a risk adjusted basis, could be worth up to \$3.01 in value.

	Prospect Inventory - Up to Several Years in the Future	Recoverable Resource Potential		Unrisked Net Present Value per Fully Diluted Share @ \$15.00/b or \$2.50/mcf	Possible Success Ratio	Risky Net Present Value per Fully Diluted Share
		mmb	tcf			
Pacific Energy	Pacific Creek		0.80	\$5.43	10%	\$0.54
	Corsair	137	0.48	\$5.56	40%	\$2.22
	Middle Lake		0.09	\$0.61	40%	\$0.24
		137	1.37	\$11.60		\$3.01

## California Offshore – The Eureka Platform

The rationale for acquiring the California assets was the increased production potential from restarting the Eureka platform, which had been producing at 4,600 bd prior to an oil leak requiring the shutting-in of production. Prior owners of the block differed on solutions to the problem and offered the asset for sale. Pacific Energy plans to reline the pipeline connecting Eureka to the nearby processing platform and have the wells on the Eureka platform on full production by mid-2008. Reservoir pressure has been building since the wells have been shut-in, thus initial production should be higher – possibly 5,000 bd.

## Third Quarter Financials

The Alaska asset acquisition was completed on August 24, 2007, thus the third quarter does not reflect the full impact of the assets.

For the third quarter of 2007, Pacific Energy reported cash flow of \$482,771 (nil on a per share basis). Gross revenue of US\$32.8 million was derived almost entirely from oil production, which averaged 4.909 bd for the quarter. Working capital was US\$2.6 million. Debt of US\$526.9 million (the bulk of which is a result of the Alaska asset acquisition) resulted in interest charges of US\$10.0 million (US\$0.04 per share). Operating costs of US\$20.0 million, or US\$44.17/b, reflect the lack of exploitation in the newly acquired assets.



Subsequent to the end of the third quarter, Octagon Capital participated in an equity issue of \$60.7 million for the Company, of which \$40 million was applied against debt and the remainder to working capital.

## 2008 Outlook

The fourth quarter of 2007 should be the start of a turnaround in the Company's financial performance. We expect equivalent production to double to approximately 10,400 boed with a full quarter's effect of the Alaska assets. Cash flow is expected to come in at approximately \$5 million (\$0.02 per share).

By mid-2008, production is forecast to be 14,350 boed, providing full year cash flow of \$57 million (\$0.19 per share). Annualizing Q4/08 cash flow, suggests the Company could be cash flowing \$100 million (\$0.36 per share).

Our modelling incorporates the hedges disclosed in the Q3 financial release.

Crude Oil Hedges, September 30, 2007			
Expiry	Barrels	bd	Price /b
2007	317,688	870	\$66.03
2008	1,168,382	3,201	\$65.92
2009	1,022,169	2,800	\$65.77
2010	748,861	2,052	\$65.05
2011	492,519	1,349	\$62.09
2012	416,412	1,141	\$60.12
Total		11,414	

Source: Pacific Energy

As part of the turnaround that is underway in the Company, five events over the next year could have a positive effect on the share price.

Two exploration plays are planned – at Corsair Alaska and Pacific Creek Wyoming, either of which could positively impact the asset value and production profile of the Company.

A successful restart of the Eureka platform's wells would be a major boost to production, and contributes to the 144% increase in corporate production year-over-year. As the offshore California production volumes increase, the fixed costs of the processing and pipelining will be allocated over a greater number of barrels, and there should be significant improvement over the US\$44.17/b operating costs experienced in Q3/07.

The fourth item is the restructuring of approximately \$525 million of debt and reducing the effective interest rate by as much as one-third to 10%, which we believe could save the Company roughly \$25 million in expenses compared to the current debt terms. In addition, now that Pacific Energy is a substantial producer, some of the \$95 million of environmental liability bonds posted against the offshore California assets may be in excess of what is required and could be released to the Company, which might be applied against the debt. We also expect to see some assets sold and the proceeds used to reduce the debt.

The fifth event would be a US listing, which would facilitate the trading of the stock by a wider audience. An application for a US listing is underway, and since Pacific Energy's assets are entirely American, and Americans are more comfortable with higher levels of debt, we believe Pacific Energy could attract a wide following in the United States.



## Valuation

Based on the current stock price, the stock trades at a relatively high cash flow multiple of 11.2x. The stock price is supported by the asset value of \$5.27 per diluted share, adjusted for the Q3/07 balance sheet which reflects the impact of the acquisition of the Alaska assets and taking into account the recent share issue:

Oil and Gas, P+P, PV 10%	\$1,668.2
Net Undeveloped Land, Onshore (\$75/acre)	\$2.0
Working Capital	\$22.6
Debt	<u>\$487.0</u>
Net Asset Value	\$1,205.8
Shares Outstanding, Basic	185.08
Asset Value per Share, Basic	\$6.52
Proceeds of Dilutive Instruments	\$190.5
Shares Outstanding, Fully Diluted	265.17
Asset Value per Share, Fully Diluted	<u>\$5.27</u>
DeGolyer & MacNaughton, Netherland Sewell	
Source: Company Data and Octagon Capital Corporation	

Given the highly leveraged balance sheet (8.5x), we are uncomfortable basing our target price on the asset value. Therefore, we have discounted the asset value to arrive at our new \$3.00 target price, which is a very expensive 15.8x P/CFPS.





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The Analyst who prepared this comment has viewed the material operations of the issuer.

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