

Sefton Resources 6p

Exploration in Kansas and an upgrade to valuation.

9th September 2008

Share Price: 6p



Source – Reuters

12m High: 11.5p

12m Low: 4.25p

Market Cap: £8.3m

Shares in Issue: 138m fully diluted (*)

Core Post- Tax NPV/Share: 11.8p*

Upside Post- Tax NPV/Share: 33.6p*

Gearing: 47% (at 30.6.2008)

Interest Cover: 13.1X (at 30.6.2008)

EPIC Code: SER.L

Sector: Oil and Gas

Market: London AIM

Broker: Seymour Pierce – (changing to Religare Hichens Harrison)

PR: DHM Associates

Website: www.seftonresources.com

Description: A British Virgin Island corporation, oil and gas producer and soon to enter into exploration activities through wholly owned subsidiaries TEG Oil & Gas USA Inc. and TEG Mid-Continent Inc..

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Sefton's interim results show the company's strongest financial performance to date. First half oil and gas revenues more than doubled to \$USD 2,595k, up from the \$USD 1,276k seen for H1 2007.

During the period, the pilot enhanced recovery program at Tapia has been proven to be effectual; wells tested so far have shown improved production rates. Some (by now well documented) operational issues left oil sales volume pretty flat at around 24,000 barrels, where we had originally expected more infill drilling activity. However, high commodity prices have still boosted revenues.

Going forward, new wells are planned for the productive 'Yule Lease'. We anticipate increasing production rates from here on, with the cyclic steaming set to be rolled out field-wide. With the additional improvements at Eureka Field, we expect that net oil production should be nearer to 40,000 barrels in H2. This gives us a new forecast for full year revenues of around \$USD 6m, with profits of around \$USD 2m despite recent falls in commodity prices. (based on USD\$85 oil with timely drilling on the Yule lease). The decline in sterling-dollar exchange will boost earnings per share.

Management is very comfortable with progress, and the company is looking to commence exploration activities in Kansas. This is a step change for the company, starting in a new operational area.

- Our new core value for the Californian assets is USD\$ 28.7m (11.8p/share) with an upside with enhanced recovery to USD\$ 81.8m (33.6p/share). Sefton is now profitable and on our newly revised estimates should generate revenues of over \$USD 6m this financial year, leading to a profit of around \$USD 2.3m
- It has set out plans to drill four new wells, and re-enter a fifth, to test coal bed methane potential on its 40,000+ acres of leases in the Forest City Basin.
- Bloomfield Corporate Finance Ltd has been appointed as NOMAD, with Religare Hichens Harrison plc as broker

FY	Sales	Earnings Before Tax	Adjusted Profit	Eps.
31 st Dec	\$ 000	\$ 000	\$ 000	cents
2005 A	1,810	(564)	(564)	(0.736)
2006 A	2,696	(378)	(378)	(0.562)
2007 A	2,978	283	283	0.178
2008 E	5,976	2,247	2,247	1.835

Californian Operations

Tapia Field

The pilot for the enhanced recovery program at Tapia has been proven to be effectual; improved production rates have been seen from the wells tested so far. Some (by now well documented) operational issues left oil sales pretty flat at around 24,000 barrels during H1; we had originally expected more infill drilling activity, but high commodity prices have boosted revenues.

Work is starting on the two gas wells Yule #8 and Snow #1 in the coming weeks. If mechanical issues in either of these wells can be solved, so that gas can be supplied from them to the steam generator at an appropriate rate and pressure, the systematic steaming of other wells in the field will begin accordingly. During the initial steaming work Sefton took the view it was better to spend the money on propane and get on with the testing – so only now that has proven worthwhile they are going back to the wells to source lease gas. Should the gas supply well mechanical repairs prove ineffective, one of the new wells to be drilled will be designed and completed as new gas supply well, but we doubt this will be necessary.

Going forward, the first new set of producer wells will be drilled on the productive 'Yule Lease' in November 2008. This gives us the confidence to anticipate continually increasing production rates from here on in with the cyclic steaming planned to be rolled-out field wide. Additionally permitting has been started for five additional wells on the other Tapia leases, which should be completed in the coming months with first drilling tentatively scheduled to begin in March, 2009.

Eureka Canyon Oilfield

A successful well clean-out and pump replacement operation was carried out at Eureka in June. Sefton has stated that this improved production from an average of 230bopm to 410bopm in July. Of course this will not have been reflected in the half-yearly figures, though we have altered our forecasts.

Sefton is planning a follow-up to last year's successful reconnaissance geochemical survey. Field -work is slated for September, to refine the sampling grid over the prospective areas that were identified in the initial survey.

An infield development well is planned for August 2009, with an exploration well to be drilled in 2010.

Mid-Continental Operations

Anderson/Franklin Counties Project

Sefton is planning to undertake a pilot drilling program in order to assess the coalbed methane potential of the company's acreage (40,000 net mineral acres) in Anderson and Franklin Counties, Kansas.

The limited local availability of gas pipelines has kept previous operators from exploring and completing gas wells. According to the Kansas State records only 50 gas wells have been completed in Franklin County, and only one in Anderson County.

However, this does not pose a problem for Sefton. Two pipelines owned by Enbridge and Panhandle cross the middle of Sefton's acreage, with a third pipeline owned by Southern Star crossing about 3 miles east of the acreage. Local infrastructure support therefore opens up sales and marketing avenues to Sefton should the area prove to be productive. Detailed coal maps and engineering analysis show that Sefton's acreage lies on the thicker, and potentially most productive areas, of the local Bevier and Riverton coal deposits, together with a number of conventional oil and gas possibilities.

Local operators have had mixed results. Early players such as Petrol Oil & Gas, Inc., in Coffey County and Meritage in Anderson County, abandoned their work. Although details of their studies, completion and production methods, gas and water flow rates, gas analysis, etc. are not available from public sources, we have discussed the potential problems with a number of industry experts. We understand that the early operators that have 'dropped out' may well have completed their wells from all potential intervals concurrently, whereas Heartland (which we believe to have a similar completion strategy to Sefton) appears to achieving success by completing isolated coal formations, as Sefton plans to do. Encouragingly, Heartland appear appears to be moving into the field development stage of its programme.

Preliminary Development Plan

Coal bed methane development programmes are effectively long-life economic resource plays maximising the returns on assets by understanding the engineering and economics of the play while working to minimising the costs of production.

The objective of the Sefton's pilot test program will be to determine gas deliverability and to estimate water production for water disposal considerations.

Wells will be drilled to define the gas resources present in as much detail as possible, using open-hole well logs and drill cutting analysis, before qualitatively evaluating the producing potential of the individual coal intervals. Each well will be drilled, cemented and cased then perforated sequentially in each of the target coal intervals before being stimulated. Artificial lift equipment and surface facilities will be installed, with the wells put on-production for a period of six weeks or more for each interval so meaningful data can be collected.

If the area's production is confirmed by the pilot test program, a comprehensive economic model will then need to be generated to evaluate the project further before full-scale field development.

Drilling and completion costs of the initial test wells are normally higher than for average production wells, since multiple zones are being stimulated and tested. Although the cost of an average production well is expected to be around USD \$150,000, we assume that test wells will cost around USD\$ 250,000 each, costing increases attributed to the collection of data.

Economic Rationale

We have been able to review an independent report covering an economic case study into developing a CBM project in this area. Of course the numbers are illustrative at this stage until the detailed work on (and under) the ground is carried out but nevertheless, they are worth considering.

From published core and drill cuttings analysis, the two main coal seams (the Bevier coal seam or Riverton coal seam) may each be expected to yield 0.08 bcf of gas per well drilled. The economic returns, assuming success for a single coal completion over a 50 well development program, (drilling at a rate of 5wells/ month for 10 months with a cost per well of \$USD 130,000/well) are summarised in Table 1 overleaf.

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Table 1 Illustrative economics for completing a single coal with a 50 well drilling program

	At \$USD 8 / MCF	At \$USD 9.5 / MCF
Total Net Reserves	4 Bcf	4 Bcf
Cumulative Cashflow	\$USD 19.4million	\$USD 24.9million
Discounted Pretax Payout (NPV₁₀)	\$USD 10.6million	\$USD 14.1million
Payout	1.5 years	1.4 years
Reserve Life	20 years	20 years
Internal Rate of Return	111%	156%

Assuming local gas marketing can be arranged the data shows that the economics stack up pretty well with a short payback term for the investment and reasonably long- life reserves.

In this example the potential for multiple coal seams has been ignored with the economic case based simply on completion of a single coal seam. Sefton already has sufficient acreage to develop a program for 250 wells should the pilot program prove successful.

Overall, the ingredients are there but it is still early days and extensive production tests will yet be required to determine the productivity of individual coals and prove the feasibility of the CBM projects. Lease acreages are cheap at the moment but should the test program prove successful real value may be added to the Anderson and Franklin programs either through development of the projects or through sale of the value-added assets.

Leavenworth County Project

The Leavenworth project is on the back-burner at the moment as the focus for TEG MidContinent is on Anderson Franklin Counties.

Company Financial Forecasts and Projections

As in our previous projections, all forecast revenues come from production at Tapia and Eureka. We are for the first time including some 'unconventional production' at Tapia, as additional wells will be steam-cycled over the period (possibly starting in Snow lease).

Effective post-steaming rates have seen increased production (but with variable increases in fluid rates due to lithology) as the engineers gain experience at optimising production. This being the case, we have pared back our estimates from the engineering projections to maintain a margin of comfort.

Using published data, and assuming drilling proceeds as planned, we anticipate net production in H2 to increase to around 40,000 barrels of oil. This assumes that all three Yule wells are drilled as planned and as oil producers. The fact that the new drilling announced is centred in the Yule lease, where production rates from new wells have been favourable, lends confidence to this assumption, (although highest production rates seen to date have been from the Hartje Lease).

The Snow wells drilled earlier this year were found to be in tighter reservoir sands – where acid stimulation has been required. We expect that future wells on the Snow lease will be acid-treated as a matter of course and possibly fracture stimulated –we understand Sefton may be looking to steam-cycle these Snow wells next.

Revenue Projections

Based on 40,000 net barrels production in H2, we expect revenues to rise to around \$USD 6.2m for the current financial year on \$USD 85 wellhead oil prices. Pricing is rather volatile at the moment, shall we say – but that is as good an assumption as any at this point and remains at some discount to current wellhead oil pricing.

Profits

On this basis we expect Sefton will be profitable to maybe around \$USD 2.1m EBIT – depending again upon drilling times and flush production rates. Our profit and loss forecasts assume no tax will be payable until FY 2009 where a subnormal levy would be charged based on the current tax loss carry-forward.

Capex and Cashflow

With the expansion of activities into the mid-continent, we expect capital investment of approximately \$USD 5.2m during current financial year. These expenditures will fully fund further investment in the new wells at Tapia, the geochemical survey at Eureka, the "huff-

'n-puff" program and the Kansas pilot drilling programme. We are not, as yet producing forecasts beyond this current financial period.

Valuation

Our last published valuation for Sefton's Californian assets was \$USD 24.1m, with an upside to \$USD 67m assuming cyclic steam and steam-flood recoveries were implemented. This was based on an oil price for 2008 of \$USD 70 falling to \$USD 65 flat forward from 2009.

			Undiscounted	Discounted
		000 bbl	USD\$	at 10% USD\$
Tapia	PDP	188.5	7,978,992	3,718,789
	PDNP	46	779,940	296,677
	PUD	1,040	44,426,745	23,833,894
		1,274.5	53,185,677	27,849,360
Cyclic Steam		1028	51,812,921	31,165,492
Steam Flood		1551	67,187,910	21,877,379
Total Tapia		3,853.5	172,186,508	80,892,231
Eureka	PDP	19.5	513,793	351,692
	PUD	71	2,291,639	586,489
Total Eureka		90.5	2,805,432	938,181
Total California		3944	174,991,940	81,830,412

Our new valuation takes into account recent production (to mid year) but also ups the price bench used, assuming a flat forward wellhead price of \$USD85, which is consistent with the pricing we have assumed for our P&L forecasts beyond the present. These changes give us a new core value for the Californian assets of USD\$ 28.7m (11.8p/share) with an upside with enhanced recovery to USD\$ 81.8m (33.6p/share).

It is too early to put a meaningful value on the Kansas assets, but with the drilling program set to begin, once data is forthcoming this will change. In California, the values placed on Tapia Field should increase significantly when higher recoveries from steaming are factored into new engineering data. Enhanced recovery may well yield closer to 80% of oil in place rather than the 50% or so currently accounted for, so it's a bit of a case of 'watch this space' until the next major engineering review.

P &L Forecasts

Y/E December USD\$000	2005a	2006a	2007a	2008e
Turnover	1,810	2,696	2,978	5,976
operating costs	(282)	(834)	(673)	(1,043)
DD& A (net)	(112)	(314)	(305)	(612)
Gross profit	1,416	1,548	2,000	4,321
Gross margin	78%	57%	67%	72%
General and Administrative	(1,713)	(1,479)	(1,520)	(1,824)
Exceptional	(267)	0	0	0
Share Based Compensation	0	(448)	(197)	(250)
Operating Profit/Loss EBIT	(564)	(378)	283	2,247
Interest Receivable	15	7	0	15
Interest Payable	(84)	(186)	(79)	(150)
Net Interest	(69)	(180)	(78)	(135)
FOREX	(11)	(57)	0	0
Discontinued Operations	(88)	22	0	0
Earnings Before Tax	(732)	(593)	205	2,112
Tax Charge	0	0	0	0
Tax Charge %	35%	34%	34%	34%
Earnings After Tax	(732)	(593)	205	2,112
Effective Tax Rate %	0%	0%	0%	0%
Dividends	0	0	0	0
Retained Earnings	(732)	(593)	205	2,112
Earnings Data				
Weighted av. number of shares in issue	99,558	105,488	115,110	116,214
Actual number of shares in issue		105,488	115,110	116,388
Number of shares fully diluted	108,991	113,688	133,646	137,646
Basic FRS3 EPS cents	(0.736)	(0.562)	0.178	1.835
Adj. FRS3 EPS cents	(0.736)	(0.562)	0.178	1.835
Adj. EPS fully diluted FRS14 cents	(0.736)	(0.562)	0.153	1.580

Cashflow Forecasts

Y/E December USD\$000	2005a	2006a	2007a	2008e
Cashflows from operating activities				
Operating profit/loss	(732,464)	(592,777)	204,652	2,111,847
DD&A	237,713	433,145	304,965	612,002
Exceptional and adjustment	414,735	0	0	0
Share Based compensation	0	447,957	197,220	250,000
Gain on Disposal of Subsidiary	0	(14,866)	0	0
Change in Working Capital	82,642	(227,807)	9,371	0
Operating cash flow	2,626	45,652	1,216,208	2,973,850
Cashflows from investing activities				
Purchase of oil and gas properties	(3,314,760)	(738,790)	(2,184,816)	(5,150,000)
purchase of property and equipment	(25,951)	(27,492)	(4,857)	0
proceeds from disposal of subsidiary	0	284,728	0	0
net cash transferred with subsidiary	0	(18,060)	0	0
	(3,340,711)	(499,614)	(2,189,673)	(5,150,000)
Net cashflow before financing	(3,338,085)	(453,962)	(973,465)	(2,176,150)
Cashflow from Financing				
Share capital issues (net)	0	38,944	109,486	50,000
Issue of Debt	360,980	376,315	948,318	2,500,000
Proceeds from sale of minority interest	722,071	0	0	0
Repayment of Debt	(93,484)	(75,176)	(147,473)	0
Net Financing	989,567	340,083	910,331	2,550,000
Effect of exchange rate changes	(10,886)	56,693	0	0
Movement in net cash/(net debt) in period	(2,359,404)	(57,186)	(63,134)	373,850
Opening net cash (net debt)	2,485,513	126,109	68,923	5,789
Closing net cash (net debt)	126,109	68,923	5,789	379,639

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Management	Major Shareholders
<p>Jeremy Delmar-Morgan - Non-executive Director; Chairman of the Board, Sefton:</p>	<p>J Ellerton (inc J Ellerton Consultants) 4,780,247 4.1%</p>
<p>Jim Ellerton - Chief Executive Officer Sefton; Chairman, TEG USA, Inc & TEG Midcontinent.</p>	<p>J. Delmar Morgan 4,630,178 3.99%</p>
<p>Harry Barnum - Executive Director, Sefton; President, TEG USA, Inc.</p>	<p>A. Ashton 948,237 0.8%</p>
<p>Bruce Mackay - Executive Director, Sefton; President, TEG Mid-Continent</p>	<p>H.Barnum 380,955 0.3%</p> <p>B.Mackay 160,014 0.1%</p>
Key Dates	Key Milestones
<p>31/Dec 2008 Year end</p>	<p>2007 Headline profit achieved, steam generator built. 2008 Successful huff 'n puff steaming at Tapia Announcement of works to test CBM acreage while continuing Californian development.</p>

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