Trickle Research

Every raging river, every great lake, every deep blue sea starts … with a trickle

Q3F22 Earnings Update

ALVOPETRO

Alvopetro Energy Ltd.

(TSXV:ALV.V; OTC:ALVOF)

http://alvopetro.com/

Report Date: 11/22/22

12- 24 month Price Target: USD $7.00

Allocation: 7

Closing Stock Price at Initiation (Closing Px: 11/07/18): USD $1.14 (Post Split)

Closing Stock Price at Allocation Upgrade (Closing Px: 05/17/19): USD $1.26 (Post Split)

Closing Stock Price at Target Upgrade (Closing Px: 05/26/20): USD $1.56 (Post Split)

Closing Stock Price at Price Target and Allocation Upgrade (Closing Px: 02/11/21): USD $1.87 (Post Split)

Closing Stock Price at Target Upgrade (Closing Px: 09/29/21): USD $3.57

Closing Stock Price at This Allocation Upgrade (Closing Px: 03/15/22): USD $3.75

Closing Stock Price at This Update (Closing Px: 11/21/22): USD $4.93

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Disclosure: Portions of this report are excerpted from Alvopetro's filings, website(s), presentations or other public collateral. We have attempted to identify those excerpts by *italicizing* them in the text.

For Q3F22, Alvopetro reported resource sales of US$16.7 million, and net income of US$8.8 million. Those compared to our estimates of US$15 million and US$8.1 million respectively. Clearly, this was another strong/record quarter. Higher than projected sales were largely the result of them delivering more gas than we anticipated. Recall, in our last update, we noted that as we understood it, we expected their partner at Caburé to utilize a larger portion of the collective gas effectively leaving less for Alvopetro to sell. We obviously overstated the trajectory of that. (In retrospect one of our subscribers suggested we may be overstating that. As it turned out he was right about that). As we also noted in that update, we expect Murucututu to make increasingly larger contributions to collective sales volumes. However, again, we are modeling smaller contributions from Caburé under the assumption that their partner may use increasing portions, but from a practical standpoint, it may not matter where it comes from in the near to intermediate terms because while the Company recently boosted its daily delivery threshold to 18,000 Mcf per day, they are *already bumping up* against that threshold. For instance, they announced October sales production of 2,720 boe per day, which translates to 16,320 Mcf per day. Clearly, if Murucututu continues to add production as we expect, they will be at the threshold *soon*. The Company alluded to that on the call.

As an extension to the above, our approach to the model is to assume for the balance of 2022 and 2023, that they essentially produce at or near the threshold. To reiterate, that requires that they **collectively** (Caburé plus Murucututu) produce to the 18,000 Mcf per day threshold, which we think they can. It also requires that the threshold stays there for some period. To translate, the Company has stated that their longer-term vision is to deliver 35,000 Mcf per day and we think they will work to once again modify the agreement (and upgrade their facilities) to do so. On a related note, if we understood it correctly, the Company suggested that they believe demand for their gas is beyond their current capacity. That said, from a modeling perspective, we are assuming the 18,000 Mcf per day threshold remains through 2023, although our sense is that may change through 2023. We will monitor progress in that regard, but from a conservative bend, we have adjusted our 2023 projections around that threshold. To be clear, if we had reasonable visibility to production/sales of 35,000 Mcf per day, our targets would be north of US$12 per share. Again, we believe those production levels would require a revision to the City Gate sales agreement and some enhancements to infrastructure, as well as increased Murucututu production, new production from Caburé C and/or new production from their conventional project.

We noted in our last update that "*we think the focus, (both on and at), Alvopetro is shifting gears. Since we initiated our coverage nearly 4 years ago, the focus was on getting their share of the Caburé gas asset to the marketplace. That endeavor led to their gas sales agreement, the building of infrastructure to deliver it, and ultimately, sales, cashflow, profits and dividends. However, the Company is now set on developing additional production assets…"*. As we delineated above, driving valuations to our targets and/or higher, requires additional production beyond the legacy Caburé asset and management has positioned the Company to perhaps garner added production from multiple potential projects. One of these (Murucututu) is producing today. That said, what is perhaps worth remembering here is that management's expertise has been in exploring, finding, developing and monetizing hydrocarbon assets. Put another way, while they have spent the past several years establishing a sales conduit for gas they had already identified at Caburé, the emerging focus here is in finding, developing and monetizing, new production which is essentially their wheelhouse. We submit, the fact that they have done this before (discovered and put resources into production) does not necessarily mean they will do it again, but given the choice, we would rather bet on "been there done that" than the alternative. We believe they will develop production from additional assets in some combination of the current endeavors. We would add, the conventional resources they are currently drilling and testing have the potential to create a watershed valuation event for Alvopetro.

Beyond operations, there was a question raised on the call regarding the geopolitical posture of Brazil following elections that essentially moved the country's political needle to the left. They addressed that with some commentary from Frederico Oliveira the Company's Country Manager in Brazil. To be honest, we were not able to understand much of the commentary, and the transcript apparently experienced similar challenges, but we have a few insights of our own in that regard. First, while close, the recent Brazilian elections saw the nation elect Lula over Bolsonaro, which is a clear move to the left. Some have likened it to the U.S. elections of 2020, which raises the specter of more government control of the economy in general, which could include things higher taxes, especially perhaps on resource-based industry, and/or by extension, perhaps more draconian scenarios such as nationalization of assets like energy. While we may be on the glass half full side of things here, we think there are a handful of important reasons why this may not be markedly negative for Alvopetro.

First, as they noted on the call, because of their pricing collar, wherein they have been selling gas at the upper threshold of the collar but below otherwise prevailing prices, we think Alvopetro is a relatively low-cost provider of energy in Brazil. We actually think that notion (getting less than market for their gas) may be part of what we see as the discount in Alvopetro shares relative to what we view as its intrinsic value, but that is a conversation for another day. That said, we think under the current collar scenario, Alvopetro is probably a bit of a darling. We submit, if energy prices retrace to the point where they are selling gas at the low end of the collar (higher than prevailing prices), that could be more problematic, but for now, we think buyers of Alvopetro gas are likely quite happy.

Second, we are not sure the more draconian scenarios (nationalizing the Brazilian energy complex for instance) is particularly likely. We understand they have a new left government, but keep in mind that government came to power with a relatively small margin, which is not exactly a broad endorsement of Brazilian socialism. Granted, we have seen the current U.S. administration enact progressive legislation and/or edicts, with a similar slim majority, including perplexingly putting a lid on its own energy sector and resulting energy independence, so we are not saying Lula cannot make it more challenging for private concerns in Brazil, we just do not think he has the required mandate to make the kind of changes that might be catastrophic for companies like Alvopetro. From another perspective, energy remains king, so while political winds will always remain unpredictable, the need for energy will not. Again, we have seen governments around the world challenging the energy status quo, be forced to reassess some of their policies and goals as the reality of those challenges have begun to set in. From another perspective, as we addressed in the initiating coverage, some of Alvopetro's openings in the Brazilian energy markets are the result of the scandal that plagued Brazil's de facto state-owned energy company Petrobras. That scandal led to the divestiture of portions of Petrobras (especially onshore domestic projects). While we will never say never, it seems unlikely to us that Brazil would be eager to revisit that mess.

In a nutshell, we submit, we are not convinced the new government will necessarily be bad for a company like Alvopetro, but it is also hard for us to imagine that it will be good for them either. The geopolitical landscape of Brazil remains a topical risk, which leads us to our next point.

As we have covered in the past, the exchange rate of the Brazilian Real relative to both the U.S. and the Canadian Dollars, creates some risks. Throughout our coverage, there have been some significant exchange rate adjustments (positive and negative), that have impacted the results. Further, those changes impact multiple line items of the financial statements. To reiterate, we do not attempt to anticipate/model those adjustments. Here again, we suspect the specter of those adjustments has contributed to what we see as discounting of the shares at times in the past. Obviously, exchange risks will remain topical going forward, so that may always be a headwind for the stock, although they can certainly continue to pursue strategies to mitigate that.

Lastly, prior to the Company's earnings call they announced a 50% increase in their dividend from US$.08 to US$.12. At current prices, that should put the dividend yield at something around 10%. Further, they also announced their intention to launch a normal course issuer bid ("NCIB"), which is Canadian parlance for a share buyback program. We think both of those initiatives will prove positive for the stock price *one way or the other*. Moreover, these initiatives represent the manifestation of the Company's goals to distribute meaningful portions of their cashflow back to shareholders. In short, they just keep winning.

In summary, Alvopetro continues to execute on its plan to grow and distribute cashflow resulting in what to this point has been sequential record performance. That said, as we suggested, the focus and likely future valuation, is now moving toward the development and commercialization of *new* resources, which includes three projects, some of which (Murucututu) are currently contributing to production. Moreover, we think the development work of the conventional assets has the potential to create a watershed valuation catalyst if it is successful and we think the Company remains quite constructive around that potential. Further, visibility in that regard may not be far off. From another perspective, we think the market may be a bit *too focused* on the conventional assets. Put another way, we think the shares remain undervalued at current levels, regardless of success or failure in the conventional piece. We could be wrong about that, but we think current production visibility supports that conclusion.

We are maintaining our allocation of 7 and our 12-24 month price target of US$7.00, for Alvopetro shares. We will revisit each as data points emerge. We would also view weakness in the stock (for no particular fundamental reason) opportunistically.

Projected Operating Model

Alvopetro Energy Ltd.						
Projected Operating Model (in USD - '000s)						
By Trickle Research LLC						
	Actual	Actual	Actual	Estimate	Estimate	Estimate
	3/31/22	6/30/22	9/30/22	12/31/22	Fiscal 2022	Fiscal 2023
Oil & Gas Sales	$ 13,972	$ 15,787	$ 16,672	$ 17,336	$ 63,766	$ 75,371
Royalties and Production Taxes	$ (979)	$ (1,148)	$ (1,318)	$ (1,560)	$ (5,005)	$ (6,783)
					$ -	$ -
Oil & Gas Revenue	$ 12,993	$ 14,639	$ 15,354	$ 15,775	$ 58,761	$ 68,587
Midstream Transportation Revenues	$ -	$ -	$ -	$ -	$ -	$ -
Other Income	$ 141	$ 185	$ 240	$ -	$ 566	$ -
Total Revenue and Other Income	$ 13,134	$ 14,824	$ 15,594	$ 15,775	$ 59,327	$ 68,587
					$ -	$ -
Production	$ 853	$ 907	$ 812	$ 839	$ 3,411	$ 2,932
Transportation	$ -	$ -	$ -	$ -	$ -	$ -
General & Administrative	$ 1,208	$ 1,094	$ 1,135	$ 1,283	$ 4,720	$ 5,284
Depletion and Depreciation	$ 1,819	$ 1,279	$ 1,771	$ 1,497	$ 6,365	$ 6,352
Impairment	$ -	$ -	$ -	$ -	$ -	$ -
Exploration and Evaluation	$ -	$ -	$ -	$ -	$ -	$ 4,000
Finance Expenses and Interest	$ 650	$ 595	$ 628	$ 486	$ 2,359	$ 1,512
Accretion of Decommissioning Liabilities	$ -	$ -	$ -	$ -	$ -	$ -
Share Based Compensation	$ 250	$ 184	$ 158	$ 200	$ 792	$ 800
Foreign Exchange Loss	$ (5,009)	$ 2,967	$ 688	$ -	$ (1,354)	$ -
Loss on Disposition of Assets	$ -	$ -	$ -	$ -	$ -	$ -
Risk Management Expenses	$ 90	$ 2	$ -	$ -	$ 92	$ -
Total Operating Expenses	$ (139)	$ 7,028	$ 5,192	$ 4,305	$ 16,386	$ 20,880
Interest Expenses	$ -	$ -	$ -	$ -	$ -	$ -
Other Non-Operating Expenses	$ -	$ -	$ -	$ -	$ -	$ -
Total non-operating Expenses	$ -	$ -	$ -	$ -	$ -	$ -
Gain (Loss) Before Taxes	$ 13,273	$ 7,796	$ 10,402	$ 11,470	$ 42,941	$ 47,708
Income Tax Charge (Recovery)	$ 2,158	$ 1,165	$ 1,607	$ 1,749	$ 6,679	$ 7,275
Net Income	$ 11,115	$ 6,631	$ 8,795	$ 9,721	$ 36,262	$ 40,432
Exchange (loss) gain on translation of foreign operations	$ 3,951	$ (2,587)	$ (683)	$ -	$ 681	$ -
Comprehensive (loss) gain	$ 15,066	$ 4,044	$ 8,112	$ 9,721	$ 36,943	$ 40,432
Net Gain (Loss) per share						
Basic	$ 0.33	$ 0.20	$ 0.26	$ 0.27	$ 1.07	$ 1.12
Diluted	$ 0.30	$ 0.18	$ 0.24	$ 0.26	$ 1.00	$ 1.09
Shares O/S - Basic	33,942,744	33,973,000	34,433,913	36,213,908	34,640,891	36,235,208
Shares O/S - Diluted	36,546,229	36,637,000	36,938,695	37,122,446	36,811,092	37,165,308

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There are no letters in the rating system (Buy, Sell Hold), only numbers. The numbers range from 1 to 10, with 1 representing 1 "investment unit" (for my performance purposes, 1 "investment unit" equals $250) and 10 representing 10 investment units or $2,500. Obviously, a rating of 10 would suggest that I favor the stock (at respective/current levels) more than a stock with a rating of 1. As a guideline, here is a suggestion on how to use the allocation system.

Our belief at Trickle is that the best way to participate in the micro-cap/small cap space is by employing a diversified strategy. In simple terms, that means you are generally best off owning a number of issues rather than just two or three. To that point, our goal is to have at least 20 companies under coverage at any point in time, so let's use that as a guideline. Hypothetically, if you think you would like to commit $25,000 to buying micro-cap stocks, that would assume an investment of $1000 per stock (using the diversification approach we just mentioned, and the 20-stock coverage list we suggested and leaving some room to add to positions around allocation upgrades. We generally start initial coverage stocks with an allocation of 4. Thus, at $1000 invested per stock and a typical starting allocation of 4, your "investment unit" would be the same $250 we used in the example above. Thus, if we initiate a stock at a 4, you might consider putting $1000 into the position ($250 * 4). If we later raise the allocation to 6, you might consider adding two additional units or $500 to the position. If we then reduce the allocation from 6 to 4 you might consider selling whatever number of shares you purchased with 2 of the original 4 investment units. Again, this is just a suggestion as to how you might be able to use the allocation system to manage your portfolio.

For those attached to more traditional rating systems (Buy, Sell, Hold) we would submit the following guidelines.

A Trickle rating of 1 thru 3 would best correspond to a "Speculative Buy" although we would caution that a rating in that range should not assume that the stock is necessarily riskier than a stock with a higher rating. It may carry a lower rating because the stock is trading closer to a price target we are unwilling to raise at that point. This by the way applies to all of our ratings.

A Trickle rating of 4 thru 6 might best (although not perfectly) correspond to a standard "Buy" rating.

A Trickle rating of 7 thru 10 would best correspond to a "Strong Buy" however, ratings at the higher end of that range would indicate something that we deem as quite extraordinary..... an "Extreme Buy" if you will. You will not see a lot of these.