Trickle Research

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

# 2QF23 Earnings Update, Price Target Upgrade and Allocation Downgrade

## Alvopetro Energy Ltd.

**(TSXV:ALV.V; OTC:ALVOF)**

**http://alvopetro.com/**

## Report Date: 08/16/23

### 12- 24 month Price Target: USD *$10.00

### Allocation: **6

**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 Price Target Increase (Closing Px: 03/27/23): USD $5.30**

**Closing Stock Price at This Target Increase (Closing Px: 08/15/23): USD $7.90**

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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.

While it is just a quarterly earnings report, and the associated call was relatively short, we think there some new wrinkles with regards to Alvopetro that we will attempt to cover, but first, the numbers.

For 2QF23 Alvopetro reported revenues of US$13.9 million, Pre-tax Net Income of US$11.65 million and basic EPS of US$.27 per share. Those compare to our estimates of US$18.8 million, US$12.7 million and US$.30 respectively. Obviously, revenues were markedly short of our estimates, which is not what we were expecting, although it also is not a complete surprise. We will elaborate on that further in this update.

Despite the revenue shortfall, EPS came in much closer to our estimates than we would have expected given the top line divergence ($.27 versus $.30). From another angle, while revenues came in at just 73% of our estimate, EPS reflected 90% of our estimate. Drilling down, some of the mitigation was in G&A, which was notably lower than we estimated, but the bulk of the explanation for why earnings did not suffer more given the revenue miss was related to the relative strength of the Brazilian Real which led to forex adjustments that made up much of the shortfall. That also included better than anticipated realized gas sale prices, which are also partially impacted by exchange rates. Those who have followed the story for some time will recall, there have been quarters that were negatively impacted by forex rates as well, in fact we spent some time in a prior update discussing Brazil's new government and what impact that may or may not have on Alvopetro because we believed it created some concerns at the time. To reiterate, not to suggest that we do not think exchange rates matter, but we do not generally attempt to model changes in exchange rates so they do sometimes provide some surprises regarding our estimates. That noted, the most pertinent question is probably "why the revenue miss?", and we addressed some of the reason for that in a prior bit of research as well. From our update from August 2022:

> *"… it sounds like they may be sending a bit less Caburé gas to the city gate than in the recent past, largely because their partner at Caburé expects to access a larger portion of their share. The net of these developments is that the second half of F22 should reflect lower Caburé sales than the first half...".*

In retrospect, we modeled some of that decreased production in subsequent quarters and that approach ended up being premature. However, that is the basis for the revenue miss today, so again, it is not totally unexpected. We knew, sooner or later, this issue would impact production, and here we are. Further, at this point, Alvopetro has sold a considerably larger portion of their share of Caburé than their partner, so the modeling/projections require cognizance of Alvopetro's remaining share.

So those are the numbers for the quarter, however, as we referenced above there are several other things going on at Alvopetro, and the bottom line to that in our view, is that the story is becoming a bit more complex. We will attempt to unpack some of that.

First, historically the analysis of Alvopetro has been relatively straightforward. Recall, when we initiated coverage of the Company, Alvopetro had already established ownership of roughly 49.1% of the Caburé project, which represented a considerable resource and by extension reserve value. What they did not have was a customer and/or the infrastructure to deliver the gas. As a result, unlike most oil/gas enterprises, the analysis of Alvopetro was not about identifying and lifting the resource, but rather securing a customer and building the infrastructure to service them. The Bahiagas gas sale agreement represented a portion of that answer, while the Enerflex infrastructure agreement represented the other portion. Thereafter, the analysis was reduced to trying to figure out when they would be able to permit and build the infrastructure to ultimately deliver Caburé gas to the Bahiagas City Gate. In the meantime, along with their partner, they also continued to develop (and expand) the resource at Caburé adding to the value of the collective assets of the enterprise. Frankly, while attempting to project their pricing under the sales agreement (in the context of the oil and gas commodity indexes that determined them) always involves some challenges, modeling/projecting their production was relatively straightforward.

Second, while Caburé was the initial focus of the Company's production, the necessity to develop additional resources to replace the eventual depletion of Caburé was the next phase of the story. Murucututu represents that next phase. Again, in retrospect when we initiated the coverage, we did not include Murucututu in our assumptions because we had little visibility at the time. Rather, our approach at that time was to value the depletion of Caburé, but we also provided what we thought was an added portion for what we believed at the time might be the potential for midstream revenues from the infrastructure. In other words, we felt the midstream assets could provide value beyond Caburé. With (increasing) resource information from Murucututu, our valuation analysis and resulting targets have evolved with those data points. Obviously, the buildout and ultimate production from Murucututu is critical to the ongoing success and valuation of Alvopetro. Moreover, the timing of the decline of one and the ramp of the other will impact quarterly results. As we noted, the analysis will likely get more difficult from here as we try to model those dynamics.

Third, as we covered in prior updates, the Company recently completed their gas plant expansion, which increased their delivery capacity to 18,000 mcf/day. The Company notes that they hope to double that capacity in the future. Recognize, until that expansion occurs, they could be constrained by the current capacity. Clearly, that would require a more aggressive production ramp at Murucututu (or perhaps at the Unit C expansion at Caburé), but regardless, that is an issue that could be topical over the coming quarters. To be clear, our current models reflect long(er) term peak production that is considerably less than the 35,000 mcf/day goal. Thus, it follows that *if* Alvopetro is in fact able to approach production that would support a doubling of their delivery capacity, they will likely outrun our projections and associated targets. We look forward to that possibility.

Fourth, the Company continues to develop properties beyond Murucututu. Recall, they have announced the results of some of their activities in the "conventional" assets, which to date have not resulted in recoverable assets. Frankly, we have always looked at this as the "swing for the fences" portion of the story since success in that regard could provide an entirely new valuation leg. We do not view (nor do we think the Company views) the early challenges as indicative of the ultimate potential of these assets. Our modeling and associated targets do not include contributions from these assets.

Fifth, as the Company covered in their call, they have achieved positive results from their Bom Lugar development area. To be honest, prior to some of the more recent discussions regarding their work at Bom Lugar, we did not have this on our radar as a likely contributor to future production. Further, while they noted that they are now completing a well and putting it into production, we have not included that in our modeling, but will do so as soon as they provide a few more data points. As a result, that could create some positive surprises relative to our models.

Sixth, commodity prices remain a wild card. As most are aware, the Company's gas sale agreement include ceilings and floors and pricing is based on a backwards look at a basket of energy proxies. Energy prices have been quite volatile over the past several quarters, especially particular portions of the formula, so that volatility translates into Alvopetro's results and into the modeling as well. We expect that volatility to continue. Clearly, misses regarding future prices will impact the accuracy of the models and potentially the associated targets.

Lastly, aside from their robust dividend policy, the Company also has a stock repurchase program in place. If our model proves relatively accurate, the Company is going to accumulate considerable cash balances going forward. Granted, they could certainly choose to increase dividends, but we tend to believe that stock repurchases could prove optimal and may become a growing portion of the disposition of cash going forward. We *have* attempted to model some buybacks. That is just one more wrinkle we need to be cognizant of going forward.

To summarize, as we laid out above, beyond our initiating coverage, there are several new "moving parts" to the Alvopetro story that we think make the analysis more complex going forward. From another perspective, in our view, Alvopetro has spent much of the time since our initiation trading at levels that we believed represented a significant discount to its identifiable value, and as such we did not feel like we were particularly aggressive when it came to our targets (which were multiples of the prevailing stock prices). However, we submit, with the recent appreciation of the shares, which breached our price target of $7.75, we must sharpen our pencils a bit more when it comes to supporting subsequent allocations and targets. Again, given the added "moving parts", that endeavor is becoming more challenging. On the other hand, as we look at the Company's progress on the exploration, development and new production fronts over the past few quarters, we are comfortable arguing new, higher targets. As added support to that end, we reiterate a point we raised in a prior update. As we noted, while much of Alvopetro's success since our initiation has centered on establishing an iron clad, long term, price protected buyer for their Caburé gas, management's legacy success has largely been in identifying and developing new resources. We think that legacy will support our new target, as well as perhaps additional target increases in the future. Given the above, we are establishing a new 12-24 month price target of *$10.00. In addition, we are reducing our allocation from 7 to **6 based on the recent appreciation of the stock. To be clear, the prior allocation of 7 represented the highest allocation in our coverage universe. We will revisit our targets and our allocation as new information arises.

# Projected Operating Model

| **Alvopetro Energy Ltd.**<br>**Projected Operating Model (in USD - '000s)**<br>**By Trickle Research LLC** | Actual | Actual | Estimate | Estimate | Estimate | Estimate |
|---|---|---|---|---|---|---|
| | **3/31/23** | **6/30/23** | **9/30/23** | **12/31/23** | **Fiscal 2023** | **Fiscal 2024** |
| Oil & Gas Sales | $ 18,160 | $ 13,914 | $ 14,170 | $ 14,477 | $ 60,722 | $ 74,344 |
| Royalties and Production Taxes | $ (582) | $ (354) | $ (496) | $ (507) | $ (1,939) | $ (2,602) |
| | | | | | $ - | $ - |
| Net Oil & Gas Revenue | $ 17,578 | $ 13,560 | $ 13,674 | $ 13,971 | $ 58,783 | $ 71,742 |
| Other Income | $ 427 | $ 477 | $ 250 | $ 250 | $ 1,404 | $ 1,000 |
| Total Revenue and Other Income | $ 18,005 | $ 14,037 | $ 13,924 | $ 14,221 | $ 60,187 | $ 72,742 |
| | | | | | $ - | $ - |
| Production | $ 988 | $ 1,048 | $ 933 | $ 809 | $ 3,778 | $ 3,451 |
| General & Administrative | $ 1,222 | $ 1,286 | $ 1,254 | $ 1,362 | $ 5,124 | $ 5,559 |
| Depletion and Depreciation | $ 2,144 | $ 1,711 | $ 1,725 | $ 1,731 | $ 7,311 | $ 7,819 |
| Impairment | $ - | $ - | $ - | $ - | $ - | $ - |
| Exploration and Evaluation | $ 82 | $ - | $ - | $ - | $ 82 | $ - |
| Finance Expenses and Interest | $ 403 | $ 389 | $ 350 | $ 350 | $ 1,492 | $ 1,400 |
| Accretion of Decommissioning Liabilities | $ - | $ - | $ - | $ - | $ - | $ - |
| Share Based Compensation | $ 283 | $ 281 | $ 200 | $ 200 | $ 964 | $ 800 |
| Foreign Exchange Loss | $ (1,374) | $ (2,331) | $ - | $ - | $ (3,705) | $ - |
| Loss on Disposition of Assets | $ - | $ - | $ - | $ - | $ - | $ - |
| Risk Management Expenses | $ - | $ - | $ - | $ - | $ - | $ - |
| | | | | | | |
| Total Operating Expenses | $ 3,748 | $ 2,384 | $ 4,463 | $ 4,452 | $ 15,047 | $ 19,029 |
| | | | | | | |
| Interest Expenses | $ - | $ - | $ - | $ - | $ - | $ - |
| Other Non-Operating Expenses | $ - | $ - | $ - | $ - | $ - | $ - |
| Total non-operating Expenses | $ - | $ - | $ - | $ - | $ - | $ - |
| | | | | | | |
| Gain (Loss) Before Taxes | $ 14,257 | $ 11,653 | $ 9,461 | $ 9,769 | $ 45,140 | $ 53,713 |
| | | | | | | |
| Income Tax Charge (Recovery) | $ 2,055 | $ 1,801 | $ 1,443 | $ 1,490 | $ 6,789 | $ 8,191 |
| | | | | | | |
| Net Income | $ 12,202 | $ 9,852 | $ 8,019 | $ 8,279 | $ 38,352 | $ 45,522 |
| | | | | | | |
| Exchange (loss) gain on translation of foreign operations | $ 616 | $ 1,609 | $ - | $ - | $ 2,225 | $ - |
| | | | | | | |
| Comprehensive (loss) gain | $ 12,818 | $ 11,461 | $ 8,019 | $ 8,279 | $ 40,577 | $ 45,522 |
| | | | | | | |
| Net Gain (Loss) per share | | | | | | |
| | | | | | | |
| Basic | $ 0.34 | $ 0.27 | $ 0.22 | $ 0.23 | $ 1.06 | $ 1.27 |
| Diluted | $ 0.33 | $ 0.26 | $ 0.22 | $ 0.22 | $ 1.03 | $ 1.24 |
| | | | | | | |
| Shares O/S - Basic | 36,322,948 | 36,491,775 | 36,342,988 | 36,197,117 | 36,338,707 | 35,846,534 |
| Shares O/S - Diluted | 37,469,951 | 37,389,731 | 37,249,946 | 37,112,902 | 37,305,633 | 36,783,532 |

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**Rating System Overview:**

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.**