Trickle Research

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

3QF23 Earnings Update

ALVOPETRO

Alvopetro Energy Ltd.

(TSXV:ALV.V; OTC:ALVOF)

http://alvopetro.com/

Report Date: 11/10/23

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 Target Increase & Allocation Decrease (Closing Px: 08/15/23): USD $7.90

Closing Stock Price at This Update (Closing Px: 11/09/23): USD $6.55

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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 3QF23 Alvopetro reported revenues of US$12.3 million, pre-tax Net Income of US$6.4 million and basic EPS of US$.16 per share. Those compare to our estimates of US$14.2 million, US$9.5 million and US$.16 respectively. Revenues were again short of our estimates, which the Company has addressed both prior to, as well as in conjunction with, the quarterly filing so the miss was not a surprise. Succinctly, the Company noted that the revenue shortfall was driven by a decrease in demand from their customer (Bahiagás), which they in turn attributed to Bahia's miscalculation of demand from *their* customers. We would add, because of the "Take-or-Pay" nature of Alvopetro's sales agreement with Bahia, the sales shortage must be made up in future periods, and if our understanding of the accounting is correct, the sales shortfall below the Take-or-Pay threshold, resulted in about $400,000 worth of revenue against the roughly $1.9 million revenue miss. The Company also notes that Bahia demand for October has normalized back to levels in or around 2QF23. Keep in mind, the (higher) 6-month pricing reset occurred in Q3F23, so revenues for Q3F23 (and ostensibly Q4F23) were/will be positively impacted on a comparative basis. Further, to reiterate, we do not attempt to model forex impacts in our models, but forex adjustment made up about ½ ($1.5 million) of the earnings shortfall.

The above noted, in our last Q2F23 update, we reflected that in prior quarters we attempted to handicap our estimates for reductions in nominated working interests of their share of the Caburé field production. To edify, Alvopetro has cumulatively taken a larger portion of their share of the Caburé gas than their partner. As a result, in any given period, they may have to yield to their partner in terms of gas they are able to sell to Bahia. Again, that event impacted 2QF23 (a bit later than we anticipated), but it will likely continue to be an issue that may impact future quarters until either Caburé produces more gas into the future than reserves currently imply thus adding to Alvopetro's "share", or Alvopetro simply exhausts its share of the field. By the way, we have modeled, and our targets imply the (eventual) latter of those two scenarios.

While the Company indicates that the revenue shortfall was the result of unanticipated decreases in gas demand from Bahia's customers, we think it is important to recognize that there may be instances where Bahiagás *could be* compelled to buy gas from producers other than Alvopetro. As Q3F23 illustrated, Bihagas does have minimum requirements under that take-or-ay stipulations, but that threshold is also less than the future Bahiagás demand anticipated by our models, and by Alvopetro management's goals, i.e. their plans to get deliveries to 18 mmcf/day (and beyond). Recognize, the collars around the Bahiagás sales agreement have the potential to create situations where Bahiagás is paying Alvopetro considerably less than prevailing market prices for gas (such as in portions of 2020), or considerably more than the prevailing market for gas (which has occurred more recently). Those scenarios are the result of the ex post nature of the sales price resets in conjunction with marked volatility in the prices of the energy proxies used to derive the sales agreement prices. For instance, if current energy proxy prices are lower than today than they were six months ago, there is a chance that spot gas prices in Brazil may be lower than the reset price Bahiagás must pay to Alvopetro. In that case, Bahiagás could conceivably choose to purchase the minimum amount of gas stipulated in the sales agreement from Alvopetro, and the balance from someone else. Ultimately, those volatile proxy prices would wash through the analysis, making the reset price more competitive, but again, that is a situation that *could impact* a quarter or two along the way.

To summarize the above, as noted in one of the past updates, there are some additional complexities that are beginning to work their way through the Alvopetro story, which, along with higher share prices, require a sharper pencil in terms of the analysis. While the above nuances are certainly part of that complexity, the greater emerging variable here remains the reserve picture and by extension Alvopetro's ability to maintain and grow future production. Put another way, while the past two quarters have included some items that have impacted quarterly revenues, we suspect that in general, Alvopetro *will be able to sell* whatever gas it can produce in the future. Therefore, the question is, "how much gas can they produce in the future"? That of course depends on their exploration and development success, which is clearly becoming the focus.

In terms of the development of new resources, we submit, the news from Alvopetro has been a bit of a mixed bag. Recall, the results of their exploration activities in what we have sometimes referred to as the "conventional" assets (wells183-B1 and 182-C1) have been largely unsuccessful. More recently, the Company expressed what we interpreted as optimism about new development at their legacy Bom Lugar project, and while the now completed

BL-06 well is producing, those initial results (14 boe/day), are not what we suspect they were hoping for. That said, while success in these endeavors could certainly have provided marked catalysts, in our view these were also not considered to be the likely basis for the added production to and the ultimate replacement of Caburé. (We would add, we do not think they are done evaluating these areas). Rather, Murucututu has always been the likely workhorse to extend and ultimately replace production at Caburé, and we do not think anyone close to the story thinks that notion has changed or been diminished in any way, in fact, on the call they delineated some Murucututu information that may prove to be highly constructive.

Specifically, the Company has recently spent more time discussing the Caruacu portion of the Maracangalha formation in the Murucututu blocks. As we recall, the target of Murucututu has always focused on the Gomo portion of the Candeias formation, in fact, before they started referring to the area as "Murucututu", we referred to it as "Gomo". In short, the Caruacu could emerge as an Ace-in-the-Hole at Murucututu, and we expect to hear more about that development as we move forward, we would add, the potential of the Maracangalha formation in the Recôncavo Basin is not a secret: The Maracangalha injectite complex: An overlooked hydrocarbon play in the Lower Cretaceous Recôncavo Basin, NE Brazil - ScienceDirect .

To summarize, 3QF23 posed some downstream demand challenges that we have not seen before, could occur again, but likely not consistently. That is, while we will not call them extraordinary, we do not expect them to be a trend either. In retrospect, those headwinds were accompanied by pricing tailwinds that ultimately led to extraordinary (and what we believe are *record* high) $70+ operating netbacks. As we noted, the analysis is getting a bit more complex, but from the 10,000-foot view, record operating netbacks in the face of (seemingly temporary) demand destruction, is not worth losing sleep over. We remain bullish on Alvopetro and management's associated aptitudes, and as such we reiterate our allocation of 6 and our 12-24 month price target of US$10.00.

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 Bahiagás 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 Bahiagás 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.						
Projected Operating Model (in USD - '000s)						
By Trickle Research LLC						
	Actual	Actual	Actual	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	$ 12,313	$ 15,264	$ 59,651	$ 76,845
Royalties and Production Taxes	$ (582)	$ (354)	$ (318)	$ (534)	$ (1,788)	$ (2,690)
					$ -	$ -
Net Oil & Gas Revenue	$ 17,578	$ 13,560	$ 11,995	$ 14,730	$ 57,863	$ 74,155
Other Income	$ 427	$ 477	$ 471	$ 250	$ 1,625	$ 1,000
Total Revenue and Other Income	$ 18,005	$ 14,037	$ 12,466	$ 14,980	$ 59,488	$ 75,155
					$ -	$ -
Production	$ 988	$ 1,048	$ 1,017	$ 1,160	$ 4,213	$ 4,986
General & Administrative	$ 1,222	$ 1,286	$ 1,298	$ 1,382	$ 5,188	$ 5,621
Depletion and Depreciation	$ 2,144	$ 1,711	$ 1,621	$ 1,669	$ 7,145	$ 9,288
Impairment	$ -	$ -	$ -	$ -	$ -	$ -
Exploration and Evaluation	$ 82	$ -	$ -	$ -	$ 82	$ -
Finance Expenses and Interest	$ 403	$ 389	$ 386	$ 350	$ 1,528	$ 1,400
Accretion of Decommissioning Liabilities	$ -	$ -	$ -	$ -	$ -	$ -
Share Based Compensation	$ 283	$ 281	$ 249	$ 200	$ 1,013	$ 800
Foreign Exchange Loss	$ (1,374)	$ (2,331)	$ 1,471	$ -	$ (2,234)	$ -
Loss on Disposition of Assets	$ -	$ -	$ -	$ -	$ -	$ -
Risk Management Expenses	$ -	$ -	$ -	$ -	$ -	$ -
Total Operating Expenses	$ 3,748	$ 2,384	$ 6,042	$ 4,761	$ 16,935	$ 22,095
Interest Expenses	$ -	$ -	$ -	$ -	$ -	$ -
Other Non-Operating Expenses	$ -	$ -	$ -	$ -	$ -	$ -
Total non-operating Expenses	$ -	$ -	$ -	$ -	$ -	$ -
Gain (Loss) Before Taxes	$ 14,257	$ 11,653	$ 6,424	$ 10,218	$ 42,552	$ 53,060
Income Tax Charge (Recovery)	$ 2,055	$ 1,801	$ 605	$ 1,558	$ 6,019	$ 8,092
Net Income	$ 12,202	$ 9,852	$ 5,819	$ 8,660	$ 36,533	$ 44,969
Exchange (loss) gain on translation of foreign operations	$ 616	$ 1,609	$ (1,575)	$ -	$ 650	$ -
Comprehensive (loss) gain	$ 12,818	$ 11,461	$ 4,244	$ 8,660	$ 37,183	$ 44,969
Net Gain (Loss) per share						
Basic	$ 0.34	$ 0.27	$ 0.16	$ 0.24	$ 1.00	$ 1.24
Diluted	$ 0.33	$ 0.26	$ 0.15	$ 0.23	$ 0.98	$ 1.21
Shares O/S - Basic	36,322,948	36,491,775	36,587,442	36,458,443	36,465,152	36,148,408
Shares O/S - Diluted	37,469,951	37,389,731	37,546,465	37,425,272	37,457,855	37,133,997

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Alvopetro has paid fees to present at investor conferences that Trickle Research Co-sponsored.

Portions of this publication excerpted from company filings or other sources are noted in *italics* and referenced throughout the report.

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.