# Oil & Gas Research

# Sound Energy PLC*

## SOU LN BUY: TP 8.2p

**Non-Independent Research**
**MiFID II Exempt: Marketing Material**
**SP Angel acts as Corporate Broker**

## 9 August 2021

### Stock Data

| | |
|---|---|
| Ticker | SOU LN |
| Share Price: | 1.8p |
| Market Cap: | £28.8m |
| Enterprise Value: | £50.6m |

*Source: Bloomberg (prior trading day's close)*



**Research**

**Sam Wahab**
+44 20 3470 0473
Sam.wahab@spangel.co.uk

**Sales**

**Richard Parlons**
+44 20 3470 0472

**Abigail Wayne**
+44 20 3470 0534

**Rob Rees**
+44 20 3470 0535

**Grant Barker**
+44 20 3470 0471


## Afriquia deal confirms financing to first commercial gas

**Sound's recently announced LNG SPA with Afriquia Gaz represents a key milestone in moving forward towards the all-important FID and notice to proceed for the Tendrara Phase 1 Development in our view. The Company has also successfully secured a US$18m Loan Note from Afriquia on significantly better terms than previously anticipated. In addition, the execution of the previously announced equity subscription and £2m equity placing not only serves to boost short term liquidity but also ensures the strategic alignment between Sound and Afriquia. So far, 2021 has been a particularly productive period for the new Sound leadership team with execution of the LNG SPA following on from a successful corporate bond restructuring and the announced acquisition of Schlumberger Silk Route Services. We have taken the opportunity to update our valuation to reflect the agreement, reiterating our BUY rating, and setting a revised 8.2p/share price target.**

### Afriquia Gaz conditionally commits to material volumes

Sound confirmed that the Company has entered into a binding and fully termed conditional LNG sale and purchase agreement (SPA) with Afriquia Gaz, whereby Sound will sell not less than 171,000Mcm/y of LNG per year (c.100Mcm/y of gas to be produced and liquefied from the Phase 1 Development) on behalf of the Concession joint venture (LNG SPA). Under the LNG SPA, Sound will commit, for 360 days of each year over a period of 10 years from first gas, to provide to Afriquia a daily quantity of between 475 and 546 cubic metres of LNG, and Afriquia will commit to an annual minimum "Take or Pay" quantity of 475 cubic metres per day of LNG.

### Based upon the agreed indexation, we forecast that the price will be US$7.9/mmbtu at first gas

Pricing under the LNG SPA will be within a range, the floor price being US$6mmbtu and the ceiling price commencing at US$8/mmbtu and increasing during the course of the LNG SPA to US$8.346/mmbtu and will be determined using an indexed formula which applies a combination of the European Title Transfer Facility and United States Henry Hub benchmark indices. The point of sale to Afriquia will be at the Tendrara (TE-5) field location following processing and liquefaction, with Afriquia having responsibility for transportation and delivery to its downstream customers.

### US$18m Loan Note finances Sound through to first commercial gas

The LNG SPA is conditional upon fulfilment of certain conditions precedent including the approval of the LNG SPA by the Concession joint venture, and the execution of a loan note agreement between the Company (as borrower) and Afriquia (as lender) setting out the terms of an US$18m (previously US$13.5m) secured loan with a 6% annual coupon and a 12-year term – significantly lower than the expected 11.5% expected rate. In addition, the execution of a project contract with Italfluid will be required for the provision of a gas processing and liquefaction facility relating to the Phase 1 Development, and receipt by Afriquia of regulatory approvals for the transportation of LNG by tankers and the sale of LNG.




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Another important condition will see Afriquia secure an in-principal agreement from downstream buyers to purchase not less than 60% of the Annual Take or Pay Quantity under the LNG SPA.

### £2m subscription aligns Afriquia's interests with Sound's

In conjunction with the deal, Sound also confirmed that it has entered in an equity subscription agreement with Afriquia whereby Afriquia has made a £2m subscription to the Company in consideration for which the Company has today issued for 159.7m new ordinary shares in Sound at a price of 1.2521p/share to Afriquia. We also note that Afriquia is locked into this subscription for a period of six months.

### Strong operational outlook

Sound proposes to commercialise its existing TE-5 horst discovery through a phased approach. Phase I will see the Company tap into the existing and growing Moroccan industrial gas market, supplying an annual contractual quantity of 100Mcm/y of gas (c.4Bcf/y) over a 10-year period at a rate of 10MMscf/d (sales gas). Phase II will see Sound develop the remaining discovered resource of the TE-5 horst via additional wells, a CPF and a gas export pipeline (which will tie-in the major Gaz Maghreb Europe pipeline, GME) to monetise gas via the strong domestic gas to power market. Sound's gas commercialisation strategy centres firmly around the Energy Transition and supports Morocco's ambition to progressively de-carbonise its energy mix.

### Partial withdrawal of tax claim

Last week the Moroccan Tax Administration and LTC has found that the tax charges of SEME relating to the free acquisition of intangible assets will be dropped. The LTC reasoning offered was that, as a claim had also been brought by the Moroccan Tax Administration against SEMS, the LTC considers that taxing the same operation twice would be inappropriate. However, we note that the LTC has not dropped the charges relating to the Moroccan Tax Administration's assessment of a purported disposal of assets by SEME to Schlumberger in relation to the entry of a brand-new petroleum agreement for exploration at Greater Tendrara. The Company remains clear that the assessments by the Moroccan Tax Administration arise from a fundamental misunderstanding of the historical licensing changes and inter-group ownership outside of Morocco. The dropping of the main tax charge against SEME is a welcome development in our view, however the remaining charge against SEME related to the signing of a brand-new petroleum agreement for Greater Tendrara in October 2018, with its own exploration work commitment negotiated with ONHYM and fully approved by the State of Morocco is still due according to the Moroccan Tax Administration and the tax claims against SEMS remain in due process.

### Reiterate BUY rating, setting new TP of 8.2p/share

In our view, the conditional LNG SPA agreed with Afriquia represents another significant milestone for the Sound since the new leadership team secured the reins of the Company. As such, we have adjusted our valuation to take account of the share capital increase following the £2m subscription, lower than previously modelled coupon costs (11.5% to 6%), and higher loan note (US$13.5m to US$18m). On this basis, we reiterate our BUY rating, setting a revised TP of 8.2p/share (from 9p/share).



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# UPDATED CORE VALUATION

Our sum-of-the-parts valuation illustrates that Sound's shares trade at an 83% discount to Core NAV

Following further detailed analysis of the recently announced deal with Afriquia and assuming closing of the additional interest acquired from Schlumberger, our updated Sum-Of-The-Parts (SOTP) valuation of Sound infers a Core Target Valuation of 8.2p/share (c.£133.5m mkt cap.) demonstrating that the Company currently trades at a deep discount to NPV. We highlight that our prudent approach to our Target Valuation at this stage does not include recognition of its potentially transformational exploration portfolio at Greater Tendrara, Anoual, and Sidi Mokhtar, instead focusing on the near-term cash flow potential at Tendrara.

Updated SOTP Valuation Matrix

| | US$m | £m | p/shr |
|---|---|---|---|
| Tendrara Phase 1 (NPV10 – 75% WI) | 23.6 | 16.8 | 1.0 |
| Tendrara Phase 2 (NPV10 – 75% WI) | 200.7 | 143.4 | 8.8 |
| Cash | 3.2 | 2.3 | 0.1 |
| Afriquia Subscription | 2.8 | 2.0 | 0.1 |
| Bond | -30.4 | -21.7 | -1.3 |
| G&A (post tax) | -13.1 | -9.4 | -0.6 |
| **Core Value** | **186.8** | **133.5** | **8.2** |

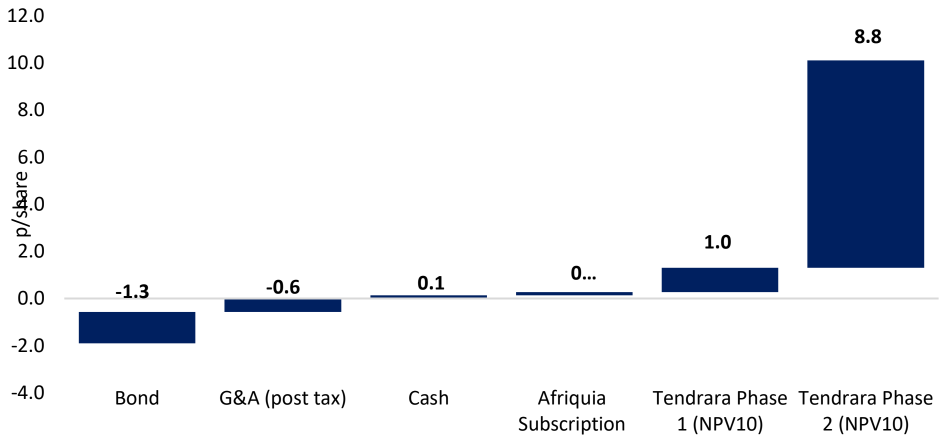
*Source: SP Angel estimates*

Our Core Valuation solely focuses on discovered resources

Our Core Valuation purely focuses on Sound's planned development of its flagship Tendrara concession and the Company's financial assets and liabilities.

The field development plan underpinning this valuation includes the development of Sound's considerable discovered gas resources, a 283Bcf (2C) (TE-5) net (SOU share) accumulation, which will be commercialised in a phased manner with Phase I being the implementation of a micro LNG development scheme and Phase II being development of a larger scale central processing facility (CPF) and gas export pipeline, tying in to the GME gas trunk line.

Updated SOTP Waterfall Chart (p/share)




*Source: SP Angel estimates*



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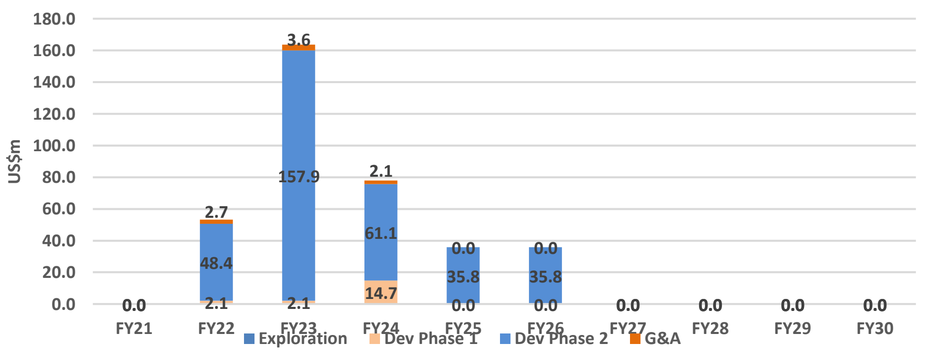
## Capital requirements and cash flow outlook

Following the conclusion of the recently announced acquisition of Schlumberger's 27.5% working interest in the Eastern Morocco licences, Sound will have a 75% working interest in the Tendrara phased development. The US$18m loan note and £2m subscription agreed with Afriquia provides sufficient capital to fund Sound through to Phase 1 and first commercial gas. As the Company progresses to the Phase 2 development, cash flows from Phase 1 in addition to a number of financing options will be made available to Sound to advance this stage including debt, equity, industry partnership, or a combination of these.

We also note that under Moroccan hydrocarbon code, state energy partner ONHYM (25% WI) is required to fund its share of costs of development across all assets in which it has an interest. Whilst Sound is sufficiently capitalised to fund 100% of the capex requirements of Phase 1 following the deal with Afriquia, the Company could see further liquidity headroom.

Gross Capex plan – US$m



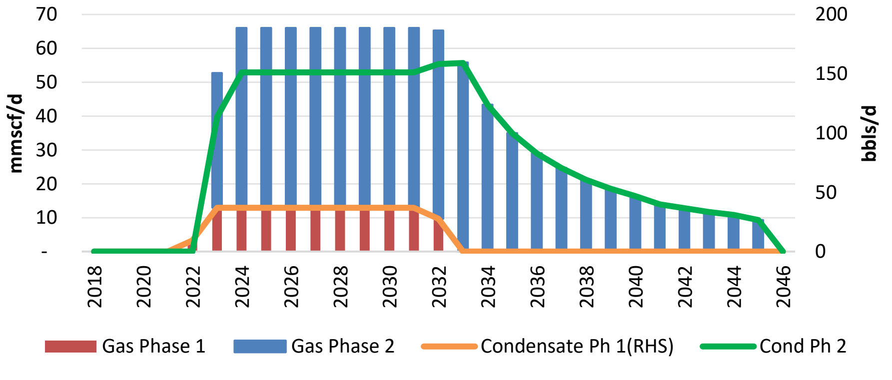

*Source: Company estimates*

Our Discounted Cash Flow (DCF) analysis takes account of the Company's Phase I and Phase II developments of its existing TE-5 horst discovery at Tendrara at a 75% working interest (post SLB acquisition).

Phase I will include a mLNG facility initially supplying 10MMscf/d

Phase I is based on the deployment of skid mounted gas processing and liquefaction (LNG) facilities to facilitate gas production and to tap into the existing and growing Moroccan industrial gas market. Phase I will supply an annual contractual quantity of 100Mcm/y of gas (c.4Bcf/y) at an average gas sales price of US$7.9/mmbtu (SPA est.), over a 10-year period at a rate of 10MMscf/d (sales gas), which will support Moroccan industry transition from LPG fuel sources to cleaner and greener gas.

Gross Daily Raw Production Profile




*Source: Company estimates*



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Phase I will consist of utilising the existing well stock of TE-6 and TE-7 in addition to drilling one new well when required to maintain the 10-year period of production.

Phase II would develop the remaining discovered resources via additional wells, a CPF and a gas export pipeline to monetise gas via the domestic gas to power market. Phase II adds a further up to 66MMscf/d of pipeline gas to sell into the Moroccan gas-to-power market.

## Valuation Methodology

We principally value Sound using a combination of a Discounted Cash Flow (DCF) model for both Phase I and Phase II of Tendrara and an appraisal of the Company's assets and liabilities to calculate Sound's Core Valuation.

We have incorporated the following assumptions into our financial model:

| Metric | Assumption |
|---|---|
| Shares in issue (post Afriquia subscription) | 1,626.7 |
| LT exchange $/£ | 1.4 |
| LT exchange £/€ | 1.2 |
| LT exchange US$/€ | 0.85 |
| Bcf/Mmboe | 5.8 |
| LT Moroccan Gas Price | US$7.9/mmbtu |
| Eastern Morocco Working Interest | 75% |
| NPV/boe Discount Rate | 10% |
| Inflation | 2% |
| Royalties - Gas | 5% |
| Royalties - Liquids | 10% |

*Source: SP Angel estimates*

Sound will commercialise Tendrara through a phased approach

As reflected in our valuation approach, Sound will undertake the commercialisation of its prolific gas development at Tendrara through a phased approach. Phase I will see first commercial gas from the TE-5 Horst field in FY22 through an innovative, cost effective, modular micro LNG (mLNG) scheme which will include first LNG sales in Morocco. The proposed mLNG production plan, which will be advanced alongside workstreams related to the full Field Development Plan (including ongoing negotiations with Morocco's ONEE), will involve the processing and liquification of the gas produced at the field with the resulting LNG being transported by the Afriquia Gaz to industrial customer sites in Morocco.

In July 2021, Sound signed a gas sales agreement with Afriquia Gaz for the purchase of LNG to be produced from the TE-5 Horst Phase I development, as well as agreeing a £2m equity subscription in Sound and an update on a proposed US$18m loan facility.

Subsequent to this in December 2020, Sound signed a letter of exclusivity with upstream services and facilities provider Italfluid, to enter into a binding project contract to commit Italfluid to design, construct, commission, operate, maintain a mLNG Plant which can produce LNG from Tendrara. The mLNG production plan (Phase I) for the TE-5 Horst is clearly an attractive route to generating shorter term cash flows from the Concession. The larger full pipeline led development plan (Phase II) can then be added to this initial plan, given the inherently longer timescales involved in its implementation, as early as 2024.



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Environmental Permits have been approved for the construction of the processing facilities for Phase I and the Phase II projects and a 120 km 20-inch Tendrara Gas Export Pipeline ("TGEP") connecting the CPF and the delivery point to the GME pipeline. The proposed 20-inch pipeline has a nameplated capacity of 230MMcf/d and is therefore oversized to facilitate timely tie-ins of future gas discoveries. The front-end engineering and design (FEED) has also been completed for the for both the Phase II CPF and TGEP.

Subject to the conclusion of ongoing negotiations and JV approval, the Company expects that it will be in a position to take FID on Phase I this year.

## Financial assets and liabilities

We also include an appraisal of Sound's financial assets and liabilities. In addition to the Company's SPA estimated cash position of US$3.2m (£2.3m or 0.1p/share) and Afriquia's subscription (£2m or 0.1p/share), Sound recently secured a restructuring of its initial €28.8m bond position.

Significant deal with noteholders protects shareholder equity

Previously, the 5-year secured bonds were due in June 2021 however in light of Sound's renewed strategy, the Company has successfully amended the maturity date of the notes to 21 June 2027. In addition, the noteholders agreed to reduce the cash interest payable from 5% to 2% and to partially amortize the outstanding principal amount of the notes, at a rate of 5% every six months, commencing on 21 December 2023. The remaining 3% will be rolled up and added to the principle for repayment at maturity.

In addition, Sound and the noteholders agreed to equitise €3.5m of the notes, pro rata across noteholders, into a total of 141m new ordinary shares in the Company, issued at a conversion price of 2.125p/share - half of these conversion shares to be subject to three-month lock-in and half to a six-month lock-in.

In addition to the Company's existing redemption rights, the newly agreed terms provide Sound the right, at any time until 21 December 2024, to redeem the Notes in full for 70% of the principal value then outstanding together with any cash interest accrued and 100% of the deferred interest then accrued at the date of redemption. As part of the recently agreed terms, Sound has issued to the noteholders c.100m warrants to subscribe for new ordinary shares in the Company at an exercise price of 2.75p/share.

We also provide for an NPV10 of the Company's non-field related post tax G&A expenditure.

### 5-year post-tax G&A

| **£m** | **FY21E** | **FY22E** | **FY23E** | **FY24E** | **FY25E** |
|---|---|---|---|---|---|
| G&A | 3.40 | 3.47 | 3.54 | 3.61 | 3.68 |
| Tax | -1.02 | -1.04 | -1.06 | -1.08 | -1.10 |
| Post Tax | 2.38 | 2.43 | 2.48 | 2.53 | 2.58 |
| **NPV10** | **-9.35** | | | | |

*Source: SP Angel estimates*

## Reiterate BUY rating, setting an 8.2p/share TP

Reiterate our BUY stance setting an 8.2p/share TP

In our view, Sound's current share price represents an attractive entry point for investors as the Company gears up for Phase I of the transformational monetisation of its flagship Tendrara gas play which is now conditionally fully funded. The deal with Afriquia further consolidates the Company's position as the leading gas developer in Morocco allowing Sound to generate enhanced returns, cashflow and value as it moves forward the phased development of the TE-5 Horst.  As such, we have adjusted our valuation to take account



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of the share capital increase following the £2m subscription, lower than previously modelled coupon costs (11.5% to 6%), and higher loan note (US$13.5m to US$18m). On this basis, we reiterate our BUY rating, setting a revised TP of 8.2p/share (from 9p/share).



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