

## JKX Oil & Gas

**Fighting to survive after losing its Ukraine bet**

# Summary

JKX stock lost 22% of its price since publishing worrisome 1H17 results on August 1 that show the company has nearly run out of cash. Its unrestricted cash balance as of the latest reporting date was just USD 4.0 mln (down 71% YTD) and accounted for less than one month of the company's operating expense.

The company's bet on the fast development of its overlooked Rudenkivske field in Ukraine did not pay off, creating a potential liquidity gap and throwing into question its ability to remain a going concern. Also the lack of a positive result of the field's study casts doubts on the validity of the company's earlier claims of huge "proved" reserves on the field (or 65% of its Ukrainian proved reserves).

The majority of its USD 10.1 mln in money outflow in 1H17, or USD 8.3 mln, came for capital expenditures in Ukraine (with the rest earmarked for higher production costs here of USD 2.2 mln yoy), which brought little positive results:

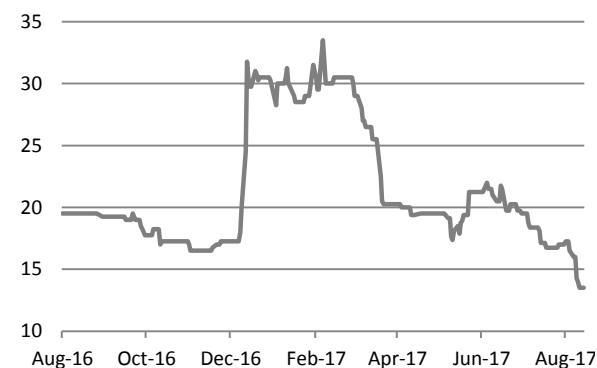
- In July 2017, the company's hydrocarbon output in Ukraine dropped 21% from January and 13% yoy;
- The vast majority of its Ukrainian CapEx was possibly invested in the appraisal program of its Rudenkivske field (with the workover of four abandoned wells), as we concluded from its semi-annual report;
- The appraisal results were disappointing, as JKX acknowledged in mid-July, and the company is reportedly preparing for Phase Two, which seems to be also capital intensive.

The company has yet to pay USD 1.4 mln in severance to recently released executives. It also needs to accumulate money to repay about USD 7.6 mln in coupons and principal on its bonds due in February 2018. On top of that, the company is planning to drill at least one test well in Slovakia at a new field, as well as continue the discovery of the Rudenkivske field and repair a well in Russia. We estimate that the company will be able to generate no more than USD 9 mln in EBITDA in 1H17, which won't be enough to cover any capital expenditures (it only will cover severance and debt servicing).

Besides that, the company is under continuous risk that Ukrainian tax authorities will demand USD 14-37 mln in taxes allegedly underpaid in 2010 and 2015. To the company's fortune, some court litigation is still occurring, which offers the chance that these tax claims won't arrive soon. At the same time, it is very likely that the company will have to pay at least USD 14 mln in the next 5-12 months. This adds to the risk for JKX to become insolvent.

All in all, we conclude that it will be hard for JKX to sustain itself without a fresh financial injection in the next 6-12 months, either via new debt, an additional equity placement, or the entrance of a new cash-rich strategic investor. So far, we see no value in JKX stock.

JKX stock performance, GBP



| Bloomberg:              | JKX LN   |
|-------------------------|----------|
| Price as of Aug. 14     | GBP 13.5 |
| 52 week chg             | -31%     |
| YTD chg                 | -55%     |
| MCap, USD mln           | 30.1     |
| EV, USD mln             | 42.4     |
| Shares outstanding, mln | 171.7    |
| Free float              | 21.6%    |

| Shareholder structure:  |       |
|-------------------------|-------|
| Eclaris (I. Kolomoisky) | 27.5% |
| Proxima (Russian fund)  | 19.9% |
| Neptune (B. Ozdogan)    | 13.0% |
| Keyhall (O. Ratskevich) | 11.4% |
| Other                   | 28.2% |

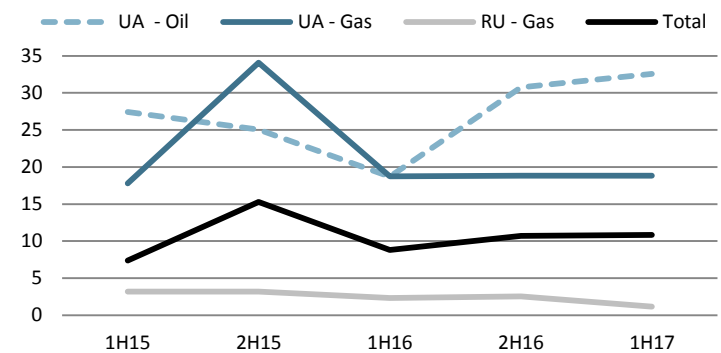
# Ukraine remains key profit generator and stumbling bloc for JKX

Even though JKX's Russian assets produce about 55% of the company's total hydrocarbons due to the low price of natural gas in Russia (which is about 4x smaller than in Ukraine), a unit of gas extracted in Russia brings about 10x less netback/EBITDA to the company than Ukrainian gas.

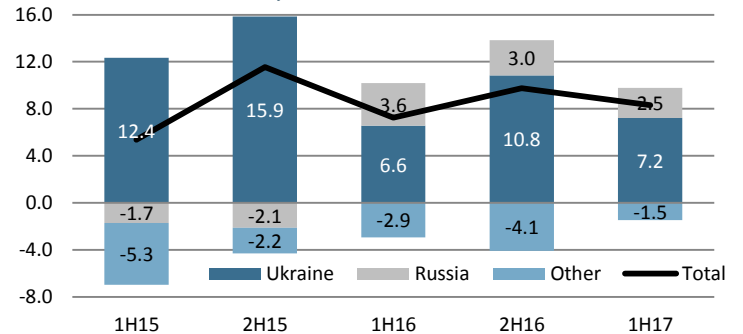
Yet contrary to common logic, JKX paid much more attention to the development of Russian gas fields in 2010-15. It invested USD 282 mln, or significantly more than the USD 200 mln invested in Ukraine.

The new JKX top management, appointed in February 2016, aimed at closing this disparity, announcing the development of Ukrainian assets as its strategic goal. While the new focus sounded logical, it did not bring any additional value to JKX. The company's stake on Rudenkivske, the most "promising" deposit at first glance – but, in fact, most troublesome deposit – did not pay out, bringing the company to the edge of a liquidity problem. Perhaps this was the key reason for the replacement of the company's board and top management at its June 2017 shareholder meeting.

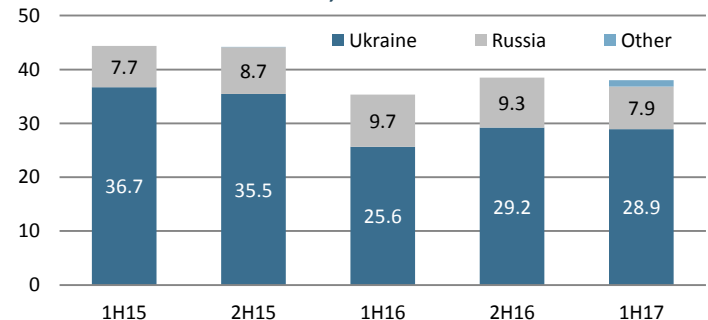
**JKX netback (price less tax & OpEx) by product & location, USD/boe**



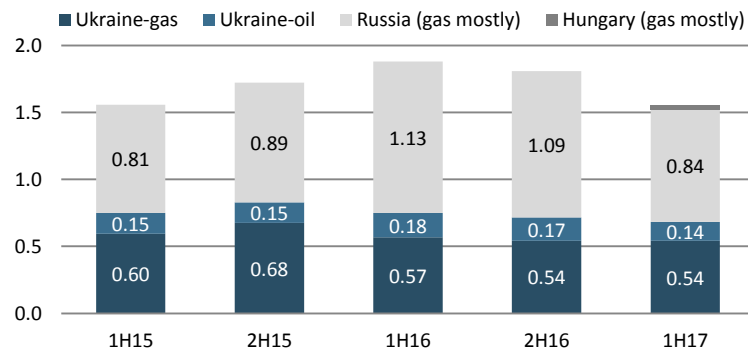
**JKX EBITDA breakdown, USD mln**



**JKX net revenue breakdown, USD mln**



**JKX hydrocarbon output, mln boe**



# Too many investments in Ukraine did not pay off in 1H17

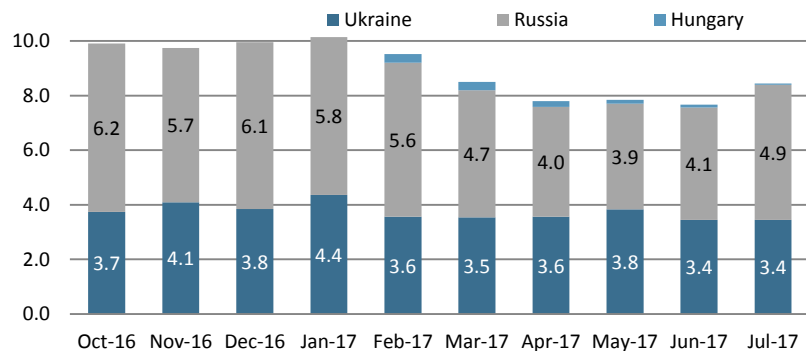
After a management reshuffle in early 2016, the company decided to direct more efforts and money on the development of its Ukrainian gas fields. The most straightforward candidate was the Rudenkivske deposit in Ukraine, which historically accounted for its largest 2P reserves, while bringing almost no production to JKK.

JKX's Phase One appraisal program at Rudenkivske, where the company seems to have spent most of its Ukraine-earmarked 1H17 CapEx of USD 8.3 mln (including USD 2.8 mln for 12 fracturing stages) did not bring tangible results. The evaluation "showed that JKX's understanding of the complex geology of the Rudenkivske field is incomplete," the company concluded. The potential gas-bearing zones of the four tested wells are not only characterized by low permeability (which could be remedied by frequent fracturing), but they are also water-rich, which makes their operation not economically viable. "The presence of water was not identified using the existing Soviet era well logs during planning," the company reported in its July 13 operating update.

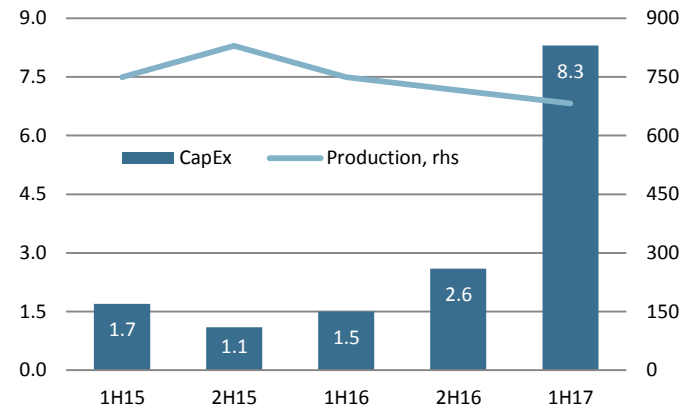
Another appraisal phase, aimed at testing other potential gas-bearing zones, also may prove to be capital-intensive (JKX cash balance does not allow to perform it in the near future) and will not necessarily bring a better result.

Since late 2016, the company managed to initiate production from two wells at its Rudenkivske field after fracturing, reaching good results in the first days of operation (over 900 boepd, or 25% of JKX's average output in Ukraine). But this achievement began shrinking quickly, with the decline rate being about 50% per month.

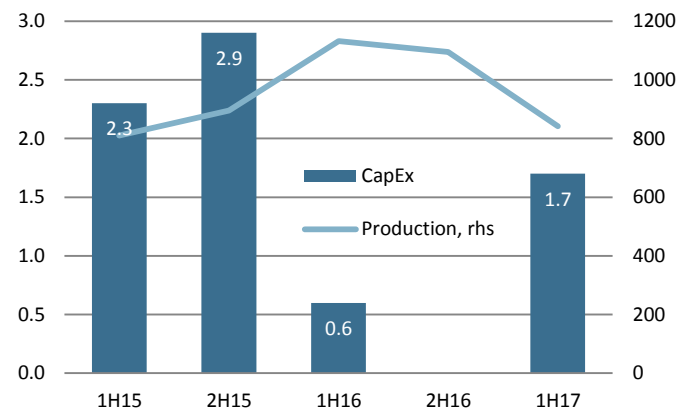
**Average monthly hydrocarbon output, ths boepd**



**CapEx (USD mln) and output (ths boe): Ukraine**



**CapEx (USD mln) and output (ths boe): Russia**



# Liquidity at dangerously low level as of end-June

JKX has burned nearly all of its cash after making abnormally high investments into the development of its Ukrainian deposits in 1H17, and achieving little tangible results in terms of output and even in terms of understanding the field that the company was discovering. It started July with just USD 4.0 mln in its unrestricted cash balance, which is not enough to even cover one month of operating costs.

We estimate that in 2H17, JKX can generate about USD 9 mln in EBITDA. This is some 8% higher than 1H17 and will be the result of better natural gas prices in Russia (which are 4% higher since July) and Ukraine. This amount to be generated will be just enough to:

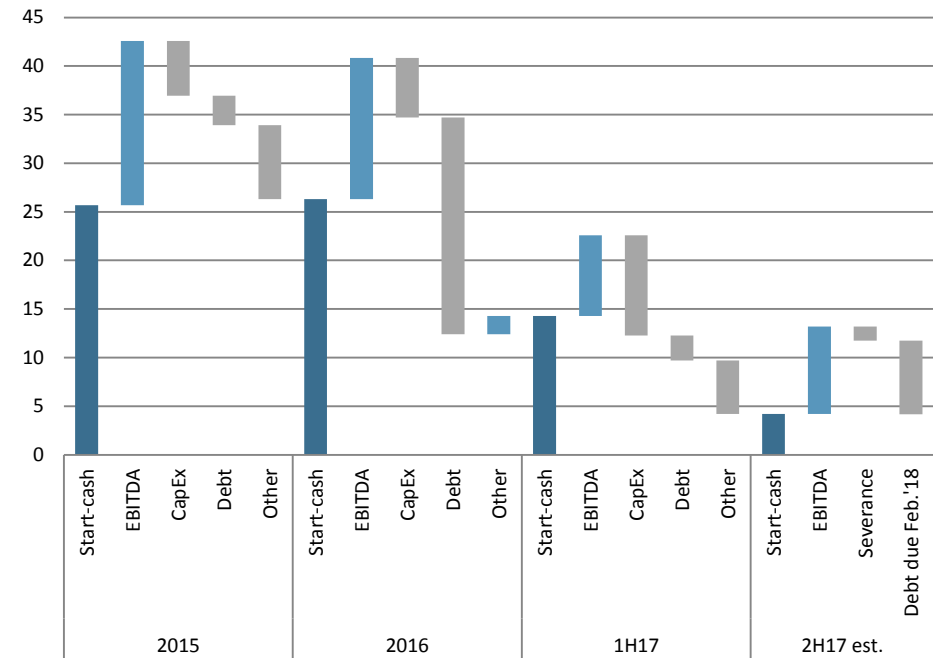
- pay severance to recently departed executives (USD 1.4 mln);
- reserve money to pay interest and principal on its bonds in February 2018 (USD 7.6 mln).

That means the company won't have enough money to invest into its development and even maintenance by the end of 2017.

With such poor liquidity, the company is unlikely to have funds to start a tubing replacement project at its #5 well in Russia and initiate exploration drilling at its new Slovakian deposit. Needless to say, there is no money for the Phase Two exploration at its Rudenkivske deposit in Ukraine.

Besides that, unavoidable claims from Ukrainian tax authorities in the amount of at least USD 14 mln (net), and up to USD 37 mln, may become due in the next 6-12 months, which could make the company insolvent.

Cash generation, use and balance, USD mln



## Tax issues: JKK net obligations to Ukraine are USD 14 – 37 mln

Over the last three years, JKK managed not only to postpone payment of tax claims for 2010 in Ukraine, but to avoid paying about half of its production taxes for 2015. But at the same time, it has accumulated USD 37.2 mln in potential obligations to Ukrainian authorities, which may become due in late 2017 or early 2018:

- JKK owes USD 25.9 mln in 2015 taxes as it stopped paying them in mid-2015, referring to an international court interim award. In early 2017, the international court ruled that the Ukrainian government has to pay USD 12.1 mln to the company, but effectively recognized JKK's USD 25.9 mln obligation to the state. That means, JKK is due to pay net USD 13.8 mln to the Ukrainian government in this episode. To JKK's good luck, the Ukrainian government filed an appeal to that ruling, so the firm won't have to pay anything related to that case until the appeal is completed in end-2017 or early 2018. But once the final decision arrives, the company will have to pay anywhere between USD 13.8-25.9 mln that it does not have.
- In another episode, JKK lost a tax case for USD 11.3 mln in Ukraine's Supreme Court in March 2017. However, its lawyers were able to find some procedural loopholes and start new litigation on that case in April, gaining positive rulings from first-tier and appellate courts. The case is now in the High Administrative Court, which should reach the final decision on that case. The chances of JKK winning are about even, with a loss having potentially disastrous consequences for the company.

So far, we can hope that the company will be able to continue muddling through and avoiding payment to Ukrainian tax authorities, using loopholes in local legislation. But another risk is that the company may suffer intensified pressure from Ukrainian law enforcement bodies investigating tax evasion, which is yet another potential risk for the company's Ukrainian operations.

# “Proved” reserves in Ukraine now seem over-stated

JKX has completed a resource audit by DeGolyer and MacNaughton, which confirmed its 109.3 mln boe in 2P (proved and probable) hydrocarbon reserves as of end-2016.

In Ukraine, the region that is JKX’s key profit driver, the audit confirmed 14.6 mln boe of proved reserves and 29.0 mln boe of 2P reserves, of which 65% and 76%, respectively, were attributed to its Rudenkivske field. This territory contributed just 3% to JKX’s total output in Ukraine in 2016, and prospects of its development are unclear, as we concluded on Page 4.

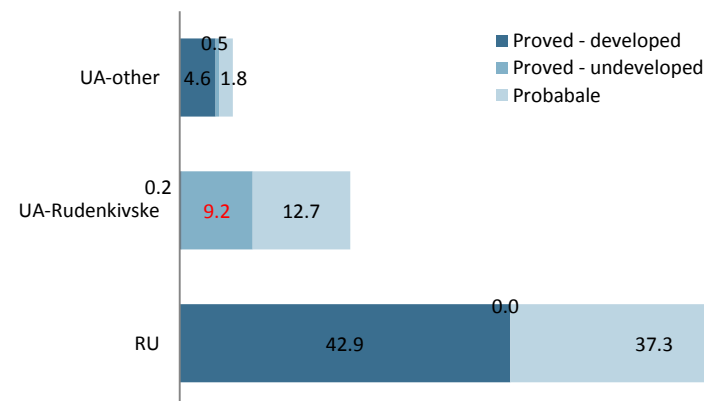
Given that the company has been unable to unlock the potential of its Rudenkivske reserves, we believe it was premature to classify most of the hydrocarbon resources at that field as “proved, undeveloped reserves”, as had been done during the audit. Unless the company proves it can produce something from Rudenkivske at a positive return, Rudenkivske’s reserves should be considered neither “proved, undeveloped” nor “probable,” in our view.

Without the Rudenkivske field, JKX’s Ukrainian reserves would be a third or a quarter of what the firm is reporting. This is why it’s important for the company to continue exploring opportunities at Rudenkivske. However, it is hard to say right now when the company will be able to continue studying this deposit again.

## 2P reserves evolution, mln boe

|          |                 | Total | Russia | Ukraine  |             |       |
|----------|-----------------|-------|--------|----------|-------------|-------|
|          |                 |       |        | UA-total | Rudenkivske | Other |
| End-2013 | Proved          | 29.2  | 24.4   | 4.8      | 0.2         | 4.6   |
|          | Proved+Probable | 93.8  | 60.7   | 33.1     | 21.4        | 11.7  |
| End-2016 | Proved          | 57.5  | 42.9   | 14.6     | 9.5         | 5.1   |
|          | Proved+Probable | 109.3 | 80.3   | 29.0     | 22.2        | 6.9   |
| Change   | Proved          | 97%   | 76%    | 204%     | 4638%       | 11%   |
|          | Proved+Probable | 17%   | 32%    | -12%     | 4%          | -41%  |

## Breakdown of end-2016 2P reserves,, mln boe



# Key financial and operational data

*USD mln, unless other stated*

|                                 | 1H17         | 2H16         | 1H16         | 2H15         | 1H15         |
|---------------------------------|--------------|--------------|--------------|--------------|--------------|
| <b>Production, boepd</b>        | <b>8598</b>  | <b>9853</b>  | <b>10336</b> | <b>9370</b>  | <b>8611</b>  |
| - Ukraine                       | 3766         | 3889         | 4114         | 4507         | 4137         |
| - Russia                        | 4654         | 5944         | 6222         | 4863         | 4474         |
| - Hungary                       | 178          | 0            | 0            | 0            | 0            |
| <b>Net revenue</b>              | <b>38.0</b>  | <b>38.5</b>  | <b>35.4</b>  | <b>44.2</b>  | <b>44.4</b>  |
| - Ukraine                       | 28.9         | 29.2         | 25.6         | 35.5         | 36.7         |
| - Russia                        | 7.9          | 9.3          | 9.7          | 8.7          | 7.7          |
| - Hungary                       | 1.1          | 0.0          | 0.0          | 0.0          | 0.0          |
| <b>EBITDA</b>                   | <b>8.3</b>   | <b>9.8</b>   | <b>7.2</b>   | <b>11.5</b>  | <b>5.4</b>   |
| - Ukraine (est.)                | 7.2          | 10.8         | 6.6          | 15.9         | 12.4         |
| - Russia (est.)                 | 2.5          | 3.0          | 3.6          | -2.1         | -1.7         |
| - Other (est.)                  | -1.5         | -4.1         | -2.9         | -2.2         | -5.3         |
| <b>Net loss</b>                 | <b>-7.7</b>  | <b>-27.0</b> | <b>-10.1</b> | <b>-67.7</b> | <b>-13.8</b> |
| <b>Cash from operations*</b>    | <b>4.0</b>   | <b>9.2</b>   | <b>7.8</b>   | <b>9.3</b>   | <b>3.5</b>   |
| <b>Net cash from operations</b> | <b>1.5</b>   | <b>8.2</b>   | <b>6.4</b>   | <b>7.8</b>   | <b>1.3</b>   |
| <b>Net CapEx</b>                | <b>-10.4</b> | <b>-3.5</b>  | <b>-2.2</b>  | <b>-4.5</b>  | <b>-4.2</b>  |
| - Ukraine                       | -8.3         | -2.6         | -1.5         | -1.1         | -1.7         |
| - Russia                        | -1.7         | 0.3          | -0.6         | -2.9         | -2.3         |
| - Other                         | -0.4         | -1.2         | -0.1         | -0.5         | -0.2         |
| <b>Total debt</b>               | <b>16.3</b>  | <b>16.8</b>  | <b>23.8</b>  | <b>34.4</b>  | <b>32.8</b>  |
| <b>Cash &amp; equivalents</b>   | <b>4.2</b>   | <b>14.3</b>  | <b>18.6</b>  | <b>26.3</b>  | <b>22.4</b>  |



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## Contacts

2 Mechnikova Street, 16th Floor  
Parus Business Centre  
Kyiv 01601, Ukraine  
Tel.: +380 44 391 5577  
Fax: +380 44 391 5571  
www.concorde.ua  
Bloomberg: TYPE CONR <GO>

CEO  
Igor Mazepa    im@concorde.com.ua

### SALES & TRADING

|                    |                            |
|--------------------|----------------------------|
| Alexandra Kushnir  | ak@concorde.com.ua         |
| Marina Martirosyan | mm@concorde.com.ua         |
| Yuri Tovstenko     | ytovstenko@concorde.com.ua |
| Alisa Tykhomirova  | at@concorde.com.ua         |

### RESEARCH

|   |                    |
|---|--------------------|
| Head of Research<br>Alexander Paraschiy | ap@concorde.com.ua |
|---|--------------------|

|  |                    |
|--|--------------------|
| Macro, Utilities, Financial, Energy<br>Alexander Paraschiy | ap@concorde.com.ua |
|--|--------------------|

|   |                      |
|---|----------------------|
| Basic Materials, Consumer<br>Andriy Perederey | aper@concorde.com.ua |
|---|----------------------|

|                                  |                         |
|----------------------------------|-------------------------|
| Editor, Politics<br>Zenon Zawada | zzawada@concorde.com.ua |
|----------------------------------|-------------------------|