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Dipping back into the special situations pool

FEBRUARY 1, 2022 / PUPPYEH / EDIT

Sometimes the market gods smile upon us, and in the interests of time/expediency this write-up will be shorter than I would normally like. Please feel free to ask any questions in the comments (though the set-up itself is quite explanatory).

FAR Limited (Australia: FAR.AX) – last price 51c – $51mm market cap, ~$750k-1mm AUD recent ADV

Thesis summary: FAR is a busted Australian O&G explorer that has been horribly mismanaged for many years. Whilst previously in possession of an extremely valuable 13.7% stake in a new, large oil and gas field in Senegal (Sangomar), poor financing of the investment led to a situation where FAR was essentially forced to sell their only meaningful near-term production asset to their partner, Woodside (see here), mid-last year, to completely delever and return some capital to long-suffering shareholders. This left FAR with a hodge-podge of African exploration projects but one 'hail mary' value creator, the Bambo well in The Gambia, which was drilled at the exhorbitant cost of >$50mm (net to FAR, 50% owner and operator) late last year. Unfortunately the exploratory well was a total failure (see here), and despite positive spin from the company regarding future potential, the stock was torched into year-end, as long-term holders like Allan Gray chose to dump the stock despite the apparent cheapness of the

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690D.DE 6690.HK 8848 8909 AER ALTO AMA.AX API.AX ARG.TO AUE.SI BRAG BRAG.TO BRG.AX BRL.AX BWMX equity to net cash and a (highly likely) earnout from Woodside in the next couple of years.

Yesterday, a 4.9% shareholder, Samuel Terry Asset Management (hereafter 'STAM'), lobbed a highly opportunistic bid at 45c – $45mm AUD – for the husk of FAR. Whilst a 22% premium to the recent trading price, as of Dec'21, FAR had $55mm (USD) of unrestricted cash on the balance sheet; an earn-out on the Woodside asset sale of up to $55mm over the next 2-3 years (to be discussed); just $15mm in future near-term cash obligations for the now-failed Bambo well; and a cash burn rate of ~$3mm per half year. There are no other material liabilities. ***In other words a large shareholder is offering FAR shareholders less than half of the adjusted net asset value per share*** – about $1.1, I estimate, using PV assumptions for the Woodside earnout – ***and nothing at all for the remaining exploration assets and licences***. Whilst these may end up being worth very little, there are a number of strategic large buyers for whom paying a token $10-20mm (or more) would mean nothing (but would transform our return as FAR equity owners). At the current takeout price, *I believe STAM would net a minimum 55% IRR from acquiring FAR on these terms*, with extremely low, or almost zero, risk (since the earn-out payment is already 'in the money' and the oil price trigger can easily be hedged in the futures market).

In any case, I believe this offer will either force the recalcitrant board to engage Samuel Terry to procure a higher offer; pursue their own liquidation; or a large buyback at a discount to intrinsic value; or may prompt a strategic bidder – say Petronas, or Woodside – to acquire the company at some token premium to cash NAV, simply for the 'free' exploration blocks. In any of these scenarios, I believe it is much more likely FAR shareholders ultimately recover something closer to the PV intrinsic value today (which I estimate as $1.1/share), or even a premium – ***setting up a huge excess return from current levels (>100% upside) with downside covered completely by 57c net cash per share on balance sheet today.*** Of course, any value for the portfolio of seemingly-defunct oil exploration assets would be gravy on top, but not something we need to win here.

Given the shareholder bid has now put FAR 'in play', I expect this to resolve itself fairly quickly (in the next six months, maximum), and thus with the equity in the low-50s, represents an extremely asymmetric risk/reward, as shall be discussed. I should mention: if the board does NOT engage the shareholder bid but yet refuses to put the company up for sale/restructuring, I intend to marshal all the resources at my disposal to get the best outcome for shareholders, as I view this as basically a straight-forward set-up for my new engagement/activist skillset, with an extremely clear valuation argument and set of prerogatives.

We shall proceed with a discussion as follows: getting to my estimate of NAV; the STAM bid and conditions attached; and what the board may do instead/competing scenarios for FAR.

FAR: rough cut of NAV is at least $1.1 AUD per share

CLMT CNE.LN CVN.AX DXLG E2N eml.ax EVO.AX FAR.AX GAN hdg.na HRBR INTL LMN MBR MET.NZ MFD.AX NIO PAC.AX PBIT.TO RAP.AX RE4.SI SAVE SF3.DE SHVA.TA SMR.AX SNEX SQZ.LN TER.AX tnk.ax TRQ TWTR UNTC URF.AX WRKS.LN WTE

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FAR has $55mm USD of cash on the balance, and, as per the latest Quarterly Activities report, is on the hook for $15mm to be paid to cover their share of the remaining Bambo drilling costs:

Corporate

Shareholders approved a capital return of A$0.80 per share at a General Meeting held on 15 September and payment was made on 28 September. On 13 October 2021, FAR announced that the ATO had published a class ruling confirming that no part of the Capital Return will be assessable as a dividend. The Ruling also confirms that qualifying shareholders will be entitled to treat any resulting capital gain as a discount capital gain and that certain foreign resident Shareholders will be entitled to disregard any resulting capital gain or loss.

FAR had US$55.6M cash at the end of the period (including US$1.1M in restricted cash held in The Gambia Joint Venture account). During the period, FAR completed drilling operations on the Bambo drilling program (inclusive of the Bambo-1 and Bambo-1ST1 side-track wells). FAR's share of the Bambo program is expected to be US$28.8M, with US$15.3M expected to be paid in Q1.

Further to the previous quarterly report, the Company has taken further steps to reduce costs and expects employment, administration and corporate costs for the forthcoming quarter to be US$0.82M.

Given the failure of this exploratory well there is very low chance they decide to spend any more money, or even have the chance to try, until the current takeover situation is resolved. The only other meaningful asset (excluding the busted exploration assets, for now) is the earn-out coming from the Woodside asset sale. Here is what FAR has disclosed regarding this contingent payment (from the 1H report to June'21):

Contingent assets

In accordance with the Sale and Purchase Agreements with Woodside for the sale of FAR Ltd's entire interest in the offshore blocks Rufisque, Sangomar and Sangomar Deep (RSSD) a contingent payment to FAR is payable in the future based on various factors relating to the sale of oil from the RSSD Project.

The contingent payment comprises 45% of entitlement barrels (being the share of oil relating to FAR's 13.67% RSSD Project exploitation area interest) sold over the previous calendar year multiplied by the excess (if any) of the crude oil price per barrel and US$58 per barrel (capped at US$70).

The contingent payment terminates on the earliest of 31 December 2027, 3 years from first oil being sold (excluding any periods of zero production), or a total contingent payment of US$55 million being reached, whichever occurs first.
The Operator's most recent estimate for commencement of oil production is mid-2023. The Operator may update timelines to first oil and production targets from time to time.

The Sangomar project is a huge one for Woodside and was supposed to be a company-maker for FAR (even with a small stake), before the creditors forced them to sell down. You can read here about Woodside's plans for the field; you can see the project is very close to first production (expected mid-2023), and they plan 100k boe/d from the first phase. Simple math implies ~$27mm in earn-outs, per year (but capped at $55mm total), from Woodside to FAR, assuming they make it to production at these rates and with Brent oil well north of the max price ($70/bbl) stated in the agreement:

		Notes
Sangomar production (boe/d)	100000	Per Woodside
Annual production (yr 1, mm)	36.5	
Original FAR stake	13.67%	
Original FAR stake (mm bbls)	4.98955	
Earnout entitlement at 45%	2.2452975	Per sale agreement
Payment per barrel if Brent >$70/bbl	12	
Total annual earnout ($mm)	**26.9**	Capped at $55mm total

I then simply take the net cash (post Bambo residual costs), add the present value of the Woodside earnout (discounting at 10%), and removing some further wind-down costs, and I get to $1.1 per share (AUD – remember the reporting currency is USD):

	Mid 2024	Mid 2025
Payment	27	28
Yr	2.5	3.5
DR	10%	10%
Disc factor	0.77	0.69
PV	20.75	19.36
Total PV of Woodside payment	40.11	
Cash on B/S	55	
Less remaining Bambo costs	15	
Less other wind-down costs	3	
Total value to FAR (USDmm)	**77.11**	
Total value to FAR (AUDmm)	**110.16**	
Value per share	**1.10**	
Current bid px	0.45	

You may choose to quibble with my 10% discount rate for an earnout on a field not even in production yet. But Woodside is a premier operator and this is slated to come online in basically 15 months; furthermore the earn-out clock only starts 'ticking' when first production occurs, and exists until 2027, so it is largely derisked from incidental delays. Most importantly, *the Brent futures market for end-2024 is already north of $70*, meaning any financial buyer of this earn-out is readily able to fully hedge the price risk and simply take execution risk on the field ramping production (in reality I expect any ultimate acquirer of FAR to turn around and offer to exchange the earn-out agreement for a cash payment at something like the above PV instead, to enhance their IRR and save Woodside the trouble). Frankly, with this operator (Woodside), and with a three year period to collect, and able to hedge most all price risk today, maybe 10% DR isn't too generous. In any case, even if you used 20% discount rate, the implied stock price for FAR would only fall to 93c…still a huge premium to where we trade and where the bid was lobbed. Obviously, this includes no value at all for any potential exploration licences left at the company.

Samuel Terry: the opportunistic bid to put FAR in play

STAM is an Australian fund manager, not particularly large, but appears to have made a very astute play here. They first acquired their stake, according to this article, after FAR shares crashed to well-below-cash levels at the end of the year. It seems they waited until they got just below the disclosure requirement (5%) to announce this bid. I believe they planned to precipitate a liquidation transaction all along, and that they could earn a >50% IRR from this deal, assuming simply the following scenario, with zero additional value from the exploration licences:

June 2020 (6)
May 2020 (7)
April 2020 (5)
March 2020 (4)
February 2020 (4)
January 2020 (4)
December 2019 (2)
November 2019 (1)
October 2019 (1)
August 2019 (2)
July 2019 (3)
April 2019 (1)
March 2019 (3)
July 2016 (1)
March 2016 (1)
February 2016 (2)
December 2015 (1)
October 2015 (1)
September 2015 (2)
August 2015 (3)
July 2015 (1)
June 2015 (1)
May 2015 (2)
April 2015 (4)
March 2015 (6)

First liquidating div (mid-2022)	37
Woodside contingent 1 (mid-2024)	27
Woodside contingent 2 (mid-2025)	28
Cashflow schedule	
30-Mar-22	-44.91
30-Sep-22	37
30-Sep-24	27
30-Sep-25	28
total IRR =	**54%**

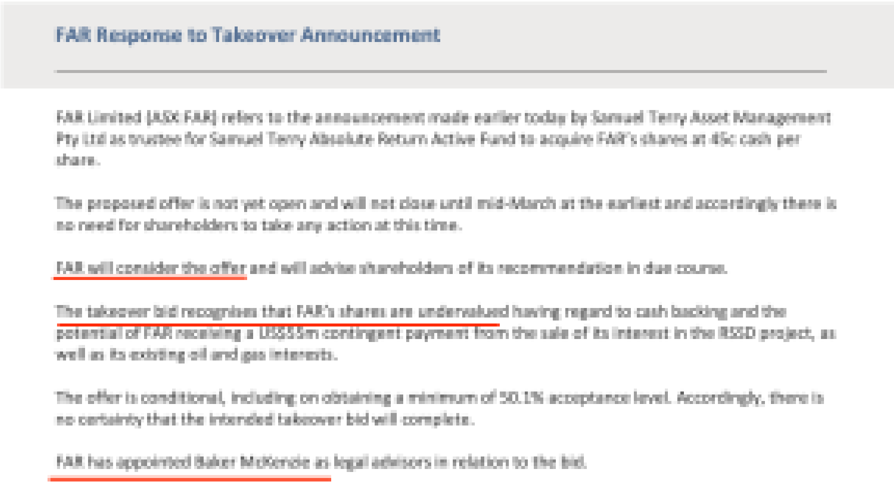
Simply by liquidating the company in the next 6 months and waiting for the next 3.5 years to get paid by Woodside (assuming they hedge price risk in the market), they would clear a gargantuan return! In reality, I think they would likely do much better, since they could likely accelerate some of the Woodside payment (via offering a discount to $55mm in return for nearer payment); or by selling some of the residual licences to current partners like Petronas. Even if the oil licences have ultimately no value, simply accelerating the crystallization of the earn-out to year-end 2022 would increase the IRR to 205%…

It should be noted, there are a number of conditions to the bid – principally a 50.1% minimum condition; as well as a 'no adverse change' clause that covers oil prices (obviously) and precludes FAR management from doing anything else with the assets/cash. Frankly these don't worry me at all, since they simply need to achieve voting control to proceed with their (likely) plan – that is, strip down the company for parts and kick out the current board. Meanwhile the oil price clause simply protects them in the event prices move down a lot before they are able to close the transaction (but after they have acquired a significant stake). I fully expect them (or any acquirer) to hedge price risk on the earn-out in the futures market as soon as the deal succeeds.

Part of my thinks STAM probably doesn't want to go through the hassle of acquiring and dismantling the whole company, and simply threw FAR into play in this manner – but this is one of the few cases where I actually wouldn't mind if their bid succeeded at 45c, because it will have meant they are simply running a huge value-creation playbook for all minorities from a cost basis near mine, and without regard to shareholders deeply underwater from FAR's troubled history. At the end of the day, I don't think STAM will be allowed to acquire the business and earn an uncontested 54-200% IRR (at least I will not stomach it). Still, it is an excellent catalyst to help us as minorities earn a similarly exceptional return…

What is the board going to do?

I won't bore you with the history of what a terrible board this has been historically. The response to the opportunistic bid, however, was quite interesting. They noted the price 'undervalues' the company, and they hired advisors to pursue options. Notably, they did not reject the deal out of hand; nor did they reiterate their previous stance post the Bambo abomination (which was to pursue other growth opportunities, organic or inorganic, in Africa O&G):



FAR Response to Takeover Announcement

FAR Limited (ASX FAR) refers to the announcement made earlier today by Samuel Terry Asset Management Pty Ltd as trustee for Samuel Terry Absolute Return Active Fund to acquire FAR's shares at 45c cash per share.

The proposed offer is not yet open and will not close until mid-March at the earliest and accordingly there is no need for shareholders to take any action at this time.

FAR will consider the offer and will advise shareholders of its recommendation in due course.

The takeover bid recognises that FAR's shares are undervalued having regard to cash backing and the potential of FAR receiving a US$55m contingent payment from the sale of its interest in the RSSD project, as well as its existing oil and gas interests.

The offer is conditional, including on obtaining a minimum of 50.1% acceptance level. Accordingly, there is no certainty that the intended takeover bid will complete.

FAR has appointed Baker McKenzie as legal advisors in relation to the bid.

It seems to me the board has just four options at this point:

- **engage STAM and negotiate a higher offer**, probably one that gives up a decent amount of value but nevertheless allows us a huge excess return from here (70c? probably higher I would imagine);
- **put the company into liquidation** via an auction for the remaining licences and some kind of announced runoff + special dividends and CVR for the Woodside earn-out;
- **announce a pre-emptive tender** for their own shares at a premium to the STAM bid using the huge excess cash, creating more value (to be discussed shortly);
- **reject the STAM deal and attempt to merge with another company** (to try to keep their jobs).

The first three of these scenarios would all result in superior returns for us, the minorities. I would prefer option 2 or 3, and frankly this is what I would push for (or may push for) unless the best outcome is pursued independently. Frankly, a child could work out that if the company simply admits failure on its growth dreams and tendered for 1/2 of the company with its excess cash at say 55c, a huge amount of value would be created for shareholders from here (in that scenario, my view on intrinsic would jump to $1.27, for example).

The problem however is that a couple of large shareholders (Meridian at 19%, for one) are sitting on large paper losses and may not approve of this kind of total liquidation plan (maybe they will, but I simply don't know yet). Still, if enough shares make their way into arbs' hands, or into supportive shareholders of STAM, something like this seems to be the likely outcome.

Given the tone of the PR, it seems like the fourth option – an outright rejection – is quite unlikely, and thus we perhaps don't need to gameplan for that scenario. But rest assured if this was the reaction, I would marshal all of my growing resources to effect a different outcome. Indeed the huge attraction of this situation, *in toto*, is that *the major* *risk scenario* – where a terrible board kept pouring cash into the Gambia exploration with no success – *has been totally removed from the table through this pre-emptive bid*.

The wild card: strategic bidders

There is a further, potential wild card: one of the oil majors with whom FAR has worked closely, comes to the party to pick at the carcass given the implied negative value at which it currently trades. There are two likely interest parties: Woodside (the former partner in Sangomar) and Petrronas, the Malyasian state-owned oil champion, the 50% partner in the Gambia Bambo well that just failed. I will not spend any time trying to ascertain whether large majors would care with the package of assets FAR has left. However, keep in mind Bambo was supposed to contain up to 1 BILLION barrels of oil (even though the first exploration well failed) and so picking up a 50% interest in these blocks for a pittance – $10mm? $20mm? who knows? – may well appeal to a deep-pocketed, long-term operator like Petronas. Of course another financial buyer could step in too…but in any of these cases the equity should be worth probably a premium to my base $1.1 NAV, and perhaps a solid premium. Given the ~100mm shares outstanding, even if nothing more accretive is done with the share count, ***every $10mm of excess value from the oil assets is ~15c on the stock – a stock that trades art 51c today***.

That about sums it up. It is going to be hard to find something more compelling in special sits land than this, my only regret being that it is quite small and thus not actionable for all readers here. I simply don't think it is possible to meaningfully lose from current prices given the state of affairs and the 'in-play' nature of the company, and many avenues exist to catalyze a huge excess return.

Disclosure: long FAR.AX

Uncategorized

FAR.AX

← A few macro musings, and one position clean-up

A few updates as earnings season kicks off; and an update on my activist ambitions →

51 thoughts on "Dipping back into the special situations pool"