NGE Capital Limited

Investment and NTA update | As at 28 February 2019

NGE CAPITAL LIMITED SUMMARY

ASX ticker	NGE
Share price (28-Feb-19)	$0.780
Shares outstanding	37,194,774
Market cap	$29.0m
NTA per share before tax	$0.879
NTA per share after tax	$0.902
NTA before tax	$32.7m
NTA after tax	$33.5m

OVERVIEW

NGE Capital Limited is an internally managed Listed Investment Company which allows investors to gain exposure to a concentrated, high conviction, actively managed portfolio of financial assets. NGE primarily focuses on listed ASX and international equities, with the aim of generating strong risk-adjusted returns over the medium to long term.

INVESTMENT STRATEGY

NGE has a flexible investment mandate and invests according to a defined set of investment principles, summarised as follows:

- Only invest in a compelling opportunity, otherwise hold cash;
- Invest based on fundamental analysis;
- Target investments that can generate strong returns with an adequate margin of safety; and
- Aim to hold a concentrated portfolio of high conviction investments.

BOARD & MANAGEMENT

David Lamm	Executive Chairman & Chief Investment Officer
Adam Saunders	Executive Director & Portfolio Manager
Ilan Rimer	Non-Executive Director
Les Smith	Company Secretary & Chief Financial Officer

CONTACT DETAILS

Level 4, North Building
333 Collins Street
Melbourne VIC 3000

+61 3 9648 2290

admin@ngecapital.com.au

www.ngecapital.com.au

NET TANGIBLE ASSETS (NTA) PER SHARE

	28 Feb 2019	31 Jan 2019
NTA per share before tax	$0.879	$0.830
NTA per share after tax	$0.902	$0.866

NTA PER SHARE PERFORMANCE SUMMARY

1 month	Year-to-date	Last 12 months	Since inception (1) (p.a.)	Since inception (1) (cum.)
6.0%	14.9%	39.8%	27.4%	72.4%

Note: Returns are before tax and net of all operating expenses. As an internally managed LIC NGE does not incur external management and performance fees.

(1) From 30 November 2016, the date on which NGE became a LIC.

TOP HOLDINGS (% OF NTA)

Company	Ticker	%
United Company RUSAL	HKE:0486	23.6%
Powerwrap	Unlisted	18.3%
Karoon Energy	ASX:KAR	17.3%
Yellow Cake plc	LSE:YCA	14.5%
Horizon Oil	ASX:HZN	7.4%
Eureka Group	ASX:EGH	7.2%
Base Resources	ASX:BSE	6.1%
Warrior Met Coal Inc	NYS:HCC	5.9%

PORTFOLIO COMPOSITION

	28 Feb 2019
Listed equities	84%
Unlisted equities	19%
Convertible notes	2%
Net cash and other	(5%)
Total	**100%**

UNRECOGNISED TAX LOSSES

The Company has ~$40 million of Australian unused and unrealised losses available as at 28 February 2019. In the aggregate these losses equate to a potential future tax benefit of ~$11.0m or ~$0.30 per share (of which only a small portion is recognised in our after tax NTA). The Company has received tax advice that these losses are available to be offset against future tax liabilities so long as NGE continues to satisfy the continuity of ownership test as set out in Divisions 165 and 166 of the *Income Tax Assessment Act 1997* (Cth).

MONTHLY COMMENTARY

NGE's portfolio produced a return of 6.0% for the month of February. On a rolling 12-month basis, the portfolio is up 39.8%.

During the month we made our single largest investment to date in **Karoon Energy Ltd (ASX:KAR)**, buying a large line of stock at $0.88 per share. In order to fund this investment opportunity and avoid the need to sell significant existing portfolio holdings at short notice, the Company entered into a flexible loan agreement and borrowed $3 million, at an interest rate of 10% p.a. and maturity of 12 months after the initial drawdown. The funds, along with a proportion of the Company's existing cash balance, were applied towards the purchase. We intend to pay down the debt as soon as practicable.

Karoon is an oil and gas explorer with operations in Australia, Brazil and Peru. Karoon's key asset is its cash balance of ~A$317 million (net of expected outflows this quarter and adjusted for FX), which equates to ~$1.29 per share. We estimate that roughly 95% of Karoon's cash is held in USD. The cash is all that is left of a US$600m windfall from the sale of Karoon's 40% interest in two WA permits containing the Poseidon gas discovery to Origin Energy (ASX:ORG) in August 2014.

Our $0.88 per share entry price equates to ~68c in the dollar of cash held by the company, which we think provides a sufficient margin of safety. Nevertheless, we will be vigilant in ensuring the intrinsic value of our significant investment is protected.

SUMMARY CAP TABLE

Ticker		ASX:KAR
Price (28 Feb 2019)	$	1.060
Market cap	$m	260
EV (1)	$m	-56
NGE position size	%	17.3%

(1) EV based on NGE internal estimate of cash balance, which assumes 95% of cash balance held in USD, adjusts for change to AUD:USD FX rate and deducts Karoon's estimated cash outflows for this March quarter.

COMPANY STRATEGY

Karoon's current strategy can be summarised as follows:

- Acquire a tier 1 producing asset to put the company on a sustainable financial footing, preferably offshore Brazil;
- Develop its Brazilian offshore oil discoveries in the Santos Basin, in conjunction with a farm-in partner; and
- Conduct "high impact" exploration, with a current focus on its permit in the Tumbes Basin, offshore Peru.

We talk through these "three pillars" below.

PILLAR 1: PRODUCTION ASSET ACQUISITION

NGE shareholders with a sharp memory will remember that we invested in Karoon in April 2016 (back then the company name was Karoon Gas Australia), which resulted in a $2.7m profit on a $3.55m investment for a 76% return over 7 months. At the time the company was also trading at a significant discount to its cash backing, but there was a belief that the company was on the cusp of a company-transforming acquisition. The market got excited, the share price shot up, and we sold out.

The company reached the final stages of Petróleo Brasileiro S.A.'s (BSP:PETR4; NYS:PBR) (Petrobras) sale process for an interest in the Baúna and Tartaruga Verde oil fields (both in the Santos Basin), only for the process to be caught up in the Petrobras corruption scandal. Whilst details of the sale price were never made public, Brazil's Petro Rio S.A. (BSP:PRIO3) was reported to have unsuccessfully bid ~US$500m for both assets.

Fast forward two years, and the mature producing Baúna field has been put up for sale again as a single asset. It was reported in early January that Petro Rio and Karoon have submitted offers. Whilst the outcome is not yet known, we noted the December quarterly published on 31 January lacked the September quarterly's enthusiasm that *"[t]he company is involved in two processes with one in ongoing advanced negotiations"*.

There have been many promises of an imminent deal, with no delivery to date. Working against Karoon is the fact that the oil price is up ~30% and its cash balance has dwindled ~$130m since 2016, and there is likely to be more competitive interest in asset sale processes. Nevertheless, if the company does acquire an attractive producing asset, the market could well get excited again.

PILLAR 2: DEVELOP SANTOS BASIN NEON (ECHIDNA) FIELD

The company is in the development planning stage for its Neon (Echidna) light oil discovery in the Santos Basin. The development concept includes a Floating Production Storage and Offloading (FPSO) facility, with two extended horizontal production wells and one gas injection well. Management has indicated that first production from Neon could happen *"in the early 2020's"*. Karoon has stated it would like to farm-down its 100% interest in the Santos Basin blocks prior to any final investment decision.

Karoon has an internal management contingent resource estimate for Neon of 55mmbbls, which was revised down from 75mmbbls in May 2018. Karoon notes that *"[t]he discovered contingent resources are categorised as contingent because further evaluation is required to confirm commerciality"*.

The company has not provided definitive numbers to the market; however we estimate it could take capex of ~US$300m to develop Neon, which might then produce ~20kbopd (~7.3mmbbls p.a.). If we assume that 35mmbbls of the 55mmbbl contingent resource is economic, a long-term oil price of US$70/bbl, all-in costs of production of US$35/bbl, and a discount rate of 10%, then we get a rough, theoretical, unrisked NPV of ~US$400-500m.

As at 30 June 2018 Karoon fully impaired the $140m carrying value of the capitalised exploration and evaluation expenditure of two nearby Santos Basin Blocks, which contain the Goiá (Kangaroo) discovery. Karoon's contingent resource estimate for Goiá was revised down to 27mmbbls from 54mmbbls at the same time as Neon's revision, making it uneconomic to tie this field into the Neon development as originally planned. In addition, the block containing the Bilby oil discovery was requested to be relinquished during FY18, having been fully impaired ($22m) at 30 June 2017.

Whilst a development of Echidna makes economic sense on paper based on publicly available information and some high level assumptions, the slow progress on finding a farm-in partner and recent impairments of the Kangaroo and Bilby oil discoveries highlight the inherent risks.

PILLAR 3: HIGH IMPACT EXPLORATION

Karoon's exploration focus is on planning for the Marina-1 exploration well in the Tumbes Basin, offshore Peru, which is expected to begin drilling in early 2020. Karoon holds a 40% interest in the exploration block, having farmed out a 35% stake to Tullow Oil plc (TLW.LSE) in January 2018. The deal is still subject to regulatory approval and Karoon's farm-in obligations to 25% JV partner Pitkin Petroleum Peru Z-38 SRL.

Tullow agreed to pay 43.75% of the first exploration well capped at US$27.5m (at 100%), beyond which Tullow will pay its 35% share. The structure means that Karoon gets a carry of US$2.3m on the well. Karoon must in turn carry Pitkin's 25% interest for this well. If Marina-1 costs US$100m, Karoon's share will be US$62.7m.

Tullow will also pay Karoon US$2m upon completion, with a further US$7m payable on declaration of a commercial discovery and submission of a development plan to Perupetro (Peruvian oil and gas regulator). Following completion of the farm-out well, Tullow will have an option to assume operatorship of the block.

There is always the chance that the Marina-1 well is a gusher, however the terms of the farm-in (US$2m on completion, US$2.3m carry), particularly when measured against Karoon's $64m of capitalised exploration and evaluation expenditure in Peru and the fact that the company is effectively paying 63% of the well cost to earn its 40% interest, highlight the low probability/high risk nature of this particular well.

POSEIDON CONTINGENT MILESTONE PAYMENTS

Karoon retains deferred milestone cash payments of up to US$200m following the sale of its 40% interest in the Browse Basin permits to Origin Energy mentioned earlier. Origin retained its interest in the permits despite selling its upstream oil and gas business to Beach Energy Limited (ASX:BPT) in January 2018.

The deferred milestone payments are split as follows:

- US$75m due at Final Investment Decision;
- US$75m due at First Production;
- Resource step-up payment of up to US$50m payable on First Production: Origin will pay US$5m for every 100 BCFe of Independently Certified 2P reserves exceeding 3.25 TCFe across the permits at the time of FID up to a maximum of US$50m.

The other JV partners are ConocoPhillips (40%, operator) and PetroChina (20%).

The second of two successful drilling campaigns ended in August 2014 at the same time as Karoon's sale. Since then, the JV partners have been in no rush to further appraise the permits. The current indicative expenditure for the permits amounts to $1m over a 5 year period to 2022, which is an aggregate amount split between the three partners and consists of technical and economic feasibility studies.

It is difficult to know when/if any of the Poseidon contingent milestone payments will be received by Karoon, but it could well generate substantial value for shareholders in the future. If the payments are received between 5-10 years from today, we estimate they could be worth up to ~$0.44-$0.71 per share on a present value basis. As investors we love contingent payments and royalties, because they represent pure upside with no downside, and do not cost the company anything. We especially love them when we get them for free.

SUMMING UP

We think our investment in Karoon provided NGE with reasonable potential upside yet limited downside. Buying in at a significant discount to cash and asset backing provided us with an adequate margin of safety and at the same time we can reasonably expect to generate strong returns from this investment.

	Book value	Valuation	
	A$m	A$m	A$ per share
Cash balance	$330	$317	$1.29
Neon (Echidna) development	$103	?	?
Peru exploration	$64	?	?
Australian exploration	$42	?	?
Other net assets and liabilities	$12	?	?
PV Poseidon contingent payments	$0	$0-$175	$0-$0.71
Total	**$552**	**$317-$492+**	**$1.29-$2.00+**
NGE entry price			**$0.88**
Upside			**47%+**

Note: Book value as at 30 June 2018, except cash balance which is as at 31 December 2018. NGE valuation of cash balance assumes 95% of cash balance held in USD, adjusts for change to AUD:USD FX rate and deducts Karoon's estimated cash outflows for this March quarter.

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Our investment in **United Company RUSAL Plc (HKE:0486)** continued to perform strongly during the month, with the share price up another 13% to HK$3.70 at month end. We initially averaged in at ~HK$2.26, following a dramatic share price fall after the US Department of Treasury's Office of Foreign Assets Control (OFAC) slapped sanctions on several Russian oligarchs and companies, including RUSAL, its major shareholder En+, and En+'s major shareholder Oleg Deripaska.

Due to the sanctions, we had significant difficulty in purchasing the stock as most brokers would not facilitate a buy order. We contacted over a dozen brokers before finding a reputable Hong Kong firm that would execute trades in RUSAL on our behalf.

Our investment thesis hinged on the presumption that the company is too important to global (non-Chinese) aluminium supply to remain on the US sanctions list. The US's position as the world's largest aluminium importer (~7mtpa), and the 28% increase in the cash price in response to the sanctions also suggested that there would be an appetite to find a solution.

Early on, the US Department of Treasury softened its stance, inviting the possibility of lifting the sanctions if Deripaska relinquished control. OFAC subsequently extended the deadline (via "General Licenses") over 10 times for trading in the company's securities and winding up dealings with the company.

We increased our stake further in December at ~HK$2.60 after OFAC announced its intention to remove the sanctions in 30 days. The sanctions were finally lifted on 28 January 2019, after RUSAL agreed to significant restructuring and governance changes.

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SUGGESTED LISTENING

We enjoyed listening to a podcast with prominent hedge fund manager and billionaire John Paulson during the quarter, which is available at: https://www.accordingtosourcespodcast.com/podcast/2019/1/21/merger-masters-series-john-paulson.

Paulson specialises in merger arbitrage. Over the years we have only made a handful of arbitrage investments. However, we do particularly like investing in arbitrage opportunities, and when the risk/return payoff lines up then we're happy to invest heavily. However, we can't build a sustainable portfolio entirely on arbitrage investments; this is just one tool in our box.

What do we mean by arbitrage? There is good arbitrage and bad arbitrage. We're only interested in what we call "Good Arbitrage". "Bad Arbitrage" is typical US hedge fund style merger arb, where there is perhaps 4-5% upside over say a 4-month period providing an IRR of say 12-15%, but when it goes wrong a potential loss of maybe 30-50%. "Good Arbitrage" is when downside risk is say 0%, or even better when the worst case scenario is in fact upside of 10%+ over a 3-4 month period, but if things go right then upside of 30-50%+ which delivers very impressive IRRs.

Paulson would probably disagree with our characterisation of his modus operandi. He talks of how some merger arb guys stand out from the pack as they consistently make the right calls over time, at least partly attributable to what he describes as a "sixth sense". This intangible quality allows the very best to be able to synthesise all the information and possible scenarios around a transaction, before making the right call about how to invest.

At his peak, Paulson managed over US$30bn and made 20+% gross returns, which led to fees "pour[ing] out of the sky". Whilst he gets no mention in the movie *The Big Short*, Paulson also correctly bet against the US subprime mortgage lending market, and in doing so made more money than anybody else: over US$15bn for his fund and US$4bn personally. This one trade is regarded as the greatest trade of all time, and propelled Paulson from relative obscurity to legendary status. His star seems somewhat on the wane, however, with his main funds returning double digit negative returns over several years, and his FUM falling to ~US$8bn. Regardless, we think the podcast is a worthwhile and interesting listen.

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Our shareholders may also be interested in listening to a podcast with David Lamm, who was recently interviewed by Alan Kohler for *InvestSMART*. The podcast is available here:

https://ngecapital.com.au/investor-information/media/