

# Standard Resources Fund



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## Quick Facts

Type	Mutual Fund Trust
Risk Rating	2/5 – Low to Average Risk
Expected Return	10-25% IRR Annually
Head Office	Calgary, Alberta, Canada
Finder's Fee	7%
Minimum Raise	Minimum Already Met
Maximum Raise	\$50,000,000
Deferred Plan Eligibility	Yes
Auditor	Collins Barrow LLP
Legal	Shea Nerland Calnan LLP
Jurisdiction	BC, AB, SK, MB, ON
Website	www.standardrf.com



## REPORT STRUCTURE

This report is divided into the following parts:

1. Introduction
2. The People
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4. Overview of the Energy Business
5. Commodity Opinion
6. Strategy
7. Structure
8. Return Expectation
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## INTRODUCTION

The Standard Resources Fund is a mutual fund trust that invests in producing energy assets in Western Canada. The fund is positioned to increase in value with potential commodity price appreciation. The fund has a low cost structure and distributes 100% of net income paid into the fund. The team is quite experienced and has had a history of creating shareholder value.

## THE PEOPLE

### **Jeremy Cheyne** – President, Chief Executive Officer, & Director

Mr. Cheyne pursued his undergraduate studies in accounting at Western Michigan University before receiving his master's degree in business administration from the University of Calgary. Mr. Cheyne spent a number of years working as an auditor at Grant Thornton LLP prior to moving into the oil and gas industry as the Controller at Ironhorse Oil & Gas Inc., listed on the TSX Venture Exchange under the symbol "IOGV." Mr. Cheyne then accepted the Chief Financial Officer position at Pan Terra Industries Inc., listed under the symbol "PNT-V." Through a joint venture arrangement with Pan Terra Industries Inc., Mr. Cheyne joined a private company, Black Goose Holdings Inc., as its Chief Financial Officer and Vice President of Finance. In 2008, Mr. Cheyne was named one of oil and gas's "rising stars" by *Oilweek Magazine*. In 2009, Mr. Cheyne accepted the Chief Executive Officer position at the General Partner.

### **Michael Fung** – Chief Operating Officer & Director

Mr. Fung received a bachelor of science degree (double major in applied geophysics and geology) from the University of Alberta in 1979. As the co-founder of Vigilant Exploration Inc., Mr. Fung (with his executive team) successfully raised \$40 million in capital and drilled 16 wells from 2004 to 2008. Mr. Fung has extensive experience in the Western Canadian Sedimentary Basin and has also participated in projects throughout North Africa, Vietnam, Mexico, and China. He has worked in varying capacities for Anderson Exploration, Devon Canada, AGIP Canada, Trinoco Exploration Inc., Double Star Energy, Coho Resources, and the General Partner.

### **Mike Lausch** – Vice President, Business Development

Mr. Lausch attended the University of Calgary, where he studied software engineering before receiving his petroleum engineering diploma from SAIT. He has previous experience in the oil and gas industry with Cathedral Energy and Phoenix Technology, where he took part in overseeing the onsite engineering of well development for many major oil and gas companies throughout Canada and Europe. In 2009, Mr. Lausch decided to relinquish his onsite duties to become the VP of Business Development at the General Partner.



## KEY PARTNERS

GLJ Petroleum Consultants Ltd.

GLJ Petroleum Consultants Ltd. is a Canadian firm that has provided engineering and geological consulting services to the petroleum industry for 38 years. Services include thorough evaluation of economic conditions, technical studies, advice, and opinions. GLJ was founded by Vic Kloepfer and Gary Last as Last Kloepfer Ltd. in 1972 in response to a need for independent evaluation services in Canada. GLJ consults its clients by preparing commodity price reports and market forecasts after a comprehensive review of information available to the reported quarter. GLJ Petroleum Consultants Ltd. is led by President and CEO Harry Jung, who has been with the company for 30 years and provides advisory services to clients in the area of divestitures, mergers, and expert witness testimony. He is responsible for liaison within the oil and gas industry, strategic direction of engineering, and information systems.

## OVERVIEW OF THE ENERGY BUSINESS

The energy business, when operated by professionals, is quite straightforward. Many energy deals in the exempt market have been based on inexperienced management and empty promises that were speculative in nature. Many EMDs have extensive experience in real estate development but lack an understanding of the energy industry. For this reason, ExemptAnalyst will provide a basic background of the energy business.

Up until 1947, Alberta had a small energy business focused on the Turner Valley area of the province. In 1947, Imperial Oil discovered oil just south of Edmonton by drilling random wells, referred to as wildcats. Wildcat wells are those drilled outside of and not in the vicinity of known oil or gas fields. This was the discovery that started the transformation of Alberta into an energy giant.

The exploration process that found oil just south of Edmonton in Leduc employed a high-risk/high-return potential exploration strategy used by Imperial Oil. The process used by management groups like Standard Resources is much lower-risk, predictable, and more dependent on the underlying commodity price than on the success of exploration.

When purchasing a potential oil asset, potential reserves are allocated into three different categories: proven, probable, and possible. Proved oil reserves are considered to have reasonable certainty of being recovered using current technology. The confidence level is normally at least 90%. Proved reserves are the only type that the U.S. Securities and Exchange Commission allows oil companies to report to investors. In Canada, companies report their reserves on a proved plus probable basis at year-end in accordance with National Instrument 51-101 based on evaluations from third-party reserve engineers.



Probable reserves are known accumulations that have only a 50% confidence of recovery. Possible reserves are known accumulations that have at least a 10% certainty of being produced. Unknown reserves are the highest-risk classification and involve a company drilling wildcat wells with unknown potential.

There are more and less desirable energy assets for investors to own. Currently, the price of oil is strong and the ExemptAnalyst research team feels bullish on the overall price of crude oil. Due to new natural gas finds in the United States, the price of natural gas is low and ExemptAnalyst is neutral on future pricing.

The other consideration is the location and whether it is accessible all year, the type of oil, and the outlook for the underlying commodity price.

The main risk for EMD comes from wholesalers or manufacturers that misrepresent investments in the energy space. For example, an exempt market manufacturer may put together an energy product that has the promise of high returns from a purchased oil field. Upon further investigation, the asset purchased may be classified as probable or possible and may actually be considered speculative using current technology.

This risk can be avoided by using third-party petroleum engineers and financial analysts. In this case, ExemptAnalyst has been provided with third-party analysis from GLJ Petroleum Consultants Ltd. that provides reserve type, classification, and estimates to help in considering the merits of this investment.

Another consideration is the Reserve Life Index. The RLI is calculated by the expected annual production divided by the size of the reserve. Since the asset is depleting, it is necessary to calculate the income based on internal rate of return with an expectation that, at the end, there is little value left of the asset that was purchased.

Light crude oil has low density and flows freely at room temperature. Light oil receives a higher price than heavy crude since it produces a higher percentage of gasoline and diesel fuels than heavy crude. This makes light crude more attractive to investors than heavy crude.

The operating net back is a consideration, as well; the lower the cost involved with bringing the oil to market, the better. Operating net back is calculated by adding all of the revenues from the oil, less all costs associated with getting the oil to the market. These costs can include but are not limited to importing, transportation, production and refining costs, and royalty fees.

Another term that may be unfamiliar is “barrels of oil equivalent.” This term is used frequently when exploration and production companies are reporting the amount of reserves they may have. By giving a BOE figure, analysts, investors, and management can assess the total amount of energy that the firm has access to, without breaking it down into barrels of crude oil or the cubic feet of natural gas.



The largest upside potential for energy assets is a technology advancement that allows a shift from probable to proven reserves. Probable assets are purchased at a discount, but new technology, such as horizontal drilling, have allowed oil companies to turn lower-cost assets into production.

The ExemptAnalyst research team looks for the following qualities in an energy investment:

1. Weighted toward proven reserves compared to probable or possible
2. Current production
3. Weighted toward oil instead of natural gas
4. Opportunity to improve asset through technology shift of probable reserves
5. Low operating cost structures with year-round access
6. Long proven reserve life index
7. High operating net back
8. Low structure costs
9. Light compared to heavy crude
10. Low purchase price compared to calculated value

## COMMODITY OPINION

Oil Outlook:

We will look at the current global demand and supply situation of oil.

2008	Total
Global Oil Production	85.43 million bbl/day
Global Oil Consumption	85.98 million bbl/day

It is interesting to compare this to 2001.

2001	Total
Global Oil Production	75.46 million bbl/day
Global Oil Consumption	76.21 million bbl/day

It is interesting to note that, in seven years, both the production and consumption of oil has increased by about 14%, or almost 2% a year.

The world's proven reserves of oil and natural gas are as follows:

Type	Size
2008 Global Proven Oil Reserves	1.343 trillion bbl
2008 Global Proven Natural Gas Reserves	177.4 trillion cu m

Type	Size
2002 Global Proven Oil Reserves	1.025 trillion bbl
2002 Global Proven Natural Gas Reserves	161.2 trillion cu m



We can see that, in the last 6 years, proven oil reserves have increased by 31% and global proven natural gas reserves have increased by about 10%. If we consume the amount of energy that we presently use at the same rate, this is the number of years that we have left:

Type	2008 Years' Supply Left
Oil	55 Years
Natural Gas	56 Years

As you can see in the information above, the use of energy has been growing tremendously in the past decade. However, since we have been able to find enough replacement reserves so far, the prices have not reached a large imbalance between supply and demand.

The following reasons have been the causes of the demand growth for energy.

Population Growth:

Year	Global Population
2000	6,080,671,215
2008	6,790,062,216

In the last 8 years, the global population has increased by approximately 11.7%, or 1.4% annually.

Transportation:

Year	Global KM of Roadways
2002	32,345,165 km
2008	68,937,575 km

During this six-year period, the total amount of global roadways increased by 113%, or 13.5% annually.

Global Vehicle Production:

Year	Global Vehicle Production
1997	52,987,000
2007	73,266,061

International Organization of Motor Vehicle Manufacturers

During this 10-year period, global vehicle production has increased by 38.37%, or 3.3% annually.



#### Airline Travel in Asia (Passenger Growth of Shanghai International Airport):

Year	Annual Passengers
2006	14,542,233
2008	28,240,000

The Shanghai International Airport demonstrates the growth of airline travel in Asia. In two years, this airport has had a 94% growth in passenger traffic.

#### Higher Standard of Living:

As citizens of China and India move into the middle class, the average individual will use more energy. This is illustrated by the barrels per year used by the average citizen. As the Chinese and Indians begin to live more like citizens of the U.S. or Canada, they will consume more energy per person. To see how little the Chinese and Indians use, it is interesting to compare this to citizens of modern countries.

Country	Average Barrels per Citizen/Year
Canada	29
US	25
Australia	17
Briton	10
China	2
India	1

#### Desalination:

The growth of desalination is causing growth in energy consumption. This newer technology is especially taking off in the Middle East. For example, Iraq's Prime Minister, Nouri Al-Maliki, inaugurated eight desalination plants in southern Basra on 20 February 2010, according to the Awat al-Iraq news agency. Desalination requires a large amount of energy; often, oil supplies the energy needed for desalination.



### Subsidized Energy:

Many countries with energy reserves subsidize the cost of energy to their own citizens. When energy costs are subsidized, people are encouraged to use more. This is affecting the global demand for energy.

To illustrate, here is a list of countries that subsidize energy for their countries' citizens. For this, we took the average 2007 price of diesel in USD. Note that in the U.S., the average cost of diesel in 2007 was \$.69.

Country	2007 Average Diesel Price USD/Liter
Algeria	\$0.19
Bahrain	\$0.13
Dubai	\$0.53
Egypt	\$0.12
Iran	\$0.03
Libya	\$0.13
Saudi Arabia	\$0.07
Turkmenistan	\$0.01
Venezuela	\$0.02

Source: [www.gtz.de](http://www.gtz.de)

### Reserve Overstatements:

It is possible that the world's energy reserves are overstated. Oil companies have invested interest to keep their reserve estimates high; it helps to support their stock price. OPEC countries also have invested interest in high energy reserves, as this determines their production quotas. The more an OPEC country reserves, the more oil they are allowed to produce.

Many individuals feel that green energy will be a substitute for the energy we use today; let's look at a couple of popular ideas.

### Peak Oil:

Peak oil happens when the maximum rate of oil extraction has been reached; after this point, the production ability enters a slow decline. The production capacity of an oil field usually grows with time until it hits peak oil production. After that, the well or field will go into a slow decline. This happened in the U.S.; in 1971, the U.S. produced over 10 million BPD of oil, and today, it produces just 5 million BPD. Many experts feel that we are close to reaching peak oil globally. If this is the case, then a slow decline in reserves will not allow the world to have a supply of oil that meets demand.



Many of the world's giant oil fields were found many years ago and could be getting close to peak production. The chart below shows the world's top five oil fields and how long they have been producing.

Country	Oil Field	Production Start Year	% of Global Production
Saudi Arabia	Ghawar	1951	5.8%
Norway	Oseberg	1988	4.4%
Venezuela	Bolivar	1922	3.5%
Russia	Fyodorovskoye	1971	2.3%
Kuwait	Burgan	1938	2.0%

Source: Simmons & Company International

Many experts, including Matthew Simmons, Donald Coxe, and Jeff Rubin, have promoted the idea that it has already experienced peak production and is a field in decline. This is concerning since it accounts for close to 6% of the oil consumed daily in the world.

The following quote shows the concern about the Ghawar field in Saudi Arabia going into decline: "The big risk in Saudi Arabia is that Ghawar's rate of decline increases to an alarming point. That will set bells ringing all over the oil world because Ghawar underpins Saudi output and Saudi undergirds worldwide production" (Ali Morteza Samsam Bakhtiari, a senior official with the National Iranian Oil Company).

Lack of Oil Substitutes:

Ethanol:

I think that Warren Buffett's business partner Charles Munger said it best when he explained his views on ethanol: "Ethanol is quite possibly the stupidest thing ever invented by rational people. The ultimate social safety net – which is a very good idea, by the way – is cheap food, and ethanol production is destroying this. It was a monstrously stupid idea like I haven't seen before."

Currently, ethanol production uses about 1/3 of the available corn in the U.S. This is why the price of corn increased by 60% between 2005 and 2007. Growing corn requires a large amount of fertilizer, which is created using natural gas. The farm equipment need for planting, harvesting, and transportation requires diesel fuel. The process of distilling ethanol requires either coal or electricity. One unit of energy derived from the finished product of ethanol requires close to .75 of a unit of energy to create.



## Hybrid and Electric Car:

The world does not have surplus electricity at peak use. If the world converted to electric cars, there would be no surplus electricity available. When you look at the breakdown of how electricity is created, you notice that the only way to add electricity quickly is through coal or natural gas projects. Nuclear and hydro projects take years to plan and come online. Hybrid and electric cars are shunned by investors due to the higher initial costs and are not very profitable for car manufacturers. Consider this quote from Fritz Henderson GM former COO referring to the company's first-generation technologies: "I don't know that I've ever seen a situation where we make money, particularly when you load all the costs in, so I don't necessarily think this is going to be the exception."

## Renewable Energy:

Often, people will comment that geothermal, wind, and solar power are short- and long-term solutions to the world's reliance on fossil fuels. The chart below shows how little renewable sources outside of hydro presently contribute to the world's energy use. Tomorrow, if every geothermal, wind, and solar project currently in use were doubled, it still would account for only 0.02% of the world's energy production.

Energy Source	Global Energy Percentage
Oil	36.33%
Coal	27.03%
Natural Gas	22.85%
Hydro	6.30%
Nuclear	5.88%
Geothermal, Wind, Solar, Wood	0.01%

Source: EAI

Based on the above data, the ExemptAnalyst research team is very bullish on oil prices going forward.



## STRATEGY

One of the greatest challenges for an energy investment in the exempt space is to raise the necessary capital first and then purchase oil assets. High-quality properties that are selling for a discount require cash to be available very quickly. Often, investments in energy properties will cost \$20-50 million. It could take an exempt market manufacturer a year to raise this type of capital. The Standard Resource Fund has eliminated this concern by being able to purchase large deals in principal and allowing the fund to purchase them at fair market value. Standard Resources has purchased an energy asset in Niton Alberta.

The EA analyst research team finds it encouraging that Standard Resources has allocated the purchase of assets to the Standard Resource Funds. Often, exempt-market companies will purchase an asset and sell it to related funds for a markup that can be as abusive as 700%. Note the following transaction. On February 3, 2010, the Corporation acquired petroleum and natural gas assets (the "Niton assets") for an adjusted cost of \$19,584,669 (\$19,800,000 less \$215,331 on purchase price adjustments). On February 3, 2010, it was determined that the Corporation holds a 73.92% interest in the assets and that the Corporation, in its capacity as the General Partner of the Partnership, holds a 26.08% interest in the assets on behalf of and for the benefit of the Partnership. \$5,107,682 of the adjusted purchase price has been allocated to the Partnership for its 26.08% interest in the assets. Note that the price was not marked up at all. EA believes that the interests of shareholders of the Standard Resource Fund have been balanced.

Standard's recent acquisition of the Niton energy asset clarifies their strategy. The ratio of proven reserves compared to probable is 69%. This is a good ratio; there are enough proven reserves that will provide income for investors, as well as some probable reserves that will provide potential capital gains and income if shifted into production through technology. The acquisition is also weighted toward oil; 90% of the assets are oil. The asset also has a proven reserve life index of 7.5 years. 131 barrels of energy equivalent are being produced, of which 84% is desirable light oil. The operating net back is \$32.50 per barrel of energy equivalent based on an average \$70.59 oil price; this assures that even with falling prices, there still will be a profit margin. The asset was also purchased at 66% of its appraised value assuming a net present value calculation using a 10% required rate of return.



## STRUCTURE

Based on a \$100,000 investment, an investor's capital would be allocated as follows:

Item	Amount
Investment	\$100,000
Commission	\$(7,000)
Offering Costs	\$(500)
Total	\$92,500

The costs are reasonable. There are also a few other key considerations.

1. There is no profit split, only a 2% management fee. Management compensation has not been paid to date and will not be paid before December 31, 2010.
2. The fund distributes 100% of the net cash flows on a quarterly basis. Two distributions have been paid in 2010 so far for a combined 5.58% return.
3. The fund also allows for quarterly redemptions.



## RETURN EXPECTATION

The main consideration is the cost of an asset, the appraised value, the cash flow, commodity price, and management skill. The Standard Resources Fund has a 35.60% interest in the asset. GLJ estimates the following amounts of income to be paid from the production based on a \$70.59/barrel estimated sale price and \$38.09 in variable expenses for an operating net back of \$32.50.

Cost Compared to Estimated Value from GLJ:

Cost	Estimated Value	Discount
\$19,584,669	\$30,203,000	35%

If Standard Resources was agreeable to selling the asset for its estimated value, investors would receive appreciation of more than 50%.

Cash Flow:

According to the GLJ estimates, the expected cash from the asset is as follows:

Year	Net Cash Flow
2010	\$5,858,000
2011	\$4,723,000
2012	\$3,955,000
2013	\$3,422,000
2014	\$2,945,000
2015	\$2,454,000
2016	\$2,017,000
2017	\$1,678,000
2018	\$1,392,000
2019	\$1,126,000
2020	\$888,000
2021	\$671,000
Total	\$31,129,000

Assuming that the price of oil does not increase from today, the expected internal rate of return for the project would be 12.32%, less the 2% management fee, for an expected return of just above 10%.



### Commodity Increase:

There is tremendous operating leverage with oil-producing assets. When oil increases in value, the operating cost does not increase as much. Note, in the table below, that the profitability of an oil asset increases with a 50% increase in oil prices.

Oil Price	Cost	Profit per Barrel
\$40	\$38.09	\$1.81
\$50	\$38.09	\$10.81
\$60	\$38.09	\$20.81
\$70	\$38.09	\$30.81
\$80	\$38.09	\$40.81
\$90	\$38.09	\$50.81
\$100	\$38.09	\$60.81
\$110	\$38.09	\$70.81
\$120	\$38.09	\$80.81
\$130	\$38.09	\$90.81

It should also be noted that the EA analyst team included only the potential oil production and not natural gas or other byproducts. If these commodities increased in value, there would be an increase in income.

### Management Skill:

It is possible that the management of Standard Resources will be able to use technology to shift probable reserves into producing assets that could significantly increase the income produced.

### Expected IRR:

The expected return from oil production works out to an expected return after fees of just above 10% a year. The potential increase in commodity prices, management skill, or early potential exit is substantial but difficult to quantitatively articulate. The EA analyst team feels that, including the aforementioned potential return elements, the expected return should be 10% to 25% annually, depending mostly on the price of oil.



## KEY VARIABLE ANALYSIS

The main consideration is lower-than-expected profit from either lower commodity prices or lower-than-expected production.

Lower production is not as concerning as lower commodity price. Since most of the costs are variable, it would only lead to a lower internal rate of return. The following are the expected IRRs if the production fell by these percentages, assuming a long-term stable oil price of \$70.59:

Percentage Drop in Production	IRR Net of Management Fee
10%	7.12%
20%	3.85%
30%	0.47%

In this test of key variables, production would have to decline by 30% from GLJ expectations in order for the investors to receive a flat IRR.

Lower commodity risk is a concern, as it could eliminate the profit if oil fell below \$40 a barrel. The EA analyst team feels that this is unlikely, but during the last recession, oil briefly reached these levels. The following table demonstrates that profitability shrinks very quickly during periods of falling commodity prices.

Oil Price	Cost	Profit per Barrel
\$40	\$38.09	\$1.81
\$50	\$38.09	\$10.81
\$60	\$38.09	\$20.81
\$70	\$38.09	\$30.81



## KEY RISKS

**Commodity** – A prolonged slump in commodity prices, especially oil, would negatively affect performance, especially considering the operation leverage. The fund would not be producing income if oil fell below \$40 a barrel.

**Assumption Risk:**

**Reliance on Management** – The performance of the fund is dependent on management's skill to find underpriced, high-quality energy assets. If management is unable to do this, the performance of the fund would suffer.

**Diversification Risk** – The fund is invested in just one energy-producing asset at the present time; this is a low level of diversification. If this one asset performs at a lower level than expected, it would have a negative effect on the fund.

**Political and Royalty Risk:**

**Competition** – Many companies have capital and are also looking to acquire discounted high-quality energy assets. If economic conditions permit, it would be expected that additional entrance to the market would appear that would add to the level of competition and, potentially, decrease the expected return for the fund.

**Foreign Exchange Risk** – Commodities are priced in U.S. dollars. Continued strengthening of the Canadian dollar leads to lower profit margins for investors. This would lower the income received for investors in the fund.

## RATING

ExemptAnalyst has rated the Standard Resource Fund at low to average risk among exempt market securities. This is due to the high levels of proven reserves, lack of leverage, assets purchased at a discount, and the low-cost structure of the fund. As mentioned above, the expected rate of return is 10% to 25% annually, depending mostly on the price of oil in the future.

Rating	Description
1	Low Risk
2	<b>Low to Average Risk</b>
3	Average Risk
4	Average to High Risk
5	High Risk



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### General

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