Mossberg's Investor Digest

Best Idea Profile — **Cano Petroleum (Amex: CFW)**

DESCRIPTION:

Founded in 2004 and headquartered in Ft. Worth, TX, Cano Petroleum is an oil and gas production company specializing in enhanced recovery methods. From 2004 to 2009 Cano assembled a portfolio of properties suitable for state–of–the–art recovery techniques. These properties are located in Texas, Oklahoma and New Mexico. The company has proved reserves of 49.1 MMBoe along with 13.9MMboe of probable reserves. In September, Cano announced a proposed merger with Resaca Exploration, Inc. which also exploits mature, low-risk oil and gas reserves. Resaca was formed in 2008 and has been actively seeking properties such Cano's. Resaca has 14.1 MMboe in proved reserves, which are already 56% developed and access to resources at Torch Energy. The proposed transaction would combine the excess capacity and resources of Resaca with the undeveloped potential of Cano. The combined company would have proved reserves of over 63 MMboe with a PV10 of $653MM (81% oil) from operating assets in Texas, Oklahoma and New Mexico.

KEY INVESTMENT CONSIDERATIONS:

Upside potential from proved undeveloped locations – Resaca has 14.1MMboe which is 56% proved developed whereas Cano has 49.1MMboe which is 21% proved developed. Resaca's current level of development will leave it in a position to shift capacity and expertise to Cano's operating assets. The areas of operation for the two companies are quite complimentary with Resaca's existing properties being located in Texas and Oklahoma. Also, the technical and operational staffs are used to working on similar projects. The companies' are suggesting that the combined entity could increase productivity by 10-20%.

Significant reductions in cost structure - Cano has already been on an aggressive cost reduction program. 1Q10 lease operating expense (LOE), on a production basis, was down 15% vs. 1Q09. CFW was already targeting LOE to trend from $38.73 per barrel of equivalent oil (BOE) in the 1Q10 to $30/BOE during the last half of the current fiscal year. The proposed merger offers synergies and scale which could result in further cost reductions. The companies are suggesting that G&A and lease operating expense (LOM) for the combined entity could see reductions in the $4.5 to $5MM range on an annual basis. For FY09 CFW and Resaca had combined G&A and LOE expenses of $48MM.

Additional financial strength and stability - Cano funds a portion of its operating and capital needs through credit agreements. CFW's credit agreement is $60MM, with $19.3MM available as of June '09. If the merger takes place the new Resaca will have about $96MM in long-term debt. The merger should provide the combined company with more efficient access to capital at a lower cost than either Resaca or CFW could have on a standalone basis. The combined company should also benefit from cash flow from the quicker ramp-up of production in Resaca's developed reserves.

VALUATION:

Based on the current price of Resaca's shares, the value of Resaca shares issued in exchange for Cano is $53 million, which is a 34% premium to Cano's current share price. (At the time the transaction was announced, Resaca's shares were valued at $88 Million, or 65% higher.) If the transaction is completed and Resaca share price stabilizes, Cano shareholders will capture the arbitrage. Longer term, as costs are reduced and debt levels are rationalized, shares should trade at a smaller discount to its peers. Based on total EV to proved Boe, the combined company's valuation of $2.97, is a significant discount to the mean value of its peers of $19.42. Cano has had restricted communications with investors in recent months due to the proposed merger with Resaca. Resaca intends to apply for a listing on the NYSE Amex thereby leaving the merged company trading on both exchanges. This dual market listing should help bring about additional liquidity and market visibility. The two companies also have little overlap in their institutional investor base which should help diversify the shareholder base.

(Amex: CFW)
Investment Data (as of 1/27/10)

Recent Price	**$0.87**
52-Week Range	0.62 - 2.55
Fiscal Year End	December
Shares Outstanding	45 MM
Average Trading Volume (3 mos)	160,000
Market Capitalization	39 MM
Cash	<1 MM
Long Term Debt	61 MM
Enterprise Value (EV)	99 MM
LT Debt/ Equity	0.4
BV/ Share	3.18
TTM Revenue	51 MM
P/ Revenue	3.0x
TTM EPS	-0.20
P/ EPS	N/A
TTM EBITDA	-47 MM
EV/ EBITDA	N/A