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HNR - Q4 2011 Harvest Natural Resources, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good morning and welcome to the Harvest Natural Resources earnings conference call for the fourth-quarter and year-end 2011. As a reminder, this conference is being recorded. I would now like to turn the call over to the Vice President and General Counsel for Harvest Natural Resources, Mr. Keith Head. Please go ahead, sir.

Keith Head - *Harvest Natural Resources - VP, General Counsel*

Thank you, Nancy. Good morning and welcome to Harvest Natural Resources 2011 fourth-quarter and year-end results conference call. This morning our press release was broadcast to the Company's fax and e-mail list. If you would like to be on one of those lists or you did not receive yours due to a technical difficulty, please call our office at 281-899-5700. In a few hours, a replay of today's call will be available in the Investor Relations portion of our website at www.harvestnr.com. Additionally a telephonic replay will be available this afternoon by dialing 719-457-0820, pass code 8284460.

This conference call will contain various forward-looking statements and information, including Management's expectations regarding financial, operating and other results. These statements are based on Management's beliefs, as well as assumptions made by and information currently available to Management. Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, we can give no assurance that such expectations will prove to have been correct.

Actual results may differ materially from the Company's expectations due to changes in operating performance, project or drilling schedules, oil and gas prices, as well as other technical, political and economic factors. Additional detailed information concerning a number of factors that could cause actual results to differ materially from today's information is readily available in the Company's SEC filings under the heading Risk Factors and Disclosure regarding our reserves.

Investors are urged to consider closely the disclosure in our form 10-K which is available from the SEC or on our website. At this time I would like to turn the call over to James Edmiston, Harvest Natural Resources President and Chief Executive Officer.

James Edmiston - *Harvest Natural Resources - President and CEO*

Thanks, Keith, and thanks for joining us today. I trust you've had a chance to review our earnings release this morning. I'm going to provide an operations summary, and then I'll ask Steve to discuss fourth quarter and full-year financials. After that I'll make a short closing comment before opening up for your questions.

Starting with Petrodelta, operationally Petrodelta delivered about 3 million barrels of oil or 32,548 barrels of oil a day [Petabasa] during the fourth quarter compared with 2.4 million barrels or 26,300 barrels of oil per day in the same period a year ago. That's an increase of about 24% year-on-year.



For the year ending December 31, 2011, Petrodelta delivered 11.4 million barrels of oil or 31,205 barrels of oil per day to Petabasa compared with 8.6 million barrels or 23,455 barrels of oil per day for the year 2010. And that's an increase year-on-year of about 33%. Currently Petrodelta is producing about 33,000 barrels of oil per day or about 6% above the 2011 average.

In spite of the heady production growth for the year, Petrodelta again failed to fully execute its capital program, and in doing so, failed to meet projected production targets. CapEx for the year was about \$138 million compared with about \$99 million in the prior year. As we've discussed before, the business is generating more than enough cash from operations to fully fund a much more aggressive program, however, Petabasa's return to cash to Petrodelta has been substantially less than what has been earned as well as what is required to execute the capital program. Further as debt to contractors has risen, so have costs for those services those contractors provide. Clearly this type of situation is not sustainable over the long term and we're working actively with Petabasa to remedy the situation.

With all that said, I think it's worth the time to dig into the numbers a bit to give a glimpse of the potential of the business. First, as I pointed out, production grew 33% year-on-year in spite of completing one less well than the prior year. Production capacity is actually a good bit higher than production actuals, owing to facility constraints and downtime associated with facility restrictions. Revenue for the year topped \$1.1 billion, 86% above 2010. However, cash from operations came in only slightly above 2010 at \$196 million.

Further, EBITDA under IFRS jumped about 31% during the year to \$397 million. The glaring disconnect between the top line and bottom line is almost entirely associated with the windfall profits tax. Between royalties and windfall profits tax, exclusive of income tax, Petrodelta generated over \$600 million for the Venezuelan government. Indeed, Petrodelta is a powerful engine for cash for the government and that's why we continue to believe that the current situation will be resolved. In the meantime, Petrodelta's cash surplus continued to grow.

At year-end 2011, the net cash surplus attributable to Harvest's 32% interest reached \$66 million, which includes our undistributed 2009 dividend of \$9.8 million as well as undeclared dividends of \$56 million corresponding to 2010 and 2011 cash surpluses. I don't plan to go into any details on the reserve report. I think the disclosures are fairly detailed. In essence, the reserve report continues to confirm our bullish, technical view of the volumes, although at a lower recovery factor than we have as our own internal review. We saw some proved, undeveloped reserve move to probable due to the SEC's five-year rule. There's no technical basis for the certainty of the reserve to be reduced, simply the five-year rule is a policy artifact of the actual rules with no geoscience or engineering basis. As our disclosure says, we believe these reserves will be accessed and moved into the approved category in the near term.

Moving to our exploration program. In Indonesia, we expensed the two wells on the Budong-Budong Block at year-end. As I said before our near-term focus will be on further appraisal and explorations of horizons found in the LG-1 well in the Lariang Basin to the north. We're working with our partner to better firm up future plans while at the same time we're pursuing operatorship of the block. To be honest the performance of the operator has been well below expectations. Furthermore, they now have only about a third interest in the block. I continue to be hopeful that we can resolve the situation between the two partners, however, I am committed to avoiding Harvest being subject to further operational under performance and we will pursue all avenues to correct the situation if need be.

In Oman, we've completed our commitments under our Block 64 award. While the results were not as we hoped, I am extremely pleased with the team in Oman for their excellent, operational performance. As a Company, we like Oman and we continue to view it as a place where Harvest is a good fit both technically and operationally. We're currently evaluating other possible opportunities there, and we're hopeful that our technical and operational performance on our Block 64 work may be recognized with the potential for additional opportunities.

In Gabon, we recently completed the acquisition of 545 square miles of 3-D seismic in board of our current survey on the Dussafu Block. Additionally we shot a line through our Ruche discovery in order to compare the newer, more modern acquisition techniques with our pre-existing 3-D. We should have the time migration on the 3-D complete in the May/June timeframe, and from there we'll be able to better define our next steps on the block. Additionally from what we've seen as a test line through Ruche, we believe that the new data should provide us with the better images below the salt than the current data. To my geophysicist, that's exciting. To me, it translates to better risking of a large prospect inventory.

As I've said before, the certainty of an oil development on the block is extremely high. We're determined, however, to go about it in an optimized way so as to maximize the overall project economics. The key to doing that is to make sure our initial infrastructure footprint provides the flexibility

to integrate future drilling and discoveries. The new 3-D will play a very key role in helping us determine the next steps toward the development of our Ruche, Walt Whitman and Moubenga discoveries, as well as the future exploration on the block. Right now the three discoveries, we have about 26 million barrels in growth contingent resources. However, we've identified numerous analog structures to date which hold as much as ten times that amount in gross, unrisk, mean perspective resources. With that ratio of defined upside to discover resources, it's important to make sure our initial development decisions are the right decisions.

With that, I'm going to turn it over to Steve to go through the financials.

Steve Haynes - *Harvest Natural Resources - VP, CFO, and Treasurer*

Thanks, James, and good morning, everyone. Our form 10-K will be filed today and will be posted on our website at www.harvestnr.com. First I'll provide the 2011 financial results of Harvest. Harvest posted a fourth-quarter net loss of \$44.7 million or \$1.30 per diluted share compared to a net loss of \$4 million or \$0.12 per diluted share for the 2010 fourth quarter. For the year-ended December 31, 2011, Harvest net income was \$53.9 million or \$1.37 per diluted share compared with a net income of \$15.4 million or \$0.42 per diluted share for 2010. The fourth-quarter results include exploration charges of \$6.3 million or \$0.18 per diluted share and dry hole expense of \$49.7 million or \$1.45 per diluted share.

Dry hole expense reflects the costs incurred for the Oman Block 64 wells in the amount of \$9.7 million and costs related to the wells drilled in Indonesia Budong-Budong Block in 2011 of \$40 million. Adjusted for these items, Harvest's fourth-quarter income was \$11.3 million or \$0.33 per diluted share. For the year, Harvest incurred exploration charges of \$13.7 million or \$0.35 per diluted share, dry hole expense of \$49.7 million or \$1.26 per diluted share and a loss on extinguishment of debt of \$9.7 million or \$0.25 per diluted share. Also related to the sale of the Utah assets occurring in the second quarter of 2011, the Company reported income for the year from discontinued operations of \$97.6 million or \$2.48 per diluted share for revenue, expenses, taxes and gain recognized. Adjusted for these items, net income for the year was \$29.4 million or \$0.75 per diluted share.

Now I would like to talk about Petrodelta's financial results. Petrodelta reported fourth-quarter earnings from operations at \$74 million or \$23.7 million net to Harvest's 32% equity interest under IFRS. Petrodelta reported fourth-quarter earnings of \$66.2 million or \$21.2 million net to Harvest's 32% equity interest under IFRS. After adjustments with Petrodelta, [IFSR] earnings primarily to conform with the US GAAP, Harvest's 32% share of Petrodelta's earnings was \$14.6 million, a 44.1% increase over the same period in 2010.

Now let's cover Petrodelta's 12-months operating results for 2011. Petrodelta reported income from operations for the year of \$338.5 million or \$108.3 million net to Harvest's 32% interest. Petrodelta reported earnings of \$332.5 million or \$74.4 million net to Harvest's 32% equity interest under IFRS. After adjustments of Petrodelta's earnings, primarily to conform with US GAAP, Harvest's 32% share or Petrodelta's earnings was \$57.7 million, an 8.7% increase over 2010.

Now let's address our outstanding debt. On March 8, 2012, Harvest entered into exchange agreements with certain existing note holders of its 8.25% senior convertible notes pursuant to which the note holders agreed to exchange approximately \$16 million principal amount of the notes for approximately 2.9 million share of the common stock resulting in an effective exchange price of \$5.56. I will remind you the original conversion price was \$5.71; and, therefore, this exchange calls [novo dilution]. In addition to the cash, Harvest agreed to issue the note holders 161,603 shares of common stock, \$8.16 per share in exchange for going one-year interest make-whole approximately of \$1.3 million. After giving effect to the exchange, approximately \$15.6 million principal amount of the notes remain outstanding. The remaining outstanding notes come due March of 2013. The actual notes in common stock were exchanged yesterday, March 14, 2012. This exchange was an opportunity for the Company to clean up its balance sheet and preserve cash by way of reducing interest expense. Following, I'd like to talk about our cash position which was \$58.9 million as of December 31, 2011.

This concludes my comments. I'll turn it back over to James.



James Edmiston - *Harvest Natural Resources - President and CEO*

Thanks, Steve. I don't have too much to follow up on other than to address a recent announcement concerning the Venezuelan assets. Our belief, that Petrodelta has the potential to be a world class business. When we first began the Petrodelta journey, the key uncertainty was whether or not our very bullish view of Temblador and El Salto Fields was founded. I think we can clearly say at this point that Temblador and El Salto have exceeded expectations and we believe that we've only scratched the surface.

We've also spoken about our long-term view before. We continue to take a long-term view of our investment in Venezuela. That's not news. Our long-term view remains that our Venezuela business has outstanding potential and a very long runway for growth. In the course of 20-year investments, you expect ups and downs, especially in our business. You don't cut and run, but you manage them. We also view the Venezuelan investment environment differently than it would seem the equity markets do, perhaps owing to that difference in time horizon. The bond markets seem to have a fairly bullish view of the Venezuelan environment given the recent run they've had. There seems to be a bit of a disconnect to me.

What I do know is this. Any decision to sell our Venezuelan business will be an economic and strategic one with the long-term interests of the shareholders in mind. I've said it before and I've said it very openly, there will be no fire sale of our Venezuelan assets and I'll stand by that statement today. The current negotiations are at an early stage and we can't give assurances that the negotiations will result in a transaction. In addition, the negotiations are subject to confidentiality between the parties, so if I disappoint those of you wanting more detail, I'll apologize in advance and now I'll open up for questions.

QUESTIONS AND ANSWERS

Operator

Thank you, sir. (Operator Instructions) We'll go first to John Malone from Global Hunter Securities.

John Malone - *Global Hunter Securities - Analyst*

Good morning, gentlemen. Just two questions. One kind of broad and one a little more narrow. I know James you just addressed this in your closing remarks, but just to fill it out a little bit. Assuming you do the successful sale of Petrodelta at a good price, can you give us an idea of what the go-forward thinking would be? Would you consider a Gabon sale? Would you turn your attention to developing that? And are any other exploration opportunities you could talk about beyond expansion in Oman or maybe going back into the northern blocks in Indonesia?

James Edmiston - *Harvest Natural Resources - President and CEO*

John, I think the simple answer to that question is, the decision hasn't been made, but the range of outcomes are fairly obvious. Venezuela is a significant part of the portfolio, so the range of what we might do is broad. You should understand that an asset of that size, given the size of our portfolio, would be subject to shareholder approval, and I'm sure those strategic decisions would be addressed in that proxy, as well. So the shareholders' voices would be heard clearly.

John Malone - *Global Hunter Securities - Analyst*

Okay. Fair enough. And then just a narrow question. You had 15 successful wells in Venezuela versus 16 last. You mentioned this in your comments. CapEx was at \$137 million (sic - see press release) versus last year's \$99 million. How much of that is a function of just increasing costs given the debts to contractors and is there any infrastructure build in there that we should be thinking about?



James Edmiston - Harvest Natural Resources - President and CEO

A bit of all of the above. I mean, costs having just gone up in Venezuela, they've gone up all over the place. What we did have is, there was quite a bit more pads, new drilling pads, built, so there was infrastructure there. There were lines built and put into commission that allows us to deliver the El Salto volumes more directly, so we cut down on trucking. So there's a bit of that in that CapEx. It was basically just switched from what used to be OpEx to CapEx, and I think you'll see a continuation of that.

I think the rigs that we're employing are probably not what you would necessarily employ long-term when you ramp this thing up. So they're not quite as efficient as perhaps some of the rigs we've had in the past, and so it's a bit of drilling days. There's been extended move times because of where we moved the rigs, but I think we'll see some improvement here in the near term, as there's going to be a much bigger focus on El Salto coming up. We're building actually some very, very large pads that you could drill six to ten wells off those pads. So we ought to see some time shaved off those curves.

John Malone - Global Hunter Securities - Analyst

Okay. Thanks. And then just one last one. I couldn't help but notice in the comments about the sale process and this relates versus the last one you mentioned, a specified time period. Can you give us any sense at all of what that is, weeks, months, years?

James Edmiston - Harvest Natural Resources - President and CEO

No. The simple answer, John, is no, but -- (multiple speakers)

John Malone - Global Hunter Securities - Analyst

Fair.

James Edmiston - Harvest Natural Resources - President and CEO

Yes.

Operator

(Operator Instructions) We'll go next to Zachary Prenskey from Little Bear Investments.

Zachary Prenskey - Little Bear Investments - Analyst

Thank you very much. Again, I respect having been in your shoes in a number of my situations. You have a confidentiality agreement in place and you want to honor both the letter and the spirit of that agreement. I think what would be helpful, certainly as myself as a large shareholder and others, is to give us a little more color as to what metric you find the most compelling internally as you strike your own valuation on the Petrodelta asset. What I mean is, you quoted, and I think the quote is there will be no fire sale of the asset, which warms my heart as I'm sure it does most people.

But as you define a fireside sale, what is the single-most important metric that you look at, at valuing it, and then comparing your own internal valuation to what you would accept in the sale process?



James Edmiston - Harvest Natural Resources - President and CEO

Well, let me answer it this way. First off, we have an unusual business in that I'm restricted from telling you what I think it's worth even if we didn't have a process going on. We have our own internal view technically that suggests the recovery factors that are used in the reserve report are probably well too conservative. So we have our own view of that that we run on the risk models, and obviously that spits out the back end what we think the economic value is.

What I can point to, though, what I'm allowed to point to are things like the reserve report where the after-tax PV-10 in the reserve report this year for the 2 PKs is a little over \$1 billion for the one, a little over \$1 billion. So it's a pretty big chunk of money. The other thing you can point to is just classical metrics, I guess. I mean, in the -- last year I believe Steve pointed out we had \$57.7 million in earnings from Petrodelta at the Petrodelta level.

So, you'd have to tell me what's the appropriate multiple for a business that grew at 33%, that has a reserve-to-production ratio of well in excess of 20.20 to well in excess of 30 if you count the 2P are the best estimate reserves. So there's a broad range of metrics you can throw at this thing and obviously we have our own internal view.

Zachary Prensky - Little Bear Investments - Analyst

I'll throw this at you. You know, you've got, I think the number is, 38 million, 39 million barrels of hard, proved oil in the ground as part of your share. If we were located in Saskatchewan, that would be worth \$14, \$15. Is it fair to say that the Venezuelan political and tax environment, an \$8 to \$9 value on those hard barrels is appropriate?

James Edmiston - Harvest Natural Resources - President and CEO

Well, I'll be honest with you, I don't think anybody in our business is trading on a 1P metric in the first place. I know the analysts like to use 1P, and they show it as a metric, but as a buyer and a seller of assets, I can't -- nobody does that. I mean -- (multiple speakers)

Zachary Prensky - Little Bear Investments - Analyst

I appreciate all -- I appreciate all the color. I'm going to ask you one last thing, just to follow up on that. I've spoken with potential Chinese buyers of these assets, and as buyers, they kind of laugh at what you say. They say we'll pay based upon a 1P discount, based upon what it will be worth in the Saskatchewan or something. And Venezuela, that discount is probably worth 30% to 60%, go figure, based upon future acreage that you can develop and how you schmoozy you are with the Venezuelan government.

Again, not commenting, because you're not allowed to by SEC and confidentiality, what transactions have you seen in the last year or two that show what the 2P portion would be worth, and could you comment on that?

James Edmiston - Harvest Natural Resources - President and CEO

Well, there have been no transactions in Venezuela that I'm aware of.

Zachary Prensky - Little Bear Investments - Analyst

Exactly.



James Edmiston - *Harvest Natural Resources - President and CEO*

But I'm pretty certain if anybody thinks they're going to buy assets in Venezuela or anywhere else at a significant discount based on 1P, I'd suggest they're going to have a very frustrating M&A career. It's just -- (multiple speakers)

Zachary Prensky - *Little Bear Investments - Analyst*

Okay. That is very helpful. Very helpful. Thank you very much, sir.

Operator

(Operator Instructions) We'll go next to Andrew Wallach from Cumberland Associates.

Andrew Wallach - *Cumberland Associates - Analyst*

Good morning, guys.

James Edmiston - *Harvest Natural Resources - President and CEO*

Good morning, Andrew.

Andrew Wallach - *Cumberland Associates - Analyst*

Could you talk a little bit more about what you might be able to do to recover the [\$66 million] in potential dividends from 2010 and '11, and the \$9.8 million from 2009?

James Edmiston - *Harvest Natural Resources - President and CEO*

Well, I think the simple answer is we'll continue to work with Petabasa. Our interest has always been that in these early years, the full amount of the cash generated from operations be reinvested in capital. The margins only increase as we build scale. So that's our first choice, to be honest with you.

We'd be happy to dedicate a significant portion of that, the outstanding undistributed dividend, to that effort; and that's really what we're pushing for. So that's in the context of us continuing on with the asset, Andrew. I think in the other context of whether or not we have a sale, obviously those amounts attributable in the normal course of business would be considered.

Andrew Wallach - *Cumberland Associates - Analyst*

Okay. And could you also talk about what your capital expenditure plans are for this year? Or give some kind of range, acknowledging that you don't yet know about Gabon.

James Edmiston - *Harvest Natural Resources - President and CEO*

Well, I think the simple answer is, the majority of CapEx we spend ex-Venezuela will likely be Gabon. So you kind of -- the simple answer is, Andy, it's premature. Until we see what we're doing, and we can calibrate that, we don't know at this point in time. I think in terms of Budong, we've got



a similar issue as far as coming to agreement with the partner A on -- we've certainly focused in on the north end of the Budong Block where we had the numerous oil and gas shows at much shallower intervals.

The timing on that yet is undecided. And, as I said, I'm not terribly eager to have to foot the bill for the type of operational performance we've seen to date. So at this point, I can't answer you.

Andrew Wallach - *Cumberland Associates - Analyst*

Okay. Thank you.

James Edmiston - *Harvest Natural Resources - President and CEO*

All right.

Operator

That does conclude today's question-and-answer session. I would like to turn the conference back over to our speakers for any additional or closing remarks.

James Edmiston - *Harvest Natural Resources - President and CEO*

Well, thanks, folks, for joining us. Obviously we'll be around here. Steve will be around if you need any help reconciling the numbers. He'll be happy to walk you through that. We look forward to telling you of our progress here in the near future, not only vis-a-vis the transaction, but also importantly, Petrodelta's growth plan, as well as our future plans in Gabon and elsewhere. So, thank you once again.

Operator

That does conclude today's presentation. Thank you for your participation.

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