

ARENA RESOURCES INC
Form SB-2/A
July 07, 2004
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As filed with the Securities and Exchange Commission on July 7, 2004.

Registration No. 333-113712

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

AMENDMENT NO. 2

to

FORM SB-2

REGISTRATION STATEMENT

UNDER

THE SECURITIES ACT OF 1933

ARENA RESOURCES, INC.

(Name of small business issuer in its charter)

Nevada (State or Other Jurisdiction of Organization)	1311 (Primary Standard Industrial Classification Code)	73-1596109 (IRS Employer Identification #)
Arena Resources, Inc. 4920 South Lewis Avenue Suite 107 Tulsa, Oklahoma 74105 (918)747-6060 (Address and telephone number of registrant s principal executive offices and principal place of business)		John B. Johnson, Jr., Esq. 15 West Sixth Street Suite 2200 Tulsa, Oklahoma 74119 (918) 584-6644 (Name, address and telephone number of agent for service)

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APPROXIMATE DATE OF COMMENCEMENT OF PROPOSED SALE TO THE PUBLIC: As soon as practicable after the effective date of this Registration Statement.

If this Form is filed to register additional common stock for an offering under Rule 462(b) of the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "

If this Form is a post-effective amendment filed under Rule 462(c) of the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "

If this Form is a post-effective amendment filed under Rule 462(d) of the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. "

If delivery of the prospectus is expected to be made under Rule 434, please check the following box. "

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Amount to be Registered	Proposed Maximum Offering Price Per Unit (1)	Proposed Maximum Aggregate Offering Price Per Unit (1)	Amount of Registration Fee
Units, consisting of one share of common stock and one warrant to purchase one share of common stock ⁽²⁾	1,518,000			
Common stock included in Units	1,518,000	\$ 7.15	\$ 10,853,700	\$ 1,375.16
Warrants to purchase common stock included in Units	1,518,000	\$ 0.10	\$ 151,800	\$ 19.23
Common stock underlying public warrants	1,518,000	\$ 8.70	\$ 13,206,600	\$ 1,673.28
Representatives' options:				
Units, consisting of one share of common stock and one warrant to purchase one share of common stock ⁽³⁾	132,000	\$ 0.001	\$ 132	\$ 0.02
Common stock included in Representatives' options	132,000	\$ 10.725	\$ 1,415,700	\$ 179.37
Warrants included in Representatives' options	132,000	\$ 0.165	\$ 21,780	\$ 2.76
Common stock underlying Representatives' warrants	132,000	\$ 8.70	\$ 1,148,400	\$ 145.50
Total ⁽⁴⁾			\$ 26,798,112	\$ 3,395.32

(1) Estimated pursuant to Rule 457(o) under the Securities Act of 1933 solely for the purpose of calculating the registration fee.

(2) Includes units the underwriters have the option to purchase from us to cover over-allotments, if any.

(3) Issuable upon exercise of the representatives' options to purchase units consisting of common stock and warrants.

(4) In accordance with Rule 416 under the Securities Act of 1933, a presently indeterminable number of shares of common stock are registered hereunder which may be issued in the event provisions preventing dilution become operative, as provided in the representatives' warrant for the purchase of common stock. No additional registration fee has been paid for these shares of common stock.

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

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The information in this preliminary prospectus is not complete and may be changed. We may not sell the securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell the securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted

Subject to completion, dated July 7, 2004

PROSPECTUS

1,320,000 Units

Each Unit Consisting of One Share of Common Stock

and

One Warrant to Acquire One Share of Common Stock

Our common stock is traded on the American Stock Exchange under the symbol **ARD**. The offering price of the units was determined largely by reference to our common stock whose closing price was \$ _____ per share on _____, 2004. The units offered hereby have been approved for trading on the American Stock Exchange under the symbol **ARD.u**. The common stock and warrants will initially trade as a unit, until separated, at which time the common stock and warrants will trade separately on the American Stock Exchange. Currently, no public market exists for the units or separately for the warrants.

Investing in our securities involves risks that are described in the Risk Factors section beginning on page 13 of this prospectus.

	<u>Per Unit</u>	<u>Total</u>
Public offering price	\$	\$
Underwriting discount	\$	\$
Proceeds to us, before expenses	\$	\$

The unit offering price consists of \$ per share of common stock and \$0.10 per warrant. The underwriters may also purchase up to an additional 198,000 units from us, less the underwriting discount, within 60 days from the date of this prospectus to cover over-allotments.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The underwriters expect to deliver the units to purchasers on or about , 2004.

Neidiger, Tucker, Bruner, Inc.

**Lane Capital
Markets**

The date of this prospectus is July , 2004

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ARENA RESOURCES, INC.

Property Locations

Arena Resources, Inc. is engaged in oil and natural gas acquisition, exploration, development and production, with activities currently in Oklahoma, Texas, New Mexico and Kansas.

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Unless the context otherwise requires, references in this prospectus to Arena, we, us, our or ours refer to Arena Resources, Inc.

You should rely only on the information contained in this prospectus. We have not, and the underwriters have not, authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted.

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PROSPECTUS SUMMARY

This summary highlights information contained elsewhere in this prospectus. You should read this entire prospectus carefully, including Risk Factors and our financial statements and the notes to those financial statements included elsewhere in this prospectus. Unless otherwise indicated, the information contained in this prospectus assumes that the underwriters do not exercise their over-allotment option. If the underwriters exercise their option, net proceeds therefrom will be utilized for the acquisition of additional properties. The reserve information contained in this prospectus is as of December 31, 2003, unless otherwise indicated. The operating information and other data contained in this prospectus are as of March 31, 2004, unless otherwise indicated. We have provided definitions for the oil and natural gas terms used in this prospectus in the Glossary of Oil and Natural Gas Terms included in this prospectus.

About Our Company

We are engaged in oil and natural gas acquisition, exploration, development and production, with activities currently in Oklahoma, Texas, New Mexico and Kansas. Our intermediate-term focus is on pursuing acquisition of oil and gas properties that provide immediate cash flow, as well as opportunities for further development. Our intent is to minimize our near-term risks, and to increase exploration activities once we have established a larger production base. We believe we can minimize near term risk by delaying exploration or development activities on certain property interests we own (which would otherwise require us to finance such activities from outside sources) until we have a base of producing properties that will provide sufficient cash from operations to undertake further exploration or development activities.

Since our inception in August 2000, we have built our asset base and achieved growth primarily through property acquisitions. Finding properties that are suitable for our intermediate-term plans can sometimes be difficult, since we look for properties with development potential as well as existing cash flow. We believe the key to being successful is in undertaking thorough due diligence of each property we acquire or consider for acquisition.

From our inception through December 31, 2003, we increased our proved reserves to approximately 9.5 million Boe (barrels of oil equivalent), through the acquisition of interests in 10 producing leases, which have net revenue interests ranging from 24.5% to 81.32%. As of December 31, 2003, our estimated proved reserves had a pre-tax PV10 (present value of future net revenues before income taxes discounted at 10%) of approximately \$92 million. We spent approximately \$7.28 million on acquisitions and capital projects during 2002 and 2003.

On May 7, 2004, we completed the acquisition of an 82.2% working interest in a lease in Lea County, New Mexico (the East Hobbs Unit), with a net revenue interest of approximately 67.6%, and proved reserves of approximately 6.4 million Boe. With this acquisition, we estimate our total proved reserves to be approximately 15.9 million Boe. The acquisition cost of the East Hobbs Unit was approximately \$10 million.

Including the operations from the East Hobbs Unit, we have a portfolio of oil and natural gas reserves, with approximately 93% of our proved reserves consisting of oil and approximately 7% consisting of natural gas. Approximately 18% of our proved reserves are classified as proved developed producing, or PDP. Approximately 4% of our proved reserves are classified as proved developed non-producing, or PDNP, and approximately 78% are classified as proved undeveloped, or PUD.

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The following table summarizes our total net proved reserves and pre-tax PV10 value by state, as of December 31, 2003. Additionally, the table summarizes the total net proved reserves and pre-tax PV10 value of the East Hobbs Unit, as of March 1, 2004.

State	Proved Reserves			Pre-Tax PV10 Value
	Oil (Bbls)	Natural Gas (Mcf)	Total (Boe) ⁽¹⁾	
Oklahoma	3,465,351	658,484	3,575,099	\$ 32,623,882
Texas	2,729,338	1,107,544	2,913,929	36,937,529
New Mexico	2,724,228	394,484	2,789,975	20,820,341
Kansas		1,248,242	208,040	1,583,620
Total December 31, 2003	8,918,917	3,408,754	9,487,043	\$ 91,965,372
East Hobbs Unit (New Mexico)	5,867,132	3,342,901	6,424,282	\$ 73,083,241

⁽¹⁾ Boe is barrels of oil equivalent, with six thousand cubic feet of natural gas being equivalent to one barrel of oil.

Business Strategy

Our goal is to increase stockholder value by investing in oil and gas properties with attractive rates of return on capital employed. We plan to achieve this goal through the near- and intermediate-term strategy of acquiring properties with proved reserves that provide immediate cash flow with opportunities for further development. Once we have acquired a more substantial base of assets, our long-term plan is to increase our development activities. Specifically, we have focused, and plan to continue to focus, on the following:

Pursuing Profitable Acquisitions. We have pursued and intend to continue to pursue acquisitions of proved properties that we believe to have development potential, while immediately providing a source of cash flow. We target low-risk properties with the opportunity for further development, including drilling offset wells, waterfloods and multiple pay zones. We believe the key to successfully undertaking such a program is conducting substantial due diligence prior to purchasing a property. To allow us to do this, we utilize both an experienced team of in-house management, as well as independent engineers who can identify and evaluate acquisition opportunities, negotiate and close purchases and manage acquired properties. Our due diligence process results in our rejection of a significant number of properties that fail to suit our business model.

From August 2000 through May 2004, we acquired leases on 11 producing properties at an aggregate cost of approximately \$18.8 million, representing approximately 15.9 million Boe of proved reserves (at an average cost of \$1.18 per Boe).

Developing Existing Properties. We believe that there will be significant value created by conducting additional drilling activities on identified undeveloped opportunities on our current properties, and on properties we hope to acquire in the future. We own interests in a total of 14,273 gross (10,541 net) developed acres and operate essentially 100% of the net pre-tax PV10 value of our proved reserves. In addition, as of May 7, 2004, we owned interests in approximately 2,615 gross (2,106 net) undeveloped acres that contain many development opportunities. We

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currently estimate that an additional \$6 million to \$8 million in acquisitions will put us in a position where the cash flow from our properties will be sufficient to fund our development activities; however, these estimates are subject to numerous factors beyond our control, including the prices at which we may be able to acquire properties that fit our business plan.

Controlling Costs through Efficient Operation of Existing Properties. We operate essentially 100% of the pre-tax PV10 value of our total proved reserves, which we believe enables us to better manage expenses, capital

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allocation and the decision-making processes related to our production, development and exploration activities. For the year ended December 31, 2003, our lease operating expense (which includes only oil and gas production costs) per Boe averaged \$8.92 and general and administrative costs averaged \$4.33 per Boe produced. For the three months ended March 31, 2004, our lease operating expense per Boe produced averaged \$8.54 and general and administrative costs averaged \$4.82 per Boe produced.

Recent and Proposed Activities

During the year ended December 31, 2003, we invested \$2.62 million in new lease acquisitions, and \$351,000 in drilling advances. As of May 7, 2004, we acquired the East Hobbs Unit in Lea County, New Mexico, for approximately \$10 million. With this most recent acquisition, we are closer to having a base of producing properties that we believe sufficient to fund the development phase of our business plan. However, we anticipate seeking one or two more acquisitions in 2004, prior to commencing a more aggressive development program. We discuss our recent and proposed activities below under Business and Properties.

Risk Factors

An investment in our securities involves certain risks that should be carefully considered by prospective investors. See Risk Factors.

Corporate Information

Arena Resources, Inc. was incorporated in Nevada on August 31, 2000. Our principal executive offices are located at 4920 South Lewis Avenue, Suite 107, Tulsa, Oklahoma 74105, and our telephone number is (918) 747-6060.

Table of Contents**The Offering**

Securities Offered	1,320,000 units, with each unit consisting of one share of our common stock priced at \$ _____ and one warrant to purchase one share of our common stock priced at \$0.10, for an aggregate offering price of \$ _____ per unit.
Warrant attributes	Each warrant is exercisable to purchase one share of our common stock at an exercise price of \$ _____ (120% of the public offering price of the unit) during the four years ending July _____, 2008, subject to redemption rights.
Common stock to be outstanding after the offering	8,512,097 shares (prior to exercise of warrants to acquire 1,320,000 shares).
Use of proceeds	We plan to use the net proceeds to repay a portion of bank financing incurred in connection with the acquisition of the East Hobbs Unit, and to acquire additional oil and gas prospects.
Risk factors	Please read Risk Factors for a discussion of factors you should consider carefully before deciding to invest in shares of our common stock.
American Stock Exchange symbol stock	ARD .
American Stock Exchange symbol units	ARD.u
American Stock Exchange symbol warrants	ARD.ws

Our common stock is currently traded on the American Stock Exchange. Following the conclusion of this offering until the units are divided into their separate components of one share of common stock and one warrant, the units will trade on the American Stock Exchange (at the same time, but separately from, the currently issued shares of our common stock already trading on the American Stock Exchange). In an effort to avoid potential disruption in the market, each unit will be divided into its separate component of one share of common stock and one warrant upon the earlier of one year from the date of this prospectus, or upon thirty (30) days prior written notice from us. However, we will not allow separation of the units until the earlier to occur of 60 days immediately following this offering or the exercise by the underwriters of the entire over-allotment option. Following the separation of the units, the shares of common stock will trade on the American Stock Exchange (and will be indistinguishable from our common stock currently trading on such exchange), and the warrants will trade separately from the common stock on such exchange. The units will cease to exist at that time.

The number of shares outstanding after the offering excludes shares reserved for issuance under outstanding options and warrants. As of March 31, 2004, we had granted options to directors and employees to purchase 1,000,000 shares of common stock at an average price of \$3.76 per share, of which options to acquire 190,000 shares are currently exercisable. In addition, at March 31, 2004, there were outstanding warrants to purchase 1,430,723 shares of our common stock at an average price of \$4.47 per share, all of which are currently exercisable. See Capitalization.

Table of Contents**Summary Historical Financial Information**

The summary historical financial information set forth below should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and with our financial statements and the notes to those financial statements included elsewhere in this prospectus. The income statement information for the year ended December 31, 2001, and the balance sheet information as of December 31, 2001 and March 31, 2003, were derived from our financial statements that are not included herein.

	For the Three Months				
	Year Ended December 31,			Ended March 31,	
	2001	2002	2003	2003	2004
Income Statement Information:					
Revenues and other income					
Oil and gas revenues	\$ 311,733	\$ 1,657,037	\$ 3,665,477	\$ 807,021	\$ 1,200,400
Gain from change in fair value of put options		36,665	47,699	4,775	
Total revenues and other income	311,733	1,693,702	3,713,176	811,796	1,200,400
Costs and expenses					
Lease operating	106,927	594,863	1,149,136	242,071	316,290
Production taxes	14,797	117,164	269,563	53,950	78,707
Depreciation, depletion and amortization	44,148	127,847	338,157	51,091	97,555
General and administrative expense	127,696	248,018	557,576	143,631	178,202
Interest expense		15,923	38,798	9,863	9,113
Accretion expense			32,212	4,782	12,295
Total costs and expenses	293,568	1,103,815	2,385,442	505,388	692,162
Income before taxes	18,165	589,887	1,327,734	306,408	508,238
Provision for deferred income taxes		(187,193)	(491,599)	(114,289)	(189,508)
Cumulative effect of change in accounting principles			(11,813)	(11,813)	
Net income	18,165	402,694	824,322	180,306	318,730
Preferred stock dividends	(63,092)	(798,018)			
Income (loss) attributable to common shares	\$ (44,927)	\$ (395,324)	\$ 824,322	\$ 180,306	\$ 318,730
Operating Data:					
Net production:					
Oil (Bbl)	12,895	58,717	117,646	23,590	33,783
Natural gas (Mcf)	4,776	46,819	67,329	10,912	19,323
Total (Boe)	13,691	66,520	128,868	25,408	37,003
Average sales price:					
Oil (Bbl)	\$ 22.36	\$ 26.09	\$ 29.06	\$ 32.18	\$ 33.23
Natural gas (Mcf)	1.79	2.67	3.67	4.40	4.00
Total (per Boe)	21.69	24.91	28.44	31.76	32.43
Other Financial Information:					

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Net cash provided by operating activities	\$ 84,023	\$ 570,748	\$ 1,652,950	\$ 278,265	\$ 568,710
Capital expenditures	1,584,645	3,268,373	4,015,313	153,715	314,066
EBITDA ⁽¹⁾	62,313	696,992	1,689,202	367,369	627,201

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	As of December 31,			As of March 31, 2004	
	2001	2002	2003	Actual	Pro Forma ⁽²⁾
Balance Sheet Information:					
Total assets	\$ 2,137,689	\$ 6,050,493	\$ 10,018,731	\$ 10,550,832	\$ 20,721,355
Long-term liabilities		637,797	1,678,965	1,880,769	9,921,656
Stockholders equity	2,037,954	5,124,837	8,088,899	8,429,379	8,429,379

- (1) We define EBITDA as earnings before interest, taxes, depreciation, depletion and amortization. We further include in our calculation of EBITDA the effects of any cumulative change in accounting principle, accretion expense and the gain (loss) from changes in the fair value of certain outstanding put options. EBITDA is not a measure of performance calculated in accordance with generally accepted accounting principles in the United States, or GAAP. Although not prescribed under GAAP, we believe the presentation of EBITDA is relevant and useful because it helps our investors to understand our operating performance and makes it easier to compare our results with other companies that have different financing and capital structures or tax rates. EBITDA should not be considered in isolation of, or as a substitute for, net income as an indicator of operating performance or cash flows from operating activities as a measure of liquidity. EBITDA, as we calculate it, is likely not comparable to EBITDA measures reported by other companies. In addition, EBITDA does not represent funds available for discretionary use.

The following table presents a reconciliation of our net income to EBITDA:

	Year Ended December 31,			For the Three Months Ended March 31,	
	2001	2002	2003	2003	2004
Net income	\$ 18,165	\$ 402,694	\$ 824,322	\$ 180,306	\$ 318,730
Cumulative effect of change in accounting principle			11,813	11,813	
Deferred income taxes		187,193	491,599	114,289	189,508
Interest expense		15,923	38,798	9,863	9,113
Accretion expense			32,212	4,782	12,295
Gain from change in fair value of put options		(36,665)	(47,699)	(4,775)	
Depreciation, depletion and amortization	44,148	127,847	338,157	51,091	97,555
EBITDA	\$ 62,313	\$ 696,992	\$ 1,689,202	\$ 367,369	\$ 627,201

- (2) On May 7, 2004 we acquired the East Hobbs Unit for approximately \$10,000,000. Our unaudited pro forma balance sheet included with our financial statements herein (at page F-2) reflects the impact of this acquisition as if it had occurred as of March 31, 2004. The summary pro forma balance sheet information as of March 31, 2004 reflects only the effect of the acquisition and the related financing and does not include any of the potential effects from this offering.

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The following table presents summary information regarding our estimated net proved oil and natural gas reserves as of December 31, 2001, 2002 and 2003 and, with respect to the East Hobbs Unit, as of March 1, 2004. All calculations of estimated net proved reserves have been made in accordance with the rules and regulations of the Securities and Exchange Commission, or the SEC, and, except as otherwise indicated, give no effect to federal or state income taxes. For additional information regarding our reserves, please read *Business and Properties Summary of Oil and Natural Gas Properties and Projects*.

	As of December 31,		
	2001	2002	2003
Reserve Data:			
Total estimated net proved reserves:			
Oil (Bbls)	494,823	5,982,687	8,918,917
Natural gas (Mcf)	2,960,373	3,187,757	3,408,754
Total (Boe)	988,219	6,513,980	9,487,043
Estimated net proved developed reserves:			
Oil (Bbls)	142,371	750,464	1,580,531
Natural gas (Mcf)	1,038,564	1,151,985	1,612,738
Total (Boe)	315,465	942,462	1,849,321
Estimated future net revenues before income taxes	\$ 11,071,319	\$ 112,237,773	\$ 185,064,651
Present value of estimated future net revenues before income taxes ⁽¹⁾⁽²⁾	\$ 7,373,058	\$ 69,958,528	\$ 91,965,372
Standardized measure of discounted future net cash flows ⁽³⁾	\$ 5,203,372	\$ 42,476,827	\$ 61,840,947

- (1) The present value of estimated future net revenues attributable to our reserves was prepared using constant prices, as of the calculation date, discounted at 10% per year on a pre-tax basis.
- (2) The December 31, 2001 amount was calculated using a period end average realized oil price of \$19.25 per barrel and a period end average realized natural gas price of \$2.52 per Mcf; the December 31, 2002 amount was calculated using a period end average realized oil price of \$24.00 per barrel and a period end average realized natural gas price of \$3.00 per Mcf; the December 31, 2003 amount was calculated using a period end average realized oil price of \$29.25 per barrel and a period end average realized natural gas price of \$3.46 per Mcf.
- (3) The standardized measure of discounted future net cash flows represents the present value of future cash flows after income tax discounted at 10%.

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	As of
	March 1, 2004
East Hobbs Unit Reserve Data:	
Total estimated net proved reserves:	
Oil (Bbls)	5,867,132
Natural gas (Mcf)	3,342,901
Total (Boe)	6,424,282
Estimated net proved developed reserves:	
Oil (Bbls)	1,445,427
Natural gas (Mcf)	1,932,984
Total (Boe)	1,767,591
Estimated future net revenues before income taxes	\$ 144,224,494
Present value of estimated future net revenues before income taxes ⁽¹⁾⁽²⁾	\$ 73,083,241
Standardized measure of discounted future net cash flows ⁽³⁾	\$ 48,234,939

- (1) The present value of estimated future net revenues attributable to the East Hobbs reserves were prepared using constant prices, as of the calculation date, discounted at 10% per year on a pre-tax basis.
- (2) The March 1, 2004 amount was calculated using an oil price of \$29.25 per barrel and a natural gas price of \$4.71 per Mcf.
- (3) The standardized measure of discounted future net cash flows represents the present value of future cash flows after income tax discounted at 10%.

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The following table presents summary information regarding our historical operating data for the years ended December 31, 2001, 2002 and 2003 and as of March 31, 2003 and 2004 (which are derived from our financial statements):

	Year Ended December 31,			Three Months Ended	
				March 31,	
	2001	2002	2003	2003	2004
Operating Data:					
Net production:					
Oil (Bbls)	12,895	58,717	117,646	23,590	33,783
Natural gas (Mcf)	4,776	46,819	67,329	10,912	19,323
Total (Boe)	13,691	66,520	128,868	25,408	37,003
Net sales:					
Oil	\$ 302,424	\$ 1,532,045	\$ 3,418,480	\$ 759,038	\$ 1,123,034
Natural gas	9,309	124,992	246,997	47,983	77,366
Total	\$ 311,733	\$ 1,657,037	\$ 3,665,477	\$ 807,021	\$ 1,200,400
Average sales price:					
Oil (per Bbl)	\$ 22.36	\$ 26.09	\$ 29.06	\$ 32.18	\$ 33.23
Natural gas (per Mcf)	1.79	2.67	3.67	4.40	4.00
Total (per Boe)	21.69	24.91	28.44	31.76	32.43
Average (per Boe):					
Lease operating expenses	\$ 7.81	\$ 8.94	\$ 8.92	\$ 9.53	\$ 8.54
Production taxes	1.08	1.76	2.09	2.12	2.13
Depreciation, depletion and amortization expense	3.22	1.92	2.62	2.01	2.64
General and administrative expenses	9.33	3.73	4.33	5.65	4.82
Net income (loss) after preferred stock dividends	(3.28)	(5.94)	6.41	7.10	8.61

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RISK FACTORS

You should carefully consider each of the risks described below, together with all of the other information contained in this prospectus, before deciding to invest in our securities. If any of the following risks develop into actual events, our business, financial condition or results of operations could be materially adversely affected, the trading prices of the securities could decline and you may lose all or part of your investment.

Risks Relating to the Oil and Natural Gas Industry and Our Business

A substantial or extended decline in oil and natural gas prices may adversely affect our business, financial condition or results of operations and our ability to meet our capital expenditure obligations and financial commitments.

The price we receive for our oil and natural gas production heavily influences our revenue, profitability, access to capital and future rate of growth. Oil and natural gas are commodities and, therefore, their prices are subject to wide fluctuations in response to relatively minor changes in supply and demand. Historically, the markets for oil and natural gas have been volatile. These markets will likely continue to be volatile in the future. The prices we receive for our production, and the levels of our production, depend on numerous factors beyond our control. These factors include, but are not limited to, the following:

- changes in global supply and demand for oil and natural gas;
- the actions of the Organization of Petroleum Exporting Countries, or OPEC;
- the price and quantity of imports of foreign oil and natural gas;
- political conditions, including embargoes, in or affecting other oil-producing activity;
- the level of global oil and natural gas exploration and production activity;
- the level of global oil and natural gas inventories;
- weather conditions;
- technological advances affecting energy consumption; and
- the price and availability of alternative fuels.

Lower oil and natural gas prices may not only decrease our revenues on a per unit basis but also may reduce the amount of oil and natural gas that we can produce economically. Lower prices will also negatively impact the value of our proved reserves. A substantial or extended decline in oil or natural gas prices may materially and adversely affect our future business, financial condition, results of operations, liquidity or ability to finance planned capital expenditures.

A substantial percentage of our proven properties are undeveloped; therefore the risk associated with our success is greater than would be the case if the majority of our properties were categorized as proved developed producing.

Because a substantial percentage of our proven properties are proved undeveloped (approximately 78%), or proved developed non-producing (approximately 4%), we will require significant additional capital to develop such properties before they may become productive. Further, because of the inherent uncertainties associated with drilling for oil and gas, some of these properties may never be developed to the extent that they result in positive cash flow. Even if we are successful in our development efforts, it could take several years for a significant portion of our undeveloped properties to be converted to positive cash flow.

While our current business plan is to fund the development costs with cash flow from our other producing properties, if such cash flow is not sufficient we may be forced to seek alternative sources for cash, through the issuance of additional equity or debt securities, increased borrowings or other means. See, [Business and Properties](#) Estimated Costs Related to Conversion of Proved Undeveloped Reserves to Proved Developed Reserves.

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Drilling for and producing oil and natural gas are high risk activities with many uncertainties that could adversely affect our business, financial condition or results of operations.

Our future success will depend on the success of our exploitation, exploration, development and production activities. Our oil and natural gas exploration and production activities are subject to numerous risks beyond our control, including the risk that drilling will not result in commercially viable oil or natural gas production. Our decisions to purchase, explore, develop or otherwise exploit prospects or properties will depend in part on the evaluation of data obtained through geophysical and geological analyses, production data and engineering studies, the results of which are often inconclusive or subject to varying interpretations. Please read Reserve estimates depend on many assumptions that may turn out to be inaccurate (below) for a discussion of the uncertainty involved in these processes. Our cost of drilling, completing and operating wells is often uncertain before drilling commences. Overruns in budgeted expenditures are common risks that can make a particular project uneconomical. Further, many factors may curtail, delay or cancel drilling, including the following:

delays imposed by or resulting from compliance with regulatory requirements;

pressure or irregularities in geological formations;

shortages of or delays in obtaining equipment and qualified personnel;

equipment failures or accidents;

adverse weather conditions;

reductions in oil and natural gas prices;

title problems; and

limitations in the market for oil and natural gas.

If we are not successful in acquiring additional producing properties, rather than utilizing cash flow from existing production to finance future development, we may be forced to delay production, or incur debt or sell additional equity as sources of financing our development program.

Our current business strategy is to continue our program of acquiring properties that satisfy our business model, until we have a base of producing properties from which we can utilize cash flow from production to further finance additional development of those properties. We anticipate using approximately \$6 million of the proceeds of this offering for such acquisition purposes. If, after utilizing the proceeds of this offering to conclude our acquisition program, our cash flow from production is not sufficient to develop our properties to their complete potential, we will be required to delay or curtail anticipated development activities, or alter or increase our capitalization substantially through the issuance of debt or other equity securities, the sale of production payments, increase borrowings or other means. Each of these alternatives involves more risk to investors (and enhances the possibility that the trading price of our stock and the units would be negatively impacted by reason of a balance sheet reflecting a less favorable capital structure or dilution of existing shareholders) than if we are able to fund development activities from existing cash flow.

If our assessments of recently purchased properties are materially inaccurate, it could have significant impact on future operations and earnings.

We have aggressively expanded our base of producing properties, including the recent acquisition of the East Hobbs Unit. The successful acquisition of producing properties requires assessments of many factors, which are inherently inexact and may be inaccurate, including the following:

the amount of recoverable reserves;

future oil and natural gas prices;

estimates of operating costs;

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estimates of future development costs;

estimates of the costs and timing of plugging and abandonment; and

potential environmental and other liabilities.

Our assessment will not reveal all existing or potential problems, nor will it permit us to become familiar enough with the properties to assess fully their capabilities and deficiencies. As noted previously, we plan to undertake further development of our properties through the use of cash flow from existing production. Therefore, a material deviation in our assessments of these factors could result in less cash flow being available for such purposes than we presently anticipate, which could either delay future development operations (and delay the anticipated conversion of reserves into cash), or cause us to seek alternative sources to finance development activities.

If oil and natural gas prices decrease, we may be required to take write-downs of the carrying values of our oil and natural gas properties, potentially requiring earlier than anticipated debt repayment and negatively impacting the trading value of our securities.

Accounting rules require that we review periodically the carrying value of our oil and natural gas properties for possible impairment. Based on specific market factors and circumstances at the time of prospective impairment reviews, and the continuing evaluation of development plans, production data, economics and other factors, we may be required to write down the carrying value of our oil and natural gas properties. Because our properties serve as collateral for advances under our existing credit facilities, a write-down in the carrying values of our properties could require us to repay debt earlier than we would otherwise be required. A write-down could also constitute a non-cash charge to earnings. It is likely the cumulative effect of a write-down could also negatively impact the trading price of our securities.

Reserve estimates depend on many assumptions that may turn out to be inaccurate. Any material inaccuracies in these reserve estimates or underlying assumptions will materially affect the quantities and present value of our reserves.

The process of estimating oil and natural gas reserves is complex. It requires interpretations of available technical data and many assumptions, including assumptions relating to economic factors. Any significant inaccuracies in these interpretations or assumptions could materially affect the estimated quantities and present value of reserves shown in this prospectus. Please read *Business and Properties Summary of Oil and Natural Gas Properties and Projects* for information about our oil and natural gas reserves.

In order to prepare our estimates, we must project production rates and timing of development expenditures. We must also analyze available geological, geophysical, production and engineering data. The extent, quality and reliability of this data can vary. The process also requires economic assumptions about matters such as oil and natural gas prices, drilling and operating expenses, capital expenditures, taxes and availability of funds. Therefore, estimates of oil and natural gas reserves are inherently imprecise.

Actual future production, oil and natural gas prices, revenues, taxes, development expenditures, operating expenses and quantities of recoverable oil and natural gas reserves most likely will vary from our estimates. Any significant variance could materially affect the estimated quantities and present value of reserves shown in this prospectus. In addition, we may adjust estimates of proved reserves to reflect production history, results of exploration and development, prevailing oil and natural gas prices and other factors, many of which are beyond our control.

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You should not assume that the present value of future net revenues from our proved reserves referred to in this prospectus is the current market value of our estimated oil and natural gas reserves. In accordance with SEC requirements, we generally base the estimated discounted future net cash flows from our proved reserves on

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prices and costs on the date of the estimate. Actual future prices and costs may differ materially from those used in the present value estimate. If future values decline or costs increase it could negatively impact our ability to finance operations, and individual properties could cease being commercially viable, affecting our decision to continue operations on producing properties or to attempt to develop properties. All of these factors would have a negative impact on earnings and net income, and most likely the trading price of our securities. These factors could also result in the acceleration of debt repayment and a reduction in our borrowing base under our credit facilities.

Prospects that we decide to drill may not yield oil or natural gas in commercially viable quantities.

We describe some of our current prospects and our future plans to explore those prospects in this prospectus. A prospect is a property on which we have identified what we believe, based on available seismic and geological information, to be indications of oil or natural gas. Our prospects are in various stages of evaluation, ranging from a prospect which is ready to drill to a prospect that will require substantial additional seismic data processing and interpretation. There is no way to predict in advance of drilling and testing whether any particular prospect will yield oil or natural gas in sufficient quantities to recover drilling or completion costs or to be economically viable. This risk may be enhanced in our situation, due to the fact that a significant percentage (78%) of our proved reserves are currently proved undeveloped reserves. The use of seismic data and other technologies and the study of producing fields in the same area will not enable us to know conclusively prior to drilling whether oil or natural gas will be present or, if present, whether oil or natural gas will be present in commercial quantities. We cannot assure you that the analogies we draw from available data from other wells, more fully explored prospects or producing fields will be applicable to our drilling prospects.

We may incur substantial losses and be subject to substantial liability claims as a result of our oil and natural gas operations.

We are not insured against all risks. Losses and liabilities arising from uninsured and underinsured events could materially and adversely affect our business, financial condition or results of operations. Our oil and natural gas exploration and production activities are subject to all of the operating risks associated with drilling for and producing oil and natural gas, including the possibility of:

environmental hazards, such as uncontrollable flows of oil, natural gas, brine, well fluids, toxic gas or other pollution into the environment, including groundwater and shoreline contamination;

abnormally pressured formations;

mechanical difficulties, such as stuck oil field drilling and service tools and casing collapse;

fires and explosions;

personal injuries and death; and

natural disasters.