

**Recommendation** **Speculative Buy****Price** **\$3.00**
Target (12 months) **\$4.25**

Expected Return Potential

Capital growth 42%
Dividend yield 0%
Total shareholder return (TSR) **42%**

Company Data and Ratios

Enterprise value \$310m
Market cap \$396m
Issued capital 132.0m
Free float 75%
12 month price range \$1.20-4.01
GICS sector Energy

Carioca worth celebrating:



Disclaimer and disclosures

This report must be read with the disclaimer and disclosures on page 6 that form part of it. SCE acted as co-manager in the placement of 14.8m KAR shares raising \$51m in November 2007 and was paid a fee.

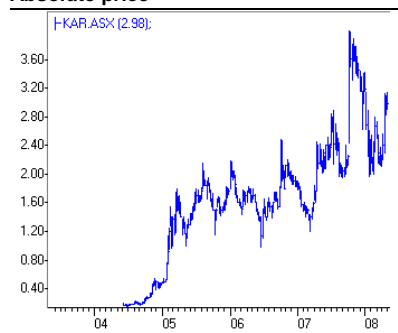
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Absolute price



Karoon Gas Australia (KAR)

Excitement in Brazil

- ◆ Well timed positioning in Brazil and Peru
- ◆ Browse drilling 4Q08, enormous option value
- ◆ Target raised to \$4.25 (\$4.00) on South America

Sharing a basin with giant oil fields

KAR's entry into South America has proven to be well timed and well directed. Subsequent to KAR's acquisition of acreage in Brazil, new discoveries of giant oil fields in the same basin have been confirmed. South America (both Brazil and Peru) provides diversified exploration potential of major proportion, favourably complementing KAR's core Browse position. It enhances KAR as a high risk gas/LNG and oil exploration play with enormous potential reward.

We have raised the target price to \$4.25 (pre Browse drilling), incorporating value for the South American assets. As we have highlighted previously, success in the Browse would almost certainly result in a substantially higher share price, as each of the 3-4 wells planned has the potential to add several dollars of value.

Brazil adds excitement and value. Since acquiring five permits in the offshore Santos basin in Brazil, major new discoveries have been confirmed in the same basin. Located 200km from KAR's blocks, the Tupi oil field has been stated as a 5-8 billion barrel field and more recently, estimates of the Carioca discovery have placed it as +30billion barrels. KAR's targets are smaller, of the order of 100-300mb, but these giant discoveries improve the chances of the existence of oil. Similar size prospects are the target in Peru where exploration is more immediate.

Browse Basin drilling approaching in 2008. KAR and JV partner are working towards spudding the first of a 3-4 well program in their Browse blocks early in the final quarter of 2008. The potential here is enormous - KAR has identified a number of prospects estimated to contain risked reserve potential of 20TCF and 600mbl of condensate. Such a reserve position, if confirmed by drilling, could support a new LNG project with onshore facilities located at Darwin.

High risk business. Oil and gas exploration is inherently a high risk business by virtue of geological and technical uncertainties. As a small cap company with no revenue stream operating in an environment of large capital requirements, KAR carries a degree of financial risk. However the company has mitigated the risks by positioning its activities in areas of large, proven oil and gas reservoirs. Furthermore, the company has a high level of technical expertise, has a world ranking partner in ConocoPhillips and is in a solid financial position. Relative to other oil and gas situations KAR's gas prospects carry low to moderate geological risk.

Target raised to \$4.25 per share. We have raised the target price from \$4.00 to \$4.25 taking into account the value of the South American position. This is a price we have assessed that should be achieved in advance of any Browse or South American drilling. Success of just one well in the Browse in identifying a multi TCF gas field, we assess, would theoretically add \$3.00-6.00 per share. It would also bring closer to fruition management's vision of building an LNG business through discovery and development.



Target price revised upwards

The valuation analysis we provided in our KAR initiation report of October 2007 based on the Browse basin interests still stands. We repeat in Table 1 below (adjusted for additional shares on issue) the assessed values of the four Browse prospects, the total of which comes to \$56.45 per share unrisks and \$17.77 per share risks.

Acquisition of the South American permits and the successes in nearby regions subsequently, has created additional value. The Santos basin permits in Brazil in particular have become more valuable following the substantial upgrading of the Carioca discovery.

We have added typical prospects in each of Peru and Brazil to our target price analysis. The company's programs include the possibility of more wells in these two regions but until more certainty emerges we include only one well each for valuation purposes. For these two typical prospects, we assess the unrisks value at \$20.43 and risks \$3.52.

\$4.25 target

We maintain the view that the share price should increase in advance of drilling to reflect a proportion of the risks valuation. Applying the same proportion of 20% as we did in our October review, but this time on a risks value of \$21.29, which includes two South American prospects, we arrive at a 12 month target price of \$4.25 per share.

Financial update

Strong financial position with no debt and cash of ~\$90m

KAR raised \$51M in November 2007 via an equity placement (SCE co-manager to the issue) which took the company's net cash position, at the end of December, to \$131m. This has subsequently been reduced to around \$90m following the completion of 3D seismic in WA-398-P, settlement of the Brazilian acquisitions and other outgoings. The company has no debt.

Under the Browse farmin agreement, ConocoPhillips will pay 80% of the cost of two wells in WA-314-P and WA-315-P and KAR 20%. KAR will be required to fund 40% of the cost of drilling and other JV expenditure in WA-398-P.

It is not known at this point exactly how many wells will be drilled and what the total cost will be but KAR has flagged the cost of the preliminary seismic work and 200-225 day drill program to be in the vicinity of \$250m. We estimate KAR's share of this program to be in the range of \$60-80m, which is covered by existing cash.

Other demands for cash should be relatively limited over the next 12 months. KAR is required to fund a 2,000km 2D seismic survey in Z38 Peru as the first phase work program, but this may take place after the Browse drilling. In Brazil, KAR may farm out part of its interest to reduce spending on the required 3D seismic and, ultimately, drilling. So at this stage, KAR's funding requirements for South America are not clear.

Table 1 - Browse prospects and valuations

	Gas	Liquids	Total Boe	KAR's share	NPV/boe	Unrisks Value		Risks Values (KAR share)		
	Tcf	Mmbl	Mmboe	%	\$/boe	\$M	\$/share	COS	Mmboe	\$/share
Selected Prospects										
Unrisks P50 Reserve Potential										
Kon-Tiki	12		2190	40	3.00	2628	19.91	35%	307	6.97
Grace	7		1280	40	3.00	1536	11.64	35%	179	4.07
Poseidon	7		1280	40	3.00	1536	11.64	35%	179	4.07
Duyfken	8		1460	40	3.00	1752	13.27	20%	117	2.65
Total Browse	34		6210				56.45		782	17.77
Peru Z38	3	200	749	40	5.00	1497	11.34	15%	45	1.70
Brazil		200	200	50	12.00	1200	9.09	20%	20	1.82
Total South America		400	949				20.43			3.52
Total							76.89			21.29

Source: KAR and SCE, *COS = Chance of Success



Santos Basin Brazil

An early entrant to the prized Santos basin

In November 2007 KAR was awarded 100% of five blocks covering 850 sq km in the offshore Santos basin, in the state of Santa Catarina, Brazil, just south of Rio De Janeiro. The blocks are located in mid-range water depths of 300m, on trend with and within 100km of a number of producing oil fields Caravela/Merluza.

Karoon was obligated to pay a total of \$US25 million in non-refundable signature bonuses and refundable bid bonds to ANP, the governing body of the Brazilian petroleum industry.

The agreed work program of the first three year term consists of:

- extensive geological analysis work
- purchase, reprocessing and interpretation of existing seismic
- acquisition of a further 170 sq km of 3D seismic on three of the blocks.

In the optional second term of two years, one well is required to be drilled in each of the five blocks.

In an excellent position to farm out

KAR stated that all expenditure will be funded either through the use of KAR funds or possibly the equity restructuring or farm out of the permits.

Discovery of potentially giant new oil fields in the Santos basin has elevated the prospectivity of the basin. At the time KAR was bidding for its blocks, the first wells in the Tupi work program (Petrobras) had been sunk and the field was later estimated to contain 5-8 Mb of recoverable oil. Tupi is located some 200km from KAR in water depths of over 1,000m.

33 billion barrels would truly be a giant

More recently, the Carioca discovery was identified as a potential giant oil discovery. During the drilling of the second well a senior government official was reported to have commented that Carioca could be a 33Bb oil field. The consortium of Petrobras (45% - operator), BG (30%), and Repsol YPF Brasil (25%) reported the discovery well (Block BM-S-9) in early September 2007, when the production test flowed 2,900 barrels of oil and 57,000 cubic meters of gas per day. There has been no official estimate of the volumes contained by the consortium, with Petrobras commenting that the second well needs to be completed, tested and all information assessed.

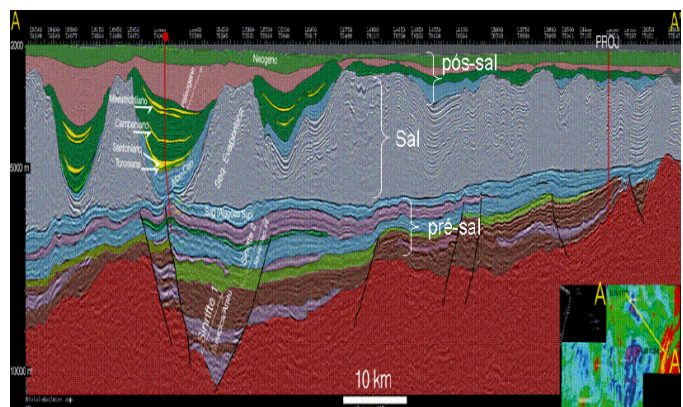
These potential giant oil fields, discovered in deep water, have established the Santos basin as a new hydrocarbon province. Reservoir trap structures may vary across the basin, but the same source rocks are associated with Carioca, Tupi and the Caravela trend where KAR's permits are located.

Figure 2 – Location of KAR's Santos basin blocks



Source: KAR

Figure 3 - Typical Pre-salt trap features



Source: Petrobras



Tumbes Basin Peru

Z38, a prime address in Peru

In January this year, KAR signed a Farmin Agreement with Vietnam American Exploration Company LLC (Vamex) for the exploration of Block Z38 located in the offshore Tumbes Basin in Northern Peru. Vamex is a 100% subsidiary of Pitkin Petroleum, a United States independent oil and gas company. KAR will earn an initial 20% interest in the block by funding a new 2,000 km 2D seismic survey with the option of earning an additional 40% interest by acquiring 670 sq km of new 3D seismic data.

The expectation is that the seismic acquisition will commence later in 2008. The block is prospective for both oil and gas with any offshore development facilitated by the close proximity of existing infrastructure. Two advanced leads have been identified with 100-200mb or multi TCF resource potential.

Large, 4TCF gas field next door

The prospectivity of the region has been established by the existence, between Block Z38 and the coastline, of a number of large oil and gas fields. The Corvina field, held by BPZ in adjoining Block Z1 contains 3P reserves of 4TCF gas.

During the December quarter, KAR was offered and accepted Block 144 in the onshore Marañon Basin in Peru. Subject to the receipt of regulatory approvals, KAR will earn an initial 100% interest in the block by carrying out the Primary Term work program of 1,000km 2D seismic reprocessing. In the optional Secondary Term the work program includes the acquisition and interpretation of a 300 km 2D seismic survey. In each of the optional Third and Fourth terms the work program is to drill one well.

Figure 4 - Peru



Source: KAR



Browse Basin

Seismic completed as planned

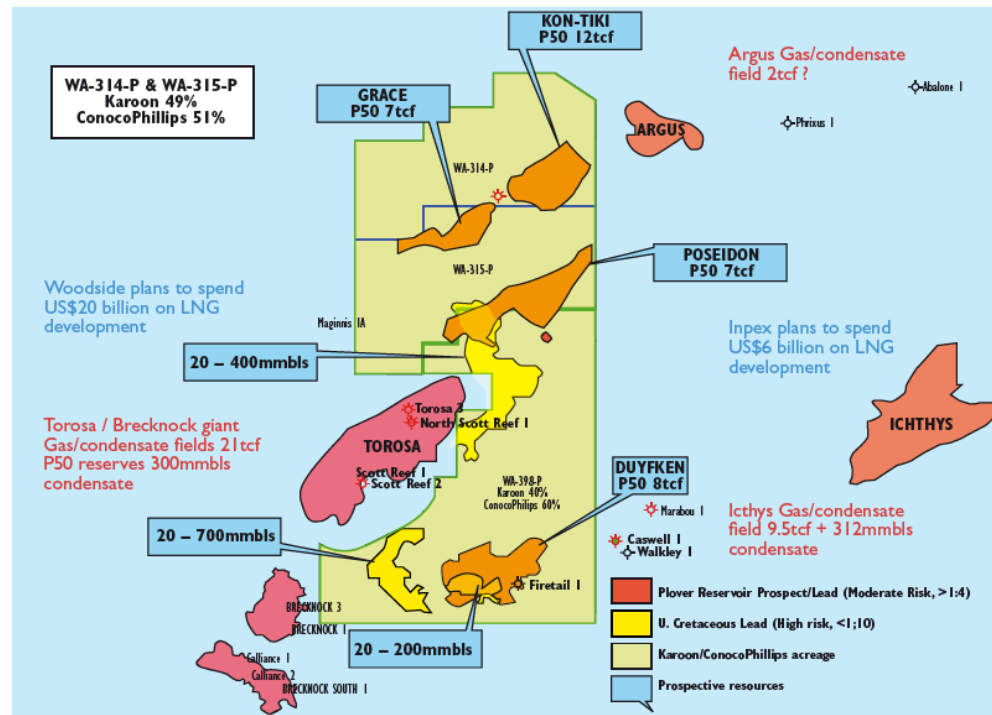
As planned, 1,400 sq km of 3D seismic survey has been completed in permit WA-398-P, plus an additional 500 sq km outside the permit boundary was also covered. The 3D seismic data was acquired to improve the definition of several leads identified within the permit, with the interpretation to be completed later this year.

This follows the interpretation during the December half of seismic data acquired in 2006 and 2007. The results have confirmed prior assessments and will be used to further define drilling prospects.

Much awaited drilling coming up in 4Q08

Under the work programs, one well is planned to be drilled in each of the blocks WA-314-P, WA-315-P and WA-398-P in 2008/09. This is the minimum requirement but there may be the opportunity to drill one or two additional wells, depending on the outcomes of the initial wells and test requirements. The main (Plover Sands) targets identified to date are Kon-Tiki, Grace, Poseidon and Duyfken, as shown in Figure 5 below.

Figure 5 - Browse Basin



Source: KAR

Figure 6 – Sedco 703 semi-submersible drill rig

The JV has contracted the offshore drilling rig, Sedco-703 semi submersible, which is due to commence drilling in the fourth quarter of 2008. The rig has been contracted for 200-225 days. It is currently under contract by Woodside in the Browse basin and will be available after the conclusion of this contract and some time in maintenance. The total cost to the operating joint venture of employing this rig, along with drill hardware is expected to approach \$1m per day.



Source: Industry source



Recommendation structure

Buy: Expect >15% total return on a 12-month view
Speculative Buy: Expect >30% total return on a 12-month view but carries significantly higher risk than its sector
Fair Value: Expect total return between -15% and +15% on a 12-month view
Sell: Expect <-15% total return on a 12-month view

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Disclosure of Interest

Southern Cross Equities Ltd and its associates hold 833,000 shares in Karoon Gas Australia (KAR) as at the date of this report. This position is subject to change without notice.

SCE acted as co-manager in the placement of 14.8m KAR shares raising \$51m in November 2007 and was paid a fee.