

Karoon Gas (KAR.AX / KAR AU)

| | |
|------------------------------|------------------------|
| Rating | OUTPERFORM* [V] |
| Price (06 Feb 09, A\$) | 3.35 |
| Target price (A\$) | 6.00 [†] |
| Market cap. (A\$m) | 470.71 |
| Yr avg. mthly trading (A\$m) | 25 |
| Last month's trading (A\$m) | 20 |
| Projected return: | |
| Capital gain (%) | 79.1 |
| Gross yield (%) | — |
| Total return (%) | 79.1 |
| Excess return ** (%) | 49.4 |
| 52-week price range (A\$) | 4.75 - 1.67 |

* Stock ratings are relative to the relevant country index.

** Relative to the broad market.

[V] = Stock considered volatile (see Disclosure Appendix).

Research Analysts

Andrew Williams
613 9280 1641
andrew.j.williams@credit-suisse.com

Jenny Wong
613 9280 1716
jenny.wong@credit-suisse.com

INITIATION

Initiation of coverage

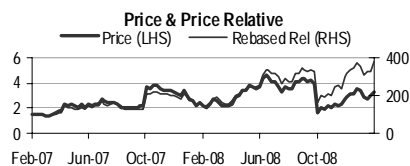
- **Event:** We are initiating coverage of Karoon Gas with a target price of A\$6.00 based on successful outcomes from the current Browse Basin drilling programme. Karoon is a pure exploration play and must be viewed within that risk context.
- **View:** The stock is leveraged to exploration success by virtue of significant equity interests in 'company-transforming' prospects, most immediately in the offshore north-west of Australia and Brazil.

The investment thesis for KAR is drilling, with a programme of three wells (minimum) having already commenced in its Browse Basin acreage, with enormous leverage to the success case outcome, although we suggest the potential LNG development scenarios look optimistic.

After significant recent capital raisings, KAR is now sufficiently financed to participate through the exploration phase and follow up appraisal, however, if successful the most likely development option will be as LNG. Although long dated, this would require (almost certainly) a massive equity injection, but let's find some gas first.

- **Risks:** The primary risk we see for KAR is the uncertainty associated with exploration drilling. Even the most optimistic assessments would only ascribe success probabilities in the order of 25% at best despite the favourable acreage location. The company is in a 'wildcat exploration phase' and needs discoveries to move to a higher investment level.
- **Valuation:** We have chosen to use cash as the basis of indicative value, either through farm-in terms (commercial transaction) or committed expenditures. We calculate the NAV of the company at A\$2.92/share, a 12% discount to a share price of \$3.30 (at time of writing).

Share price performance



The price relative chart measures performance against the Australia S&P/ASX 200 index which closed at 3428.6 on 06/02/09

On 06/02/09 the spot exchange rate was A\$1.53/US\$1

| Performance Over | 1M | 3M | 12M |
|------------------|------|------|-------|
| Absolute (%) | -0.9 | 55.1 | 48.9 |
| Relative (%) | 8.2 | 87.7 | 143.6 |

Financial and valuation metrics

| Year | 06/08A | 06/09E | 06/10E | 06/11E |
|------------------------------|----------|----------|----------|----------|
| Production (mboe/d) | — | — | — | — |
| Revenue (A\$m) | 0.0 | — | — | — |
| EBITDAX (A\$m) | -9.7 | -10.0 | -10.0 | -10.0 |
| EBIT (A\$m) | -11.4 | -10.0 | -12.3 | -11.0 |
| Net income (A\$m) | -6.1 | -6.1 | -7.6 | -8.2 |
| EPS (CS adj., Ac) | -4.66 | -4.36 | -5.11 | -5.52 |
| Change from previous EPS (%) | n.a. | — | — | — |
| Consensus EPS (Ac) | n.a. | — | — | — |
| EPS growth (%) | — | — | — | — |
| P/E (x) | NM | NM | NM | NM |
| Dividend (Ac) | — | — | — | — |
| Dividend yield (%) | — | — | — | — |
| EV / EBITDAX (x) | -40.52 | -37.66 | -41.49 | -44.21 |
| Net debt/equity (%) | net cash | net cash | net cash | net cash |

Source: Company data, ASX, Credit Suisse estimates. * Adj. for goodwill, notional interest and unusual items. Relative P/E against ASX/S&P200 based on pre GW in AUD. Company PE calculation is based on displayed EPS Currency

DISCLOSURE APPENDIX CONTAINS ANALYST CERTIFICATIONS AND THE STATUS OF NON-US ANALYSTS. U.S. Disclosure: Credit Suisse does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the Firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision. Customers of Credit Suisse in the United States can receive independent, third party research on the company or companies covered in this report, at no cost to them, where such research is available. Customers can access this independent research at www.credit-suisse.com/ir or call 1 877 291 2683 or email equity.research@credit-suisse.com to request a copy of this research.

Figure 1: Financial summary

KAROON GAS AUSTRALIA LIMITED

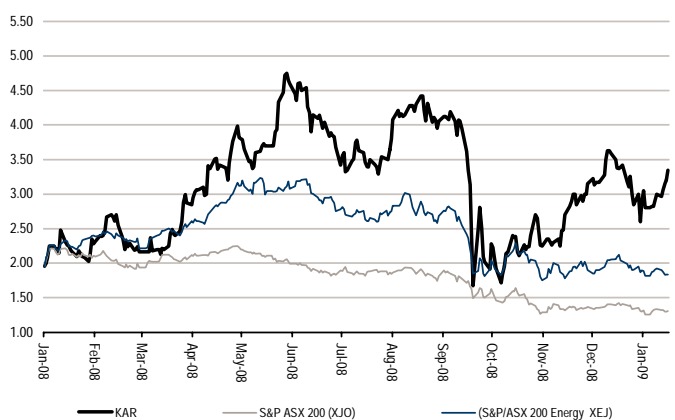
Year ending 30 Jun

| Profit and loss (\$mn) | 2007A | 2008A | 2009F | 2010F | 2011F |
|----------------------------------|--------------|--------------|--------------|--------------|--------------|
| Sales revenue | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| EBITDA | -17.3 | -11.0 | -10.0 | -12.3 | -11.0 |
| Depr. & Amort. | 0.2 | 0.3 | 0.0 | 0.0 | 0.0 |
| Goodwill amort. | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| EBIT | -17.5 | -11.4 | -10.0 | -12.3 | -11.0 |
| Net interest | -2.9 | -5.3 | -3.9 | -4.7 | -2.8 |
| Profit before tax | -14.6 | -6.1 | -6.1 | -7.6 | -8.2 |
| Income tax | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Profit after tax | -14.6 | -6.1 | -6.1 | -7.6 | -8.2 |
| Minorities | na | na | na | na | na |
| Equity adjustment | na | na | na | na | na |
| Net profit after tax | -14.6 | -6.1 | -6.1 | -7.6 | -8.2 |
| Preferred dividends | na | na | na | na | na |
| Net profit after tax | -14.6 | -6.1 | -6.1 | -7.6 | -8.2 |
| Unusual item after tax | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Reported profit after tax | -14.6 | -6.1 | -6.1 | -7.6 | -8.2 |
| Balance sheet (\$mn) | 2007A | 2008A | 2009F | 2010F | 2011F |
| Cash & equivalents | 76.4 | 77.4 | 94.1 | 55.8 | 28.6 |
| Inventories | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Receivables | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Other current assets | 0.0 | 9.6 | 0.0 | 0.0 | 0.0 |
| Current assets | 76.6 | 87.3 | 94.4 | 56.1 | 28.9 |
| Property, plant & equip. | 0.5 | 0.3 | 0.3 | 0.3 | 0.3 |
| Intangibles | 0.3 | 0.2 | 0.2 | 0.2 | 0.2 |
| Other non-current assets | 6.4 | 51.6 | 117.4 | 148.1 | 167.1 |
| Non-current assets | 7.1 | 52.1 | 117.9 | 148.6 | 167.6 |
| Total assets | 83.7 | 139.4 | 212.3 | 204.7 | 196.5 |
| Payables | na | na | na | na | na |
| Interest bearing debt | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other liabilities | na | na | na | na | na |
| Total liabilities | 2.5 | 8.6 | 41.5 | 41.5 | 41.5 |
| Net assets | 81.2 | 130.7 | 170.8 | 163.2 | 155.0 |
| Ordinary equity | 81.2 | 130.7 | 170.8 | 163.2 | 155.0 |
| Minority interests | na | na | na | na | na |
| Preferred capital | na | na | na | na | na |
| Total shareholder funds | 81.2 | 130.7 | 170.8 | 163.2 | 155.0 |
| Cashflow (\$mn) | 2007A | 2008A | 2009F | 2010F | 2011F |
| EBIT | -17.5 | -11.4 | -10.0 | -12.3 | -11.0 |
| Net interest | 2.0 | 5.3 | 3.9 | 4.7 | 2.8 |
| Depr & Amort | 0.2 | 0.3 | 0.0 | 0.0 | 0.0 |
| Tax paid | na | na | na | na | na |
| Working capital | 2.3 | 3.4 | 10.5 | -8.2 | -3.3 |
| Other | 15.3 | 2.1 | -10.2 | 10.5 | 4.3 |
| Operating cashflow | 2.3 | -0.2 | -5.8 | -5.3 | -7.2 |
| Capex | -2.5 | -41.1 | -65.8 | -33.0 | -20.0 |
| Acquisitions & Invest | 0.0 | -1.0 | 0.0 | 0.0 | 0.0 |
| Asset sale proceeds | na | na | na | na | na |
| Other | 0.0 | -9.5 | 9.6 | 0.0 | 0.0 |
| Investing cashflow | -2.5 | -51.6 | -56.2 | -33.0 | -20.0 |
| Dividends paid | na | na | na | na | na |
| Equity raised | 62.5 | 54.6 | 49.9 | 0.0 | 0.0 |
| Net borrowings | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | 0.0 | 2.6 | 0.0 | 0.0 | 0.0 |
| Financing cashflow | 62.5 | 57.2 | 49.9 | 0.0 | 0.0 |
| Net cashflow | 62.3 | 5.5 | -12.1 | -38.3 | -27.2 |

Share Price: \$3.35

| Financial summary | | 2007A | 2008A | 2009F | 2010F | 2011F |
|-----------------------------|------|---------|---------|--------|-------|-------|
| NPAT | \$mn | -14.6 | -6.1 | -6.1 | -7.6 | -8.2 |
| Credit Suisse NPAT | \$mn | -14.6 | -6.1 | -6.1 | -7.6 | -8.2 |
| Credit Suisse EPS | c | -12.2 | -4.7 | -4.4 | -5.1 | -5.5 |
| EPS growth | % | -279.4 | 61.8 | 6.4 | -17.1 | -8.0 |
| P/E | x | -27.5 | -71.9 | -76.8 | -65.6 | -60.7 |
| P/Earnings Growth | x | na | -15.3 | -6.2 | na | na |
| Dividend payout ratio | % | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Dividend | c | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Yield | % | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Franking | % | na | na | na | na | na |
| Operating CFPS | c | 1.9 | -0.2 | -4.1 | -3.6 | -4.8 |
| P/OCF | x | 172.4 | -2222.3 | -81.5 | -94.2 | -69.2 |
| EV/EBITDA | x | -24.3 | -38.2 | -42.1 | -34.2 | -38.3 |
| FCF yield | % | 0.0 | -9.5 | -15.2 | -7.7 | -5.5 |
| Financial ratios | | 2007A | 2008A | 2009F | 2010F | 2011F |
| Profitability Ratios | | | | | | |
| EBITDA margin | % | na | na | na | na | na |
| EBIT margin | % | na | na | na | na | na |
| Return on equity | % | -18.0 | -4.6 | -3.6 | -4.7 | -5.3 |
| Return on assets | % | -240.4 | -18.4 | -8.5 | -8.3 | -6.6 |
| ROCE | % | -158.1 | -39.2 | -15.4 | -13.4 | -9.4 |
| Effective tax rate | % | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Balance Sheet Ratios | | | | | | |
| Net debt | \$mn | -76.4 | -77.4 | -94.1 | -55.8 | -28.6 |
| Net debt/Equity | % | -94.1 | -59.2 | -55.1 | -34.2 | -18.5 |
| Net debt/Capital | % | -1604.0 | -145.2 | -122.8 | -52.0 | -22.7 |
| Interest cover | x | 6.1 | 2.1 | 2.6 | 2.6 | 3.9 |
| Capex/Sales | % | na | na | na | na | na |
| Capex/Depn | % | -11.2 | -118.9 | na | na | na |
| Working capital/Sales | % | na | na | na | na | na |
| Share Items | | | | | | |
| Equiv. FPO (period avg.) | mn | 120 | 130 | 141 | 149 | 149 |

Share price performance (AUD) 52 week range: \$1.67 - \$4.75



Source: ASX

Source: Company data, Credit Suisse estimates

Karoon Gas – it's about holes in the ground

We initiate on Karoon Gas Australia Limited (KAR) with \$6.00/share target price and an OUTPERFORM rating.

We initiate with a A\$6.00 target price

KAR is a traditional and conventional exploration play the scope of which is indicated by its market capitalisation of A\$430mn or about A\$300mn (ex-cash). For a company with no current production or reserves it already imputes a significant value, pre-drilling.

The investment thesis for KAR is drilling, with a programme of three wells (minimum) having already commenced in its Browse Basin acreage, with enormous leverage to the success case outcome, although we would suggest the potential LNG development scenarios look optimistic.

The investment thesis for KAR is drilling

The cost of the drilling programme will largely be borne by ConocoPhillips under a farm-in agreement which sees KAR reduce to 49% in permits WA-314-P and 315P; and 40% in WA-398-P for 80% of the cost of the programme.

The cost of the drilling programme will largely be borne by ConocoPhillips

After significant recent capital raisings, KAR is now sufficiently financed to participate through the exploration phase and follow up appraisal; however, if successful the most likely development option will be as LNG. Although long dated, this would require (almost certainly) a massive equity injection, but let's find some gas first.

On 15 September 2008, the company released a summary of an Independent Prospective Resources Report compiled by DeGolyer and McNaughton.

The report suggested:

"Karoon has mean estimated risked prospective resources of 1.23bnboe in its 19 prospects in Australia and South America."

Note that the prospective resource estimates were defined as those quantities of petroleum estimated, as of a given date, to be potentially recoverable from undiscovered accumulations by application of future development projects. Prospective resources have both an associated risk of discovery and a risk of development.

We highlight this resource potential simply to demonstrate the leverage to the upside upon success and imply no certainty at all to this scenario.

We see leverage to the upside of approximately \$3.00/share through the initial drilling phase based on the company's assessment of a likely commercial development opportunity, but naturally dependent on the subjective assessment of the risk discount.

We see significant potential upside on success

Within the remaining portfolio, we see opportunity in the company's Brazil acreage of five blocks (at 100%) in the offshore Santos Basin. Although there is no drilling commitment within the primary three year lease term, the region is highly regarded for its prospectivity and much sought after as an exploration address.

We believe the company is in a strong position to be able to attract a 'farminee' on attractive terms and could fast-track a drilling programme within the primary term.

Although valuing exploration assets is a highly subjective exercise we have based our NAV on capital transaction or comparative multiples where possible.

On that basis we value the company at \$2.92/share with upside to be derived on a success case—KAR is about "holes in the ground" through 2009.

The assets

Browse Basin Offshore (KAR 49%/40%)

KAR holds three permits in the Browse Basin, which lie immediately adjacent (to the East) to the Torosa/Brecknock gas fields operated by Woodside.

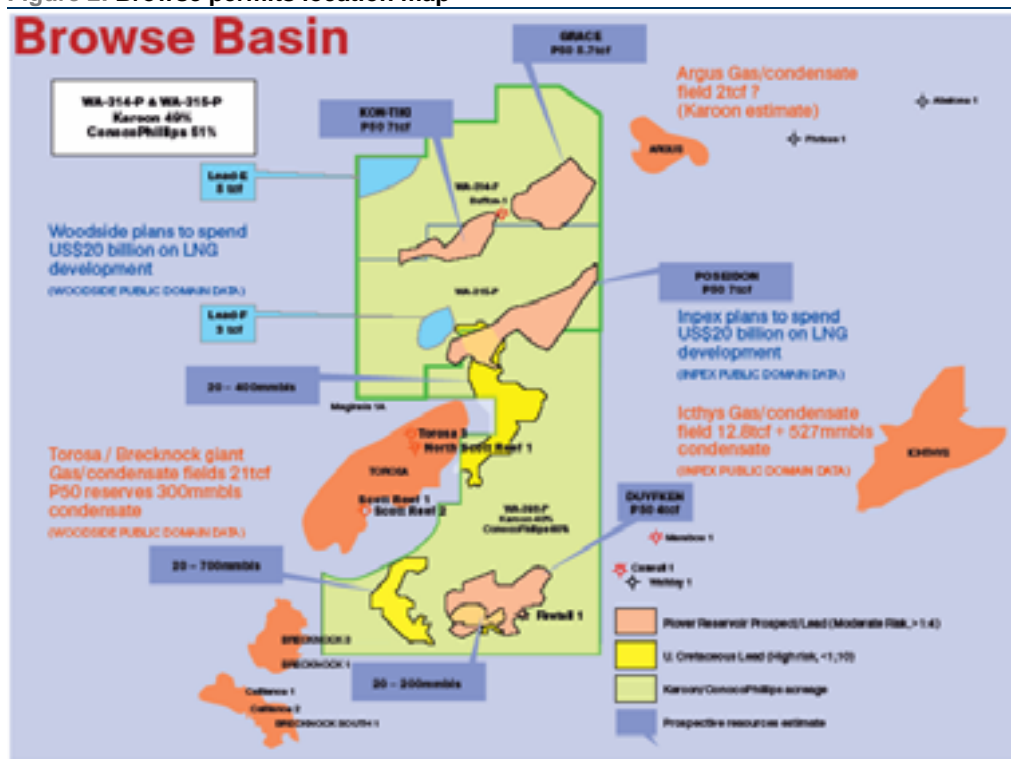
In addition, some 80km further East is the large, Inpex gas/condensate field at Ichthys.

Although these discoveries are yet to reach a commercial go-ahead, planning is underway for developments as independent LNG projects, note the indicative capital costs to first gas would be around US\$10+bn for each proposal.

As an exploration address, the location of the permits is favourable, with similar play types and geology mapped through the areas that correlate well with existing discoveries. Prospects sizes support a likely commercial threshold and success is likely to be relatively liquids rich – KAR indicates a liquids stripping option is probably viable.

A favourable exploration address and successful exploration analogues

Figure 2: Browse permits location map



Source: Company data

The immediate drilling programme focuses on these permits and is scheduled to be completed late in 3Q 2009.

The first well in the programme (Poseidon-1) spudded on 26 January.

Farm-out to ConocoPhillips

ConocoPhillips (CoP) is currently proceeding through a farm-in agreement, entered into in October 2006 which give CoP the right to acquire up to a 60% interest in the WA-314-P and -315-P permits in two tranches.

A 51% interest will be transferred after paying:

- a reimbursement to KAR of US\$9.6mn being 80% of the Year 2 work expenditure including all phases of seismic activity; and

- 80% of the cost of the Year 3 drilling programme of at least one well in each permit. The cost of drilling is estimated to be in the range of US\$60-80mn per well (100% basis).

CoP has the option to increase its interest to 60% in these permits by paying an additional:

- 80% of the next US\$125mn of related costs (net US\$100mn).

We speculate that CoP would need to see at least two drilling successes before exercising its US\$100mn option.

To LNG or not to LNG? That is the question

The location and potential discovery sizes of KAR Browse holdings support a LNG development scenario, as indicated by the company's analysis. The modelled cashflow and development outlooks remain theoretical, particularly so as a well has not been drilled yet, let alone a discovery made.

A LNG development is the most likely outcome

Although we agree that on success, LNG is the most logical commercial outcome we do not share the company's optimistic development scenario as modelled—a 5.5Mtpa train, starting up in 2014.

The development scenario is predicated on Conoco selecting (say) Poseidon as the preferred gas source into a D-LNG expansion where the company holds the licence for up to 10Mtpa of capacity.

Compared to Conoco's alternate expansion options at Sunrise and Caldita/Barossa this is probably not an unreasonable assumption if discoveries meet pre-drill expectations.

Figure 3: Conoco 'other gas'

| Field | Equity | CO2 | Liquids (b/mmcft) | Comments |
|------------------|--------|--------------------------------------|-------------------|----------------------------------------------------------|
| Caldita/Barossa | 60% | 12-15% | | nil-low flowed 30-33mmcfd on test no reserves definition |
| Sunrise | 30% | Low unspecified | 35-40 | 8Tcf+300Mb |
| Poseidon | 60%* | | | 7Tcf potential Similar to Torosa but thicker sands |
| Torosa/Brecknock | WPL | 8-10% | | 15 waxy condensate |
| Ichthys | Inpex | 8.5% main reservoir 17% secondary | | 40 |

Source: Company data, Credit Suisse estimates; * Poseidon equity assume CoP exercise all farm-in rights

Most certainly, we think that CoP would use its best efforts to fast track a D-LNG expansion given the competition for resources heading into a 2014-2015 development window.

From a partnership perspective, Conoco offers the optimum outcome for Karoon with a higher probability of being able to develop a timely LNG project than perhaps other companies.

Conoco is the ideal partner

However, in the current oil price environment, with a number of competing developments (most notably Conoco's CSG investment) timing would remain the greatest risk and we'd suggest a 2014 start-up remains an 'optimistic' assessment of first production, particularly when KAR would not be in a position to drive or accelerate a development agenda.

It's also worth noting the recent announcement by Conoco to reduce its 2009 capital budget.

Although initial scoping estimates have been conducted by WorleyParsons and steel prices in particular have fallen significantly, we believe the cost estimate of US\$7.5-8bn (as proposed) looks skinny—even for a brownfields expansion opportunity and one requiring a notional 900km pipeline.

Note that both Woodside and Inpex with adjacent discoveries, more reserves certainty, long marketing led times and arguably equal or better ability to manage costs have struggled to move these projects to FID...in fact, Woodside is still contemplating its preferred development concept and will not commit to that option until end 2009 at the earliest.

The capital costs estimates associated with both the Woodside and Inpex options are US\$10bn at a minimum.

We see success in the programme as offering company transforming potential for KAR, but cannot see a development evolving under the scenario as indicated at this stage.

Timor Sea – Offshore Bonaparte Basin (KAR 66%)

KAR holds a 66% stake in one permit (AC/P8) located in two parts adjacent to the Laminaria-Corallina development.

The company has identified a number of leads and prospects, with the most advanced being the Jania Prospect of circa 20Mb potential.

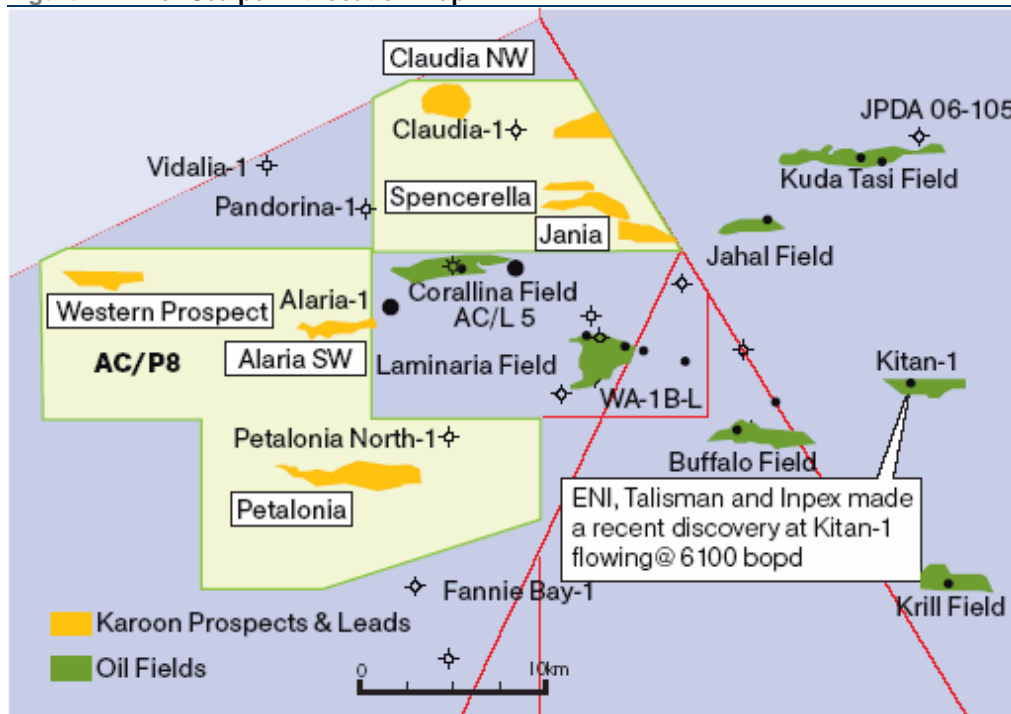
There is no drilling commitment until 2012 and the ground remains very much an early stage exploration and assessment play. We ascribe little current value to the permit at this stage.

The immediate region contains a host of discoveries but few developments, even through the recent peak of near \$150/b oil. Few accumulations demonstrate the required reserves to underpin a stand-alone development, which we see as the main risk to upside here.

A prospect size of 20Mb, in our opinion, barely provides sufficient reserves cover and would require crude oil prices well over US\$70/b, however, the play here is most likely to be for tie-back potential into the underutilised Laminaria facility. On that basis, perhaps there is some realistic development upside.

A reasonable exploration premise—small prospects within tie-back distance, but no drilling till 2012

Figure 4: Timor Sea permit location map



Source: Company data, Credit Suisse estimates

South America

The South American opportunities held by KAR look interesting and certainly worth the exposure but with significant drilling commitments around 2011, it will require a farm-out, in our opinion.

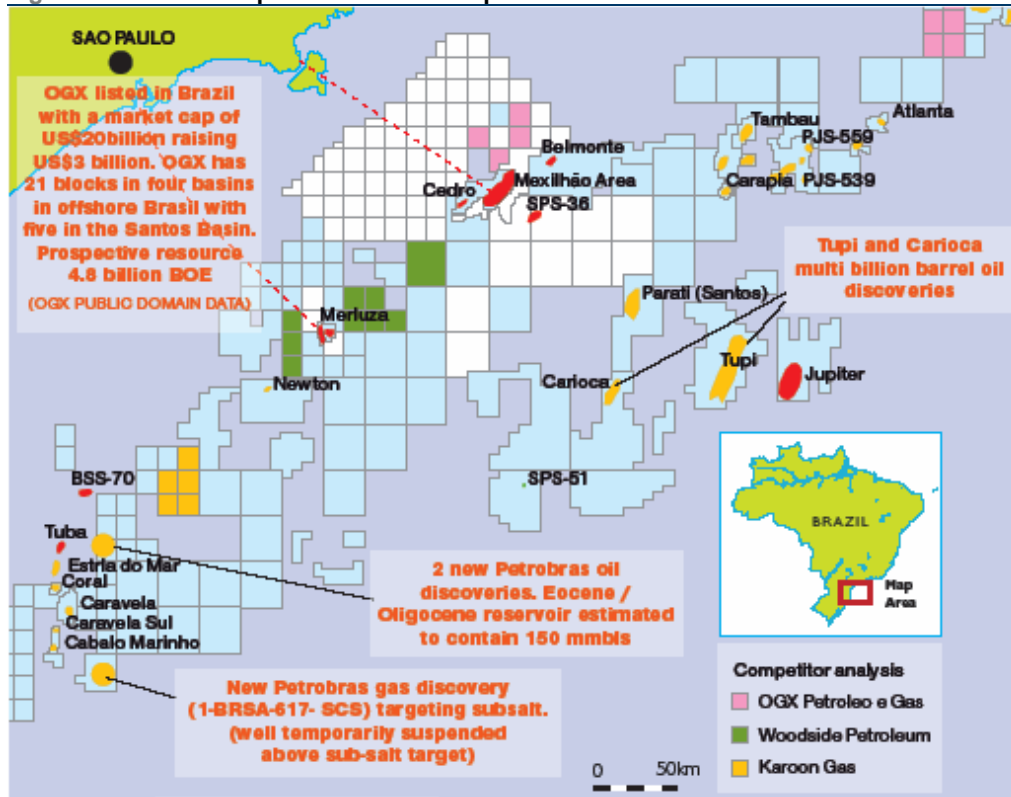
Offshore Brazil, in particular looks interesting

Ultimately, the value of these blocks will be determined by any farm-out deal, particularly as KAR holds 100% in its Brazilian exploration blocks.

Offshore Santos Basin – Brazil (KAR 100%)

KAR holds 100% of five contiguous offshore blocks in the Santos Basin, Brazil.

Figure 5: Location map – Santos Basin exploration blocks



Source: Company data, Credit Suisse estimates

The Santos Basin holds numerous recent hydrocarbon discoveries most notably the giant Tupi and Carioca accumulations (notionally multi-billion barrels). However, the KAR blocks lie at a relatively significant offsetting distance – about 100km from the nearest production (to the South-West) and 50km on this trend to recent successes in Block BM-S-40.

A much sought after exploration address

Although the acreage is along the Caravela/Merluza trend as indicated, we assess the blocks (at this stage) as wild cat and relatively high risk.

The permits have been granted for an initial three-year term with a drilling commitment in 2011 as part of an optional two year extension. KAR has indicated one well is scheduled for each block in that period (so up to five wells over two years).

The capital commitment prior to drilling totals some US\$15mn and consists mainly of G&G and the acquisition of 510km of 3D seismic over 3 blocks. Drilling costs will be in the order of US\$50-60mn per well as advised.

Given the necessity to secure to secure a farm-out, we could value the acreage at a theoretical cost of the work programme submitted, assuming a two well drilling programme is completed (with a farm-in partner), at an estimated cost of around US\$125mn or A\$1.08/share.

As a counterpoint we could use OGX [OGXP3] as a comparable asset benchmark. The OGX portfolio comprises 22 offshore blocks in Brazil (also in a pre-operational phase, with drilling likely to start sometime this year and notional production in 2011), of which five blocks are in Santos basin. The company is currently trading at around US\$1/boe of risked prospective resources (based on an average recovery factor of 27%).

KAR has noted that within its Brazil Blocks there are three main leads with 100 to 200Mb oil potential (or multi TCF) based on existing 2D data. Using the low end-point of approximately (say) 300Mb of resource potential and a risk weighting of 25% would generate a theoretical value of A\$0.69/share (A\$109mn).

Assuming these two indicative values as the ends of the range and taking a conservative view, we value the company's Brazil holdings at A\$109mn (A\$0.69/share), the bottom of our notional value range.

We acknowledge that our valuation remains a very subjective assessment.

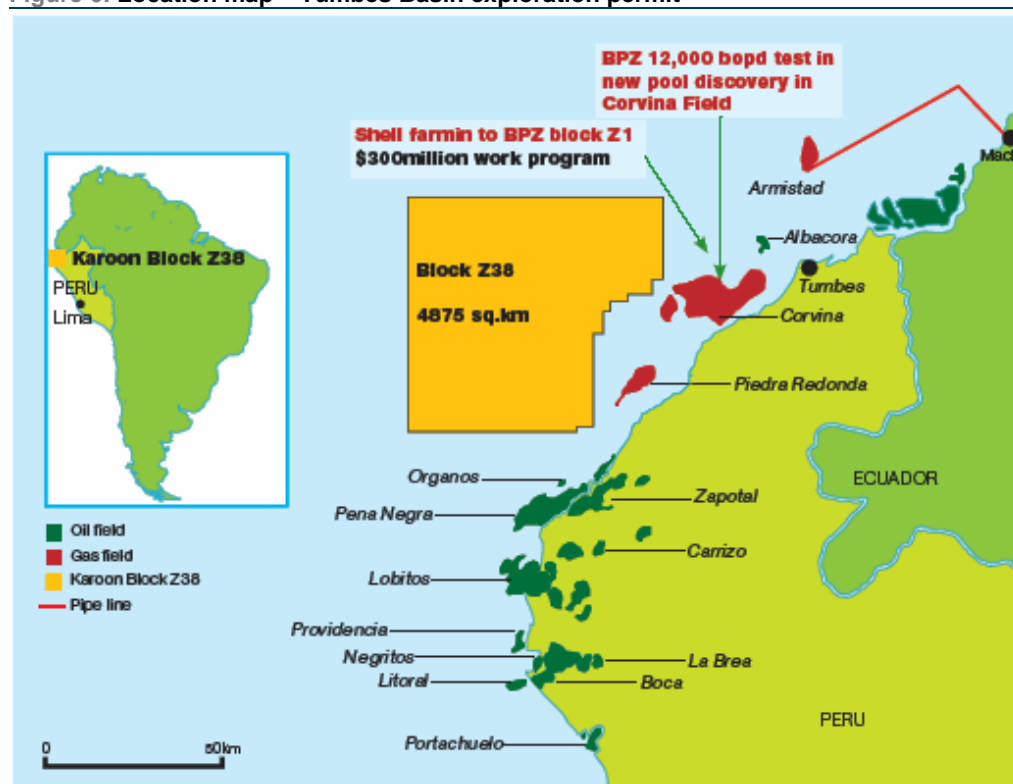
The ascribed value is relatively high based on the commensurately high level of activity within the basin and the potential upside from farm-in or discovery. But with exploration at an early stage and a partnership deal still to be struck (at least), the realisation of this upside could be long-dated.

We have ascribed a significant value for un-drilled acreage.

Offshore Tumbes Basin – Peru (KAR 60%)

KAR is forming into the massive offshore Block Z38 in Peru, earning up to a 60% interest for funding the acquisition of a 2B and 3D seismic programme over 2009.

Figure 6: Location map – Tumbes Basin exploration permit



Source: Company data, Credit Suisse estimates

KAR has indicated the lead potential in the Block is 100-200Mb or multi-Tcf, which is headline attractive, although the nearby existing discoveries are significantly more modest (Albacora 7Mb, Corvina 700bcf and Piedra Redonda < 100bcf).

The geological play looks uncomplicated and with water depth of 50-80m, we estimate the cost of a well to be US\$40-60mn.

A well programme is scheduled for 2010.

We value the permit at the equivalent of committed capex pertaining to the farm-in and drilling, being US\$30mn or A\$0.27/share.

Karoon has also been granted exploration rights within Block 112, offshore Peru (KAR 100%) but we understand the Block is still awaiting regulatory approval.

Valuation/target price

How to value an exploration play—a vexed question where no ‘one’ answer is more appropriate than any other.

We have chosen, where possible and applicable, to use cash as the basis of indicative value, either through farm-in terms (commercial transaction) or committed expenditures.

Although we acknowledge this valued methodology does not capture the notional upside, its more tangible than assessing probability weighted potential discoveries, which remain extremely subjective.

Post discovery, it would be more appropriate to use risk weighted development scenarios or comparative EV multiples; but for KAR, we are not yet at that stage.

Valuing exploration assets is highly subjective, although we have tied our assessment to ‘cash’ where possible

Figure 7: Valuation

| Asset | | | | A\$m | cps | Comments |
|-----------------|-----------|---------|------|------------|---------------|----------------------------------------------------------------------------------------------------|
| Browse Basin | Australia | WA-15-P | 49% | 175 | \$1.12 | We have used the mid point of the value of COP's farm-in options |
| | | -14-P | 49% | | | |
| | | -398-P | 40% | | | |
| Bonaparte Basin | Australia | AC/P8 | 66% | 3 | \$0.02 | Based on the forward work programme and assuming a 2 well drilling schedule (farmed-out) |
| Gippsland Basin | Australia | EL-4537 | 100% | | | We ascribe no tangible value to this holding at this time |
| Santos Basin | Brazil | | 100% | 109 | \$0.69 | Forward work programme, pre-drilling. Value better benchmarked should a farm-out deal be completed |
| Tumbes Basin | Peru | | 60% | 43 | \$0.27 | Value of the farm-in deal currently being undertaken |
| Total | | | | 330 | \$2.10 | |
| Net cash/(debt) | | | | 129 | \$0.82 | Based on end DecQ cash balance |
| Total | | | | 459 | \$2.92 | On a fully diluted basis |

Source: Company data, Credit Suisse estimates

We value KAR's exploration assets at A\$2.07 share and the NAV of the company at A\$2.92/share a 12% discount to a share price of \$3.30 (at time of writing).

Target price

More so than valuation, the difficult benchmark to set is the price target.

Given the company currently has no booked reserves, no discoveries, no development projects and is simply a pure exploration play, it could be argued that the share price at any time simply represents a risk weighted expectation of potential reserves (with a discount on the cash at hand).

A target price of \$6 is dependent on a successful drilling outcome

On that basis, we suggest the market is pricing in an approximate 2Tcf (2P) discovery from this programme at the current share price as follows:

Figure 8: Implied discovery size

| | | | |
|--------------------------|--------------|-----------------|--------------------------------------------|
| Share price | \$3.10 | Mcap (A\$m) | 491 |
| Cash discount | | | 50 |
| | | Mcap (A\$m) Adj | 441 |
| Mcap range per boe | \$10 | | \$15 |
| Implied net boe | 44.1 | | 29.4 |
| Grossed up | 90 | | 60 |
| Gross bcfe | 540 | | 360 |
| POS | 25% | | Assuming a 25% Probability of success |
| Implied discovery | 2,160 | bcfe | On a 7Tcf notional pre-drill target |

Source: Company data, Credit Suisse estimates

This still leaves significant share price upside on success as implied volumes grow and POS weighting climbs.

So the upside resides in drilling success.

Using the company's own LNG development scenario based on:

- 2014 start-up;
- estimated US\$7.5bn capex;
- commodity prices of US\$50/b (condensate), US\$40/b (LPG) and US\$5/mmBtu (gas); and
- approximate 5.5Mtpa LNG capacity.

A notional LNG development would return an IRR of 22% and a NPV = US\$5Bn (100% basis).

On an assumed working interest for KAR of 40% (after Conoco exercises its option to go to 60% interest) and a LT exchange rate of 0.73, this would indicate an upside value to the company in the order of A\$17.40/share un-risked, or A\$1.73-4.34/share using a POS of 10-25% (approximately A\$3/share using the mid point).

We have set our target price at A\$6.00 based on the notional upside on success as indicated above, noting that the downside on an unsuccessful drilling campaign could be to a low around A\$1.25-1.50/share.

Financials

It is most appropriate to consider KAR in terms of its forward cashflow position rather than any P&L outcomes as within the forecast period and till at least 2014 the company will not be generating revenue from its existing asset portfolio (i.e. in the current context, the P&L is irrelevant).

No earnings but the company is cashed up

From a cash perspective, the company does have exploration commitments but there is capacity to accelerate work activities depending on successful outcomes from both in-field work and farm-in discussions.

Figure 9: Forecast Statements of CF (end of period estimates)

In A\$m, unless otherwise stated

| | 06-07A | 07-08A | 1H | 08-09F | 09-10F | 10-11F | |
|----------------------------------------------------|-----------|-----------|------------|-----------|-----------|-----------|-----------------------------------------------------|
| Cashflow from operating activities | 2 | 0 | 3 | -6 | -5 | -7 | |
| Gross Operating Cashflow | 0 | -6 | 0 | -10 | -10 | -10 | |
| Cashflow from investing activities | -2 | -52 | -12 | -56 | -33 | -20 | |
| CAPEX | -2 | -41 | -12 | -66 | -33 | -20 | |
| Cashflows from financing activities | 62 | 57 | 50 | 50 | 0 | 0 | A series of capital raisings over a 14-month period |
| Net increase/(decrease) in cash held e/r movements | 62 | 5 | 38 | -12 | -38 | -27 | |
| | -2 | -4 | 19 | 19 | 0 | 0 | |
| Net Cash Balance | 76 | 77 | 144 | 94 | 56 | 29 | |

Source: Company data, Credit Suisse estimates, NB: 1H Cashflows are un-audited (from DecQ Report)

As at the 31 December 2008, the company held some A\$130mn (net of security deposits) to fund its exploration commitments through the forecast period.

On our assumptions the company will remain in a significant cash positive position over the next three years, but assuming success leads to fast-tracking, either from the current Browse Basin drilling programme or in Brazil, further capital raisings appear likely.

Figure 10: Forecast balance sheet

In A\$m, unless otherwise stated

| | 06-07A | 07-08A | 08-09F | 09-10F | 10-11F |
|--------------------------|-----------|------------|------------|------------|------------|
| Current Assets | 77 | 87 | 94 | 56 | 29 |
| Non-Current Assets | 7 | 52 | 118 | 149 | 168 |
| Total Assets | 84 | 139 | 212 | 205 | 196 |
| Current Liabilities | 3 | 9 | 16 | 8 | 5 |
| Non-Current Liabilities | 0 | 0 | 25 | 33 | 36 |
| Total Liabilities | 3 | 9 | 41 | 41 | 41 |
| Net Assets | 81 | 131 | 171 | 163 | 155 |

Source: Company data, Credit Suisse estimates

With no debt, the company's balance sheet has significant borrowing capacity, but we would suggest equity funding remains the critical risk through the drilling phase.

Risks

As KAR is a pure exploration play the key risk is geological, all other factors become irrelevant if the current drilling programme fails to delineate a substantial gas resource.

Geological

In terms of exploration addresses, the company's Browse Basin holdings are very well located between two large gas discoveries (Brecknock and Ichthys) in various stages along the LNG development timeline.

At this stage, the critical risks are geological

In stratigraphic terms the risks should be relatively low, with the company chasing the same play types which correlate well to existing discoveries. The risk is simply, the vagaries of geology, not all prospects are commercially successful and the region does contain some dry holes

Commercial risks

This is a moot point as a developable reserves threshold has to be discovered first, however, assuming sufficient gas can be aggregated then the commercial risks have most certainly strengthened in the past six to eight months.

The area contains numerous competing gas assets all dominantly looking for first LNG into a 2014-16 development window.

We are seeing anecdotal evidence of gas buyers changing their criteria...pushing back gas agreements and looking to revisit 'S' curve style pricing (and certainly seeking oil-price-discounts).

Although we see few LNG proposals progressing to FEED, the queue of potential projects remain deep and it's likely indicative construction capex, although ameliorating will remain high—is the KAR estimate too low?

Growth beyond Browse

The asset of most interest ex-Australia remains in our view the offshore Santos Basin acreage (Brazil).

We have assumed drilling be undertaken through the initial three year primary term but will require a farminee. Notionally when a region or opportunity delivers the outstanding success rates and discovery sizes seen through this area, attracting farminees is not difficult and the likelihood is that a premium price would be negotiated for a partnership.

We caution that the initial discoveries are now entering a development phase with Petrobras recently announcing a capex commitment of around US\$175bn over the next five years for construction and start-up, although we add these specific discoveries (Tupi, Carioca) are in ultra-deep water and stratigraphic depth.

Currently, prevailing crude prices of around US\$40/b are not conducive to enticing partners in an environment where the discretion exploration dollar is being deferred, so although we suggest the farminee potential remains high, it is likely to take longer and perhaps not be as generous in fiscal terms.

It should also be noted that there are more opportunities for farm-ins the region that are 'appraisal and development' (so reserves based).

As a general comment we suggest that without the partnership of Petrobras, the intrinsic value of any exploration acreage is diminished.

Companies Mentioned (Price as of 06 Feb 09)

ConocoPhillips (COP, \$47.01, NEUTRAL, TP \$50.00)
 INPEX Corporation (1605, ¥720,000, NEUTRAL [V], TP ¥1,150,000, MARKET WEIGHT)
 Karoon Gas (KAR.AX, A\$3.35, OUTPERFORM, TP A\$6.00)
 OGX (OGXP3, \$248.43, OUTPERFORM [V], TP \$375.00)
 Woodside Petroleum (WPL.AX, A\$32.00, NEUTRAL [V], TP A\$44.75)
 WorleyParsons (WOR.AX, A\$11.90, NEUTRAL [V], TP A\$18.75)

Disclosure Appendix

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3-Year Price, Target Price and Rating Change History Chart for KAR.AX



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Price Target: (12 months) for (KAR.AX)

Method: We set our \$6.00 target price on KAR by valuing the core assets using a pre-drilling valuation of \$2.92/share. This pre-drilling valuation uses cash as the basis of indicative value, either through farm-in terms or committed exploration expenditures. Above the pre-drill valuation, we ascribe the value of an LNG development of 2TCF of gas (TCF = 10¹² cubic feet), which equates to \$3.00/share. Our estimates for the risk weighted market expectation of potential reserves implied from the company's market cap today is for 2 TCF of gas resource.

Risks: The critical risks to KAR achieving our \$6.00 target price are geological given that the company is a pure exploration play. If the current drilling program fails to delineate a substantial gas resource, all other factors are irrelevant. Risks around the commerciality of any gas resources are moot until a gas discovery can be made. nonetheless, we note that KAR's plan for an LNG project will compete with a queue of potential projects in the region, and we highlight the company's clear need to raise equity before any type of commercial development can be made.

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