

21 July 2010

Analyst

Johan Hedstrom 612 8224 2859

Authorisation

Stuart Roberts 612 8224 2871

Kairiki Energy (KIK)

Early water but oil is there

Recommendation

Spec Buy

Price

\$0.096

Target (12 months)

\$0.20

An operational update on the Tindalo oil field shows that oil production of 4-5,000bopd is above the 3,500bopd needed to break even. The partners will do a workover in August to address the high water cut, hopefully improving the ratio of oil/water substantially. We have reduced our assumed reserves recovery and oil production but retain a Spec Buy recommendation and a new target price of \$0.20.

Expected Return

Capital growth **108%**

Dividend yield **0%**

Total expected return **108%**

Company Data & Ratios

Enterprise value **\$56m**

Market cap **\$55m**

Issued capital **570.7m**

Free float **100%**

12 month price range
\$0.095-\$0.195

GICS sector
Energy

70-80% water cut is odd this early

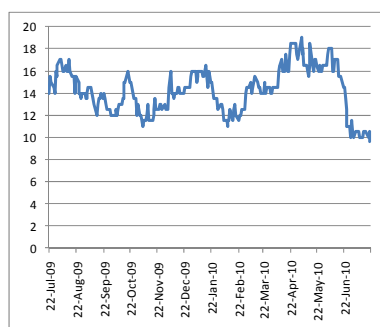
Tindalo production of 16-18,000 barrels per day of fluid demonstrates the high quality reservoir, but 70-80% water cut is restricting oil production to 4-5,000bopd. With an oil column 135-140m thick, it is odd to get water from the top 40m production zone, unless the cement job for the production casing was not done properly, or fractures allows communication to the water below the oil-water-contact. A workover is proposed for late August to address the problem, and we think there is good chance of fixing the problem.

Reservoir behaviour was always the key risk

We have highlighted risks in the Philippines limestone reservoirs, as similar oil fields have had erratic production performances. While we believe that the Tindalo field can improve on the current rate of oil production it remains a risky project. Our valuation for KIK has decreased from \$0.25 to \$0.20 as we have reduced Tindalo recoverable reserves from 4.4Mb to 3.0Mb. The valuation is of a speculative nature, so we maintain a Spec Buy on KIK.

Disclosure: Southern Cross Equities assisted KIK with equity placements in 2009 and 2010 and received fees and shares as payment.

Absolute Price



SOURCE: IRESS

Earnings Forecast

Year end June 30	FY09A	FY10F	FY11F	FY12F
NPAT (reported) (A\$m)	-4.3	-6.7	1.7	-5.7
NPAT (adjusted) (A\$m)	-3.0	-4.7	3.2	-4.0
EPS (adjusted) (cps)	-0.5	-0.9	0.6	-0.7
EPS growth (%)	n/a	0.8	n/a	n/a
PER (x)	n/a	n/a	16.0	n/a
P/CFPS (x)	n/a	n/a	4.3	17.6
EV/EBITDA (x)	n/a	n/a	4.8	31.9
Dividend (¢ps)	0.0	0.0	0.0	0.0
Yield (%)	n/a	n/a	n/a	n/a
ROE (%)	-8%	-13%	9%	-12%

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Oil and water mixes sometimes

Tindalo update

NDO released an operational update on Tindalo late on 20 July 2010, with the following key points:

- Oil-in-place estimate of 11Mb has been re-affirmed as the most likely resource base following the production performance and pressure data observed.
- Processing equipment is now fully commissioned, able to separate water from the oil in the quantities encountered.
- High reservoir production capacity of 18,000bpd confirmed.
- Water cut of 70-80% has resulted in oil production rates of 4-5,000bpd.
- More than 135,000bbl of oil has been produced to the FSO.
- Lifting of crude from the FSO planned in mid August, when 200-250,000bbl of oil should be in storage, assuming daily production in the range of 3-5,500bpd from now on. This would translate into payment of about US\$5m for KIK's 30.1% equity stake.
- Following the lifting, the rig will do a workover of the well to address the water issues.
- This will either be a "squeeze job" to re-inject cement outside the production casing to stop any water getting access this way, or:
- A re-perforation below the current production zone to get away from the high permeability fractures, if this is considered the main problem.
- The workover will be conducted by the Aquamarine Driller jack-up rig which is the rig contracted for production purposes, and is equipped to do such work.
- The workover is expected to take about two weeks.
- The purpose of the workover is to reduce or eliminate the water incursion, thereby increasing oil production.

Interpretation

We believe the planned workover is the right thing to do, as the presence of water at this early stage of production suggests that something unusual is going on. A poor original cement job would seem to be the most likely explanation for the early influx of water in our view, but wireline logging analysis will be needed to determine the most likely cause.

Figure 1 - Cement job illustration



SOURCE: WWW.ENGINEERLIVE.COM

Whether the problem is fixable also remains to be seen. If the cement job done at the time of drilling the well in 2008 was ineffective, it could still be difficult to complete the “squeeze job” with integrity.

Likewise if the problem is high permeability fractures communicating with the formation water below the OWC, another perforation below the current production zone may encounter a similar problem.

In summary, the high water cut should be able to be reduced or eliminated through the proposed workover but there is no guarantee that it will work.

Valuation discussion

Our KIK valuation has decreased from \$0.25 to \$0.20 per share. The reduction is primarily due to a more conservative production profile for the Tindalo oil field as we think the high water cut increases the likelihood of an earlier shut-down of the field. We previously forecast 4.4Mb of recoverable reserves which we now have cut to 3.0Mb. This has reduced the Tindalo valuation from \$0.06 to \$0.02/share.

We have also added the 46.7m shares issued in the placement in June 2010, increasing capital to 560.9m shares, which diluted the valuation.

The bulk of the KIK valuation remains in the exploration potential, with excellent prospects in both the inboard and outboard parts of license SC54.

Figure 2 - KIK Valuation

Oil Reserves	Mb gross	Mb net	A\$m	\$/bbl	\$/sh
Tindalo	3.0	0.9	12	13.56	0.02
Yakal	2.0	0.6	10	16.52	0.02
Nido-1X	2.4	0.7	14	19.41	0.02
Total	7.5	2.2	31	16.26	0.06
Resource potential	Mb gross	Mb net	\$m	Risk	
SC54A-Inboard (30.1%)	60	18	181	30%	0.09
SC54B-Outboard (20%)	200	40	400	10%	0.07
Assuming farm-out from 40%					
Corporate costs	\$2m pa		-15		-0.03
Conv. Notes			-11		-0.02
Cash/(Net debt)			10		0.02
Total			114		0.20

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Table 1 - Financial summary

Kairiki Energy (KIK) As at 21/07/2010						Recommendation: Spec Buy					Share price:	\$0.096
											Market cap:	\$55m
Income Statement A\$m						Valuation Data						
Year end June 30	2009A	2010F	2011F	2012F	2013F	Year end June 30	2009A	2010F	2011F	2012F	2013F	
Revenue	0.4	0.5	55.7	31.0	63.3	Adjusted NPAT	-3.0	-4.7	3.2	-4.0	5.3	
Philippines Gov't take	0.0	0.0	-6.5	-1.4	-8.1	Adjusted EPS	-0.5c	-0.9c	0.6c	-0.7c	0.9c	
Operating costs	-1.6	-2.0	-35.6	-27.8	-38.0	EPS growth	n/a	80%	n/a	n/a	n/a	
EBITDA	-1.1	-1.5	13.6	1.7	17.2	P/E ratio	n/a	n/a	16.0x	n/a	10.7x	
DD&A	0.0	0.0	-2.9	-1.5	-3.1	OpCFPS (excl. abnormals)	-0.4c	-0.2c	2.2c	0.5c	2.5c	
Exploration write-off	-1.4	-5.0	-5.0	-5.0	-5.0	Price/OpCFPS	n/a	n/a	4.3x	17.6x	3.8x	
EBIT	-2.5	-6.5	5.7	-4.8	9.1	DPS (A\$)	0.0c	0.0c	0.0c	0.0c	0.0c	
Net interest	-1.8	-0.2	-1.1	-0.9	-1.5	Yield	n/a	n/a	n/a	n/a	n/a	
Abnormals	0.0	0.0	0.0	0.0	0.0	EV/EBITDA	n/a	n/a	4.8x	31.9x	3.2x	
Pre-tax profit	-4.3	-6.7	4.6	-5.7	7.6	Profitability Ratios						
Tax	0.0	0.0	-2.9	0.0	-3.8	Year end June 30	2009A	2010F	2011F	2012F	2013F	
Minority interests	0.0	0.0	0.0	0.0	0.0	EBITDA/sales	n/a	n/a	24%	6%	27%	
Reported net profit	-4.3	-6.7	1.7	-5.7	3.8	EBIT/sales	n/a	n/a	10%	n/a	14%	
Adjusted net profit	-3.0	-4.7	3.2	-4.0	5.3	Return on assets (avg.)	-6%	-9%	5%	-6%	7%	
(adjusted net profit = pre-tax profit before abnormals minus tax at marginal rate)						Return on equity (avg.)	-8%	-13%	9%	-12%	16%	
Cashflow A\$m						Dividend cover	n/a	n/a	n/a	n/a	n/a	
Year end June 30	2009A	2010F	2011F	2012F	2013F	Tax take	0%	0%	62%	0%	50%	
Reconciliation						Liquidity & Leverage						
Net profit	-\$4.3m	-\$6.7m	\$1.7m	-\$5.7m	\$3.8m	Year end June 30	2009A	2010F	2011F	2012F	2013F	
Exploration write-off	1.4	5.0	5.0	5.0	5.0	Net debt (cash)	\$1m	\$13m	\$10m	\$18m	\$25m	
Depreciation	0.0	0.0	2.9	1.5	3.1	Net debt/equity	3%	36%	27%	56%	71%	
Change in working capital	-0.9	0.7	3.0	2.3	2.4	Interest cover	-0.6x	-8.2x	12.8x	2.0x	11.8x	
Other	1.3	0.0	0.0	0.0	0.0	Assumptions						
Net operating cashflow	-2.4	-1.1	12.7	3.1	14.4	Year end June 30	2009A	2010F	2011F	2012F	2013F	
Investing cashflow						Tindalo prod (net)	0.0	0.0	0.6	0.3	0.0	
Capex	-15.2	-7.0	0.0	-0.8	-11.8	Yakal prod (net)	0.0	0.0	0.0	0.0	0.6	
Exploration	-10.0	-10.0	-10.0	-10.0	-10.0	Nido-1X prod (net)	0.0	0.0	0.0	0.0	0.0	
Other	-1.8	0.0	0.0	0.0	0.0	Gindara prod (not included)	0.0	0.0	0.0	0.0	0.0	
Net investing cash flow	-26.9	-17.0	-10.0	-10.8	-21.8	Total Production (mmbbl)	0.0	0.0	0.6	0.3	0.6	
Financing activities						Price assumptions						
Issue of shares	11.5	6.5	0.0	0.0	0.0	2009A	2010F	2011F	2012F	2013F		
Buy backs	0.0	0.0	0.0	0.0	0.0	Oil price (US\$/bbl)	70.11	73.59	75.00	80.00	80.00	
Dividends paid	0.0	0.0	0.0	0.0	0.0	A\$/US\$	0.748	0.857	0.818	0.790	0.767	
Debt	12.2	6.5	0.0	5.3	7.5	A\$ oil price/bbl	93.74	85.83	91.72	101.29	104.28	
Others	0.0	0.0	0.0	0.0	0.0	Valuation						
Net financing cash flow	23.7	13.0	0.0	5.3	7.5	Oil Reserves	Mb gross	Mb net	A\$m	\$/bbl	\$/sh	
FX impact	0.6	0.0	0.0	0.0	0.0	Tindalo	3.0	0.9	12	13.56	0.02	
Net change in cash held	-5.1	-5.1	2.7	-2.4	0.1	Yakal	2.0	0.6	10	16.52	0.02	
Balance Sheet						Nido-1X	2.4	0.7	14	19.41	0.02	
Year end June 30	2009A	2010F	2011F	2012F	2013F	Total	7.5	2.2	31	16.26	0.06	
Assets						Resource potential						
Cash assets	\$10.1m	\$5.0m	\$7.7m	\$5.3m	\$5.4m	Mb gross	Mb net	\$m	Risk			
Receivables	1.2	0.0	13.3	6.4	11.3	SC54A-Inboard (30.1%)	60	18	181	30%	0.09	
Inventories	0.0	0.0	0.0	0.0	0.0	SC54B-Outboard (20%)	200	40	400	10%	0.07	
Other	0.0	0.0	2.0	1.4	2.2	Assuming farm-out from 40%						
Total current assets	11.3	5.0	22.9	13.0	18.9	Corporate costs	\$2m pa		-15		-0.03	
Plant and equipment	36.0	43.0	40.0	39.3	47.9	Conv. Notes			-11		-0.02	
Investment	0.0	0.0	0.0	0.0	0.0	Cash/(Net debt)			10		0.02	
Intangible assets	0.0	5.0	10.0	15.0	20.0	Total			114		0.20	
Deferred tax assets	0.0	0.0	0.0	0.0	0.0	Valuation sensitivity						
Other	0.0	0.0	0.0	0.0	0.0	Base case oil at US\$80 long term			\$m		\$/sh	
Total non-current assets	36.0	48.0	50.0	54.3	67.9	Oil price at US\$100			114		0.20	
Total assets	47.2	53.0	73.0	67.3	86.8	Oil price at US\$60			178		0.31	
Liabilities						Oil price at US\$60			114		0.20	
Debt	1.0	7.5	7.5	22.9	30.4	35% of 10Mb discovery			35		0.06	
Payables	0.6	0.0	16.8	10.3	14.9	20% of 200Mb discovery			400		0.70	
Deferred revenue	0.0	0.0	0.0	0.0	0.0	Discount rate + 2.5%			119		0.21	
Current tax liabilities	0.0	0.0	1.4	0.0	1.9	EPS sensitivity						
Provisions	0.0	0.0	0.0	2.7	4.4	Base case			2010	2011	2012	
Total current liabilities	1.6	7.5	25.8	35.9	51.6	Oil price at US\$100			-0.9c	0.6c	-0.7c	
Conv Notes	10.2	10.2	10.2	0.0	0.0	Oil price at US\$60			-0.9c	0.3c	-1.2c	
Other	0.0	0.0	0.0	0.0	0.0	Peer group Enterprise Value per reserves comparison						
Provisions	0.0	0.0	0.0	0.0	0.0		EV	2P	3P	EV/2P	EV/3P	
Total non-current liabilities	10.2	10.2	10.2	0.0	0.0		\$m	Mboe	Mboe	\$/boe	\$/boe	
Total liabilities	11.7	17.7	35.9	35.9	51.6	CVN	192	17	46	\$11.60	\$4.18	
Net assets	35.5	35.3	37.0	31.4	35.2	HZN	316	21	57	\$14.73	\$5.54	
Equity						NDO	124	5	11	\$22.68	\$11.16	
Contributed equity	44.8	51.4	51.4	51.4	51.4	NXS	525	124	145	\$4.25	\$3.62	
Reserves & outside equity	4.7	4.7	4.7	4.7	4.7	TAP	91	6	16	\$15.61	\$5.64	
Retained earnings	-14.0	-20.8	-19.0	-24.7	-20.9	Peer group average				\$13.77	\$6.03	
Total equity	35.5	35.3	37.0	31.4	35.2	KIK	56	2	4	\$25.03	\$13.23	
Diluted shares on issue	522.7	570.7	570.7	570.7	570.7	Source: Coy data						
Weighted ave diluted shares	550.2	523.9	570.7	570.7	570.7							

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Recommendation structure

Spec Buy: Expect >30% total return on a 12 month view but carries significantly higher risk than its sector

Buy: Expect >15% total return on a 12 month view

Accumulate: Expect total return between 0% and +15% on a 12 month view

Reduce: Expect -15% and 0% total return on a 12 month view

Sell: Expect <-15% total return on a 12 month view

Johan Hedstrom
Analyst Authorisation

Stuart Roberts
Authorisation

Research Team**TS Lim**

Financials Analyst
Banks/Regionals
T 612 8224 2810
E tslim@sceq.com.au

Lafitani Sotiriou

Analyst
Financials/Industrials
T 613 9235 1668
E lsotiriou@sceq.com.au

Stuart Roberts

Senior Industrial Analyst
Healthcare/Biotech
T 612 8224 2871
E sroberts@sceq.com.au

Judith Kan

Associate Analyst
Infrastructure/Utilities
T 612 8224 2844
E jkan@sceq.com.au

Daniel Blair

Industrial Analyst
Telco and Media
T 612 8224 2886
E dblair@sceq.com.au

Pareesh Patel

Industrial Analyst
Retail and Beverages
T 612 8224 2894
E ppatel@sceq.com.au

Jonathan Snape

Senior Industrial Analyst
Emerging Growth
T 613 9235 1601
E jsnape@sceq.com.au

Hamish Perks

Industrial Analyst
Emerging Growth
T 612 8224 2804
E hperks@sceq.com.au

Peter Chapman

Senior Resources Analyst
Oil/Gas/Gold
T 612 8224 2847
E pchapman@sceq.com.au

Johan Hedstrom

Senior Resources Analyst
Energy
T 612 8224 2859
E jhedstrom@sceq.com.au

Fleur Grose

Resources Analyst
Iron Ore/Coal/Diversifieds
T 612 8224 2845
E fgrose@sceq.com.au

Chris Whitehead

Associate Analyst
Resources/Energy
T 612 8224 2838
E cwhitehead@sceq.com.au

Mathan Somasundaram

Quantitative Analyst
Head of Quant & Data Services
T 612 8224 2825
E mathan@sceq.com.au

Janice Tai

Quantitative and System Analyst
T 612 8224 2833
E jtai@sceq.com.au

Joel Weiss

Quantitative Analyst
T 612 8224 2895
E jweiss@sceq.com.au

Emma Sellen

Executive Assistant
T 612 8224 2853
E esellen@sceq.com.au

This document is intended solely for the information of the particular person to whom it was provided by Southern Cross Equities Limited and should not be relied upon by any other person. Although we believe that the advice and information which this document contains is accurate and reliable, Southern Cross Equities Limited has not independently verified information contained in this document which is derived from publicly available sources, directors and proposed directors and management. Southern Cross Equities assumes no responsibility for updating any advice, views, opinions, or recommendations contained in this document or for correcting any error or omission which may become apparent after the document has been issued. Southern Cross Equities Limited does not give any warranty as to the accuracy, reliability or completeness of advice or information which is contained in this document. Except insofar as liability under any statute cannot be excluded, Southern Cross Equities Limited and its directors, employees and consultants do not accept any liability (whether arising in contract, in tort or negligence or otherwise) for any error or omission in this document or for any resulting loss or damage (whether direct, indirect, consequential or otherwise) suffered by the recipient of this document or any other person.

This document has not been written for the specific needs of any particular person and it is not possible to take into account each investor's individual circumstances and that investors should make their adviser aware of their particular needs before acting on any information or recommendation. Southern Cross Equities Limited, its employees, consultants and its associates within the meaning of Chapter 7 of the Corporations Law may receive commissions, underwriting and management fees, calculated at normal client rates, from transactions involving securities referred to in this document and may hold interests in the securities referred to in this document from time to time.

Southern Cross Equities Ltd and its associates hold 3,886,785 shares in KIK as at the date of this report. This position is subject to change without notice.

Disclosure: Southern Cross Equities assisted KIK with equity placements in 2009 and 2010 and received fees and shares as payment.



Limited Incorporated ACN 071 935 441

Level 32, Aurora Place
88 Phillip Street, Sydney 2000

Telephone +61 2 8224 2811

Facsimile +61 2 9231 0588

Email general@sceq.com.au

www.sceq.com.au