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# Kairiki Energy (KIK)

Focused on the Philippines

**Analyst**

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**Authorisation**

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**Recommendation**

**Spec Buy**

**Price**

**\$0.155**

**Target (12 months)**

**\$0.33**

KIK's shallow water discoveries and prospects in the Philippines' Palawan basin have been upgraded and are targeting production for early 2010. KIK retains a 40% interest in the highly prospective Palawan basin making it well placed to realise substantial value through production and exploration. KIK is significantly underpriced; recommendation Spec Buy, target \$0.33.

**Expected Return**

Capital growth **113%**

Dividend yield **0%**

Total expected return **113%**

**Company Data & Ratios**

Enterprise value **\$75m**

Market cap **\$79m**

Issued capital **513m**

Free float **100%**

12 month price range  
**\$0.036-0.24**

GICS sector

**Energy**

**Rapid path to production**

Plans are being finalised on rapid development works to have first production by early 2010 from the Tindalo field. Flow rates from an initial single well would provide substantial cash flow.

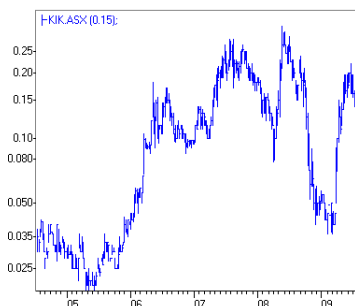
**Target of \$0.33 reflects unrecognised value**

There is great value yet to be recognised in what KIK has in the Philippines. The Inboard prospects of SC 54 (40% KIK, 60% NDO) have been recently upgraded to a total of over 200Mb while outboard prospects remain very large and potentially the making of a large E & P company.

We have upgraded our valuation of KIK's interest in SC 54, arriving at a target price of \$0.33 per share. With further drilling over the next 12 months and the start up of production likely, we expect the market to award more value to the stock. As indicated by our risked value of \$0.84, there is great potential above the target price to be realised over time.

**Disclosure:** Southern Cross Equities Ltd arranged a placement to professional and sophisticated investors of 57.8m KIK shares at \$0.14 per share to raise \$8.4m in June 2009 for which it received a fee.

**Absolute Price**



SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

**Net Asset Valuation Summary**

Asset	Valuation (risked)		Target Price
	\$m	cps	cps
SC 54 Inboard	181	0.35	0.21
SC 54 Outboard	334	0.49	0.14
Cash	9	0.02	0.02
C Notes	-13	-0.03	-0.03
<b>Total</b>	<b>512</b>	<b>0.84</b>	<b>0.33</b>

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

# SC54 Palawan Basin Inboard

## KIK retains 40% interest

In March 2009 KIK entered a conditional agreement with Focus Oil and Gas Pte Ltd to farm out 17% of Inboard SC54 for a consideration of US\$13m in both cash and future funding of the program. Focus subsequently advised it was unable to conclude its financing arrangements and the agreement lapsed on 30 June.

KIK subsequently raised \$8m through a share placement towards funding its full 40% equity in the Inboard project. The transaction price of US\$13m for a 17% interest equated to US\$30.6m or \$40m (\$0.08 per share) for KIK's 40% interest, a rating that understates its true worth.

## First oil production targeted within 9 months

Development studies and planning are under way to deliver First Oil by early 2010 from the Tindalo oil field. The planning is for a jack-up drilling rig production facility to re-enter Tindalo-1 for well testing and early production. Oil produced would be collected in an offset tanker moored adjacent to the rig.

Following the testing of the well, if successful, one option is to continue to produce in this way or suspend the well pending a 'cluster' development in the area, whereby Yakal and possibly other fields would be tied in to a single production facility. Flow potential is 7k-12kbopd.

Capital expenditure for the rapid development, jack-up rig proposal could be less than US\$15m, which will be clarified in coming weeks as studies work towards a final investment decision in that period.

## Cash flow potential

We calculate pre tax cash flow from Tindalo and Yakal to be in the range of \$115-\$230m, KIK's share, depending on the volume of recovered oil. This excludes capex of around US\$15m and is for the total volumes that would be lifted over a period of 12-18 months at an assumed price of US\$65/b. The low case is based on KIK's own November 2008 estimate of 4.15Mb and the high case is ISIS' 7.8Mb February 2009 estimate, which takes into account the vuggy porosity nature of the reservoir.

Figure 1 - Cash flow estimates from Inboard production

		Low case	High Case
<b>Reserves</b>	<b>Mb</b>	<b>4.15</b>	<b>7.80</b>
Revenue	A\$m	337	634
Fixed cost	A\$m	37	37
Variable cost	A\$m	12	23
Total cost	A\$m	49	60
Margin	A\$m	288	574
<b>KIK's 40% share</b>	<b>A\$m</b>	<b>115</b>	<b>230</b>
NDO's 60% share	A\$m	173	344
<b>KIK's 40% share</b>	<b>\$ps</b>	<b>0.22</b>	<b>0.45</b>
NDO's 60% share	\$ps	0.16	0.33

SOURCE: COMPANY AND SOUTHERN CROSS EQUITIES ESTIMATES

**Extended appraisal well production concept**

**Gross cash flow to KIK of up to \$230m**

### Resources upgraded to 200mb

Since the discoveries of Yakal and Tindalo in September and October last year, the JV has undertaken considerable technical work based on all of the new information obtained. Independent consultants Baker Atlas and ISIS were also employed to independently assess reservoir quality of these fields and evaluate updated volume estimates. Recognising the vuggy porosity nature of the reservoirs, ISIS estimated Tindalo to contain up to 24.5mb (P10) and Yakal up to 10.7mb.

**Unrisked inboard value of \$0.67 per share**

The result has been a substantial upgrade in estimated oil in place in the top 12 Inboard targets to over 200Mb. In Figure 2 below, we present the latest OIP estimates along with SCE's assessment of their unrisked value (\$0.67 per share), risked value (\$0.35) and further discounting for market awareness, target price rating of \$0.21.

This analysis is based on a US\$8.00/b, probabilities in line with company estimates and recovery factor of 40%.

Figure 2 - Inboard Prospects and Values

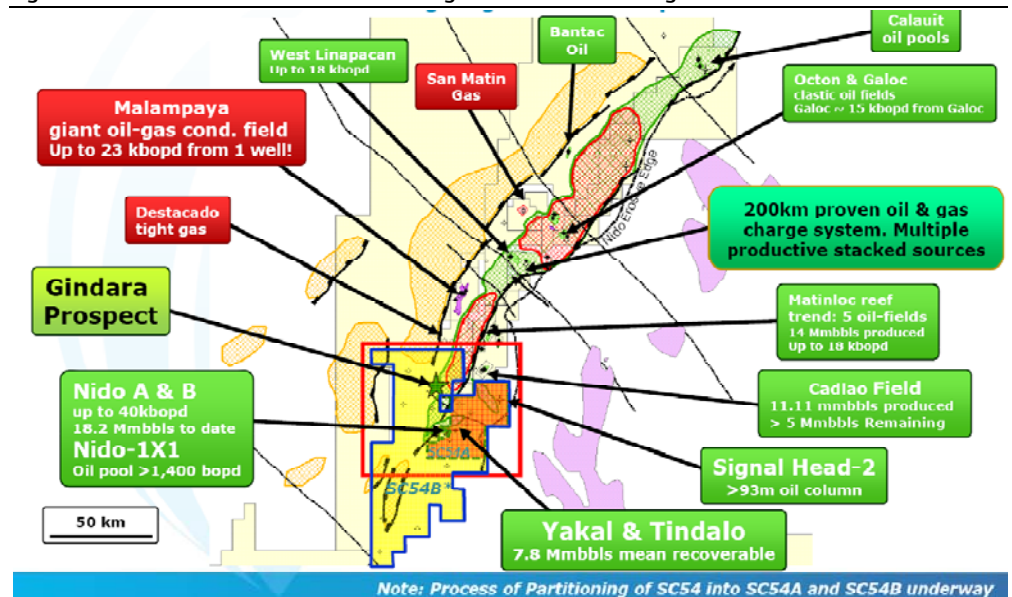
Prospect	Est OIP# Mb	KIK equity	NPV US\$/b	Unrisked NPV A\$M	NPV A\$/share**	COS* %	Risked NPV A\$M	Risked NPV A\$/share**	12 mo target adj %	12 mo target A\$/share**
Tindalo-1 discovery	13.40	40%	8	22	0.04	95%	21	0.04	80%	0.03
Yakal-1 discovery	6.00	40%	8	10	0.02	95%	9	0.02	80%	0.01
Nido 1X-1 discovery	8.80	40%	8	14	0.03	90%	13	0.03	80%	0.02
Signal Head-2 discovery	15.09	40%	8	24	0.05	90%	22	0.04	80%	0.03
Lawaan	25.38	40%	8	41	0.08	70%	29	0.06	50%	0.03
North Nido-1 updip	15.82	40%	8	26	0.05	70%	18	0.03	50%	0.02
Signal Head North-B	12.02	40%	8	19	0.04	70%	14	0.03	50%	0.01
Custodio-1 re-drill	8.50	40%	8	14	0.03	70%	10	0.02	50%	0.01
Kamagong	8.44	40%	8	14	0.03	70%	10	0.02	50%	0.01
Signal Head South	8.38	40%	8	14	0.03	70%	10	0.02	50%	0.01
Custodio North	4.97	40%	8	8	0.02	70%	6	0.01	50%	0.01
North Nido-1 East	74.35	40%	8	120	0.23	15%	18	0.04	30%	0.01
Others	10.00	40%	8	16	0.03	25%	4	0.01	30%	0.00
<b>Totals</b>	<b>211.15</b>	<b>40%</b>			<b>0.67</b>		<b>182</b>	<b>0.35</b>		<b>0.21</b>

#OIP: oil in place. KIK's mean estimates. We assume 40% recovery  
## at \$US0.79/\$A

\*COS: chance of success  
\*\* assumes options not exercised

SOURCE: COMPANY DATA AND SOUTHERN CROSS EQUITIES ESTIMATES

Figure 3 - North west Palawan Basin showing SC54 and surrounding fields



SOURCE: COMPANY DATA

# SC54 Outboard

## Large scale, low risk targets

SC 54, in which KIK retains a 40% interest, extends further offshore into deeper water where there are large volume plays in 300-400m water depth. In May 2008 NDO released its outboard prospects and leads (P&L) inventory, which amounted to a total of 2.4 billion barrels (Bb) OIP as the most likely case, with a minimum and maximum range of 0.9Bb to 5.5Bb. The two largest and priority prospects are Gindara and Lapulapu, which were assessed as having prospective reserves of +500Mb OIP (Figure 4).

**Gindara, Lapulapu likely to be far greater than 0.5Bb each**

Further interpretation is underway on the recently received final 3D seismic results updated to include the application of state-of-the-art pre-stack depth migration techniques (PSDM). This is enabling the JV to update its prospects inventory, the results of which are expected to be released in August. A preliminary interpretation of a larger structural footprint over Gindara, the lead outboard target, along with the clarity provided by PSDM is likely to lead to an upgrade in prospective resources.

The cost of drilling the outboard targets are estimated to be around US\$20m per well and a number of funding possibilities are being considered. These include farm downs and contributions from cash flow, which we have shown to be considerable. Tax deductibility rules of exploration expenditures against income may have a bearing on the funding outcome.

## Valuation analysis highlights great upside

Figure 4 shows a valuation summary of the outboard portfolio, with an unrisksed value per share ranging up to \$0.74 for Gindara, unrisksed and \$0.15, risksed. This analysis highlights the great upside provided by the larger prospects.

**Unrisksed outboard value of \$3.20 per share**

Summing the prospects gives a total unrisksed value of \$3.19 per share and a risksed value of \$0.49 per share. We extend this analysis to estimate what the market is likely to rate the portfolio in 12 months time by further discounting the risksed values. In this way, we arrive at a target component of \$0.14 for the outboard prospects, which is only a fraction of what the true value may turn out to be.

Figure 4 - SC 54 Outboard Prospects

Prospect	Est OIP# Mb	KIK equity	NPV US\$/b	Unrisksed NPV A\$M A\$/share**	COS* %	Risksed NPV A\$M A\$/share**	12 mo target adj %	A\$/share**		
Gindara	547	40%	6	499	0.74	20%	100	0.15	30%	0.04
Lapulapu	540	40%	6	492	0.73	15%	74	0.11	30%	0.03
Princesa	398	40%	6	363	0.54	15%	54	0.08	25%	0.02
Hito	178	40%	6	162	0.24	15%	24	0.04	25%	0.01
Untitled 39	318	40%	6	290	0.43	10%	29	0.04	25%	0.01
Tilapya	117	40%	6	107	0.16	15%	16	0.02	25%	0.01
Pagi	97	40%	6	88	0.13	15%	13	0.02	25%	0.00
Pagi Turbidite	80	40%	6	73	0.11	15%	11	0.02	25%	0.00
Untitled 40	52	40%	6	47	0.07	15%	7	0.01	25%	0.00
Others (x6)	42	40%	6	38	0.06	15%	6	0.01	25%	0.00
<b>Totals</b>				<b>3.19</b>			<b>334</b>	<b>0.49</b>		<b>0.14</b>

#OIP: oil in place. We assume 30% recoveries \*COS: chance of success  
## at \$US0.79/\$A \*\* fully diluted

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

# Kairiki Energy (KIK)

## Philippine acreage includes large scale targets

KIK has a 40% interest in Service Contract 54 in the Northwest Palawan Basin, a highly prospective oil region of the Philippines. Nido Petroleum, the operator, holds the remaining 60%. SC 54 contains a range of high impact targets, supported by multiple smaller but low risk prospects including two discoveries in 2008, with others already proven to be both oil bearing and capable of good flow rates.

KIK's financial position has been strengthened recently by an \$8m placement giving the company a total of \$9m cash. Debt is in the form of a US\$10m convertible note issued to IMC, a Chinese Investment company, which is repayable in September 2011.

KIK has a highly experienced management team led by Laurie Brown, Managing Director, a petroleum geoscientist with over 25 years in the industry, mostly with BP and Woodside. The Chairman, Paul Fry, formerly an oil and gas partner with Ernst & Young and PwC is, along with the MD, a highly experienced founding director.

## Investment strategy

We rate KIK a Speculative Buy offering a very high potential return at a higher than normal risk. Share price catalysts should be threefold: commencement of oil production in early 2010; subsequent Inboard drilling from the cash flow generated by Tindalo; and events relating to the drilling of the large outboard targets. We estimate the share price target over the next 12 months at \$0.33 based on expected developments within this period.

## Risks

Risks are high in the oil exploration business in which KIK operates, relating to petroleum geology, technical operating factors, oil reservoir performances and quality of information. Inboard reserves and operating risks have been reduced significantly by two adjacent geological analogous fields with many years of observed production history. Other known occurrences of oil also reduce risk in the Inboard zones.

Outboard risks are higher as they relate to exploration targets in deeper water with higher associated drilling costs and higher technical risks.

Once in production with internal cash flows being generated, KIKs' financial risk position will be greatly reduced. Successful farm outs may improve the balance of financial risk for reward, depending on cash generated by its Inboard portfolio.

**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

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Disclosure: Southern Cross Equities Ltd arranged a placement to professional and sophisticated investors of 57.8m KIK shares at \$0.14 per share to raise \$8.4m in June 2009 for which it received a fee.



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