Southern Cross Equities

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6 January 2010

Kairiki Energy (KIK)

Repeatable success in the Philippines

Recommendation
Spec Buy
Price
$0.16
Target (12 months)
$0.29

KIK is a small oil explorer developing its first oil field in the Philippines this year. The Tindalo oil discovery is being commercially developed through a low cost leasing arrangement, which could be followed at nearby discoveries at Yakal and Nido-1X. The short term cash flow boost should enable KIK to look for additional and bigger targets offshore Philippines. We recommend a Spec Buy with a target of $0.29.

Expected Return

Capital growth	**81%**
Dividend yield	**0%**
Total expected return	**81%**

Company Data & Ratios

Enterprise value	**$85m**
Market cap	**$84m**
Issued capital	**514.2m**
Free float	**85%**
12 month price range	**$0.04 - $0.22**
GICS sector	**Energy**

Tindalo oil development approved

KIK and its partners recently took the Final Investment Decision (FID) to develop the Tindalo oil field in the Philippines. This 2-11m barrel oil field will be developed using a leased jack-up rig and a nearby oil tanker to minimise capex to a very modest US$20m. Production costs will be fixed at US$0.25m/day. First oil is due in Q2 2010, at an initial rate between 7,000-15,000bopd. We forecast cash flow of $28m net to KIK in FY11, and a PE ratio of 4.8x.

Similar oil developments are likely

The SC54A license offshore Palawan Island contains two further oil discoveries on trend from Tindalo, at Yakal and Nido-1X, which are likely to be developed in a similar fashion, either subsequently or in parallel.

The cash flow will be used for further exploration in this prospective area, while farming out the more expensive deep water drilling in SC54B, where the 200mb Gindara prospect is likely to be drilled in 2H 2010, or 2011.

We value KIK's prospects at $0.29/share and recommend a Spec Buy.

Disclosure: Southern Cross Equities Ltd assisted KIK with a placement of shares in May 2009 and received a fee for its services.

Absolute Price

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

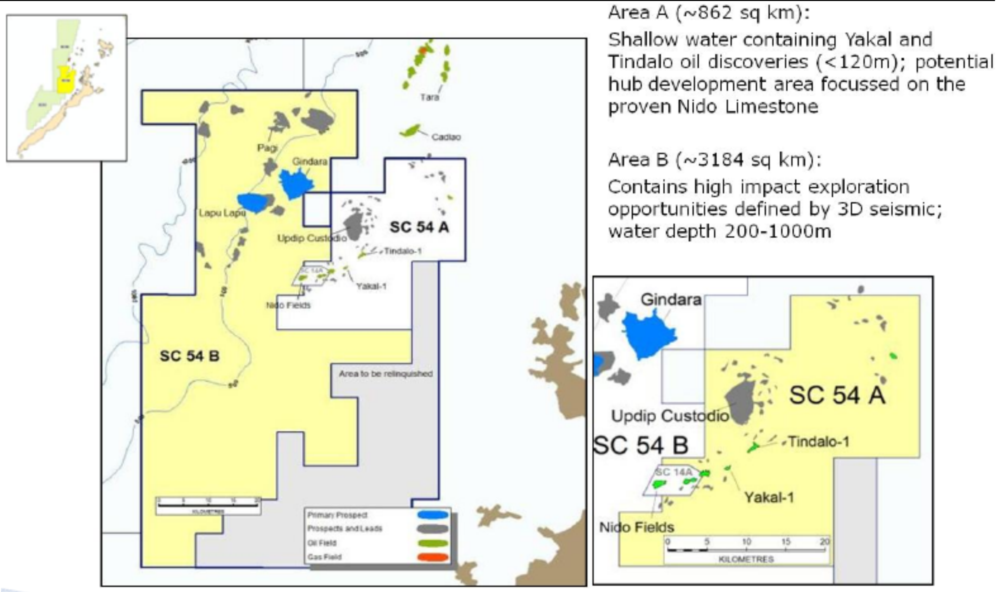
Earnings Forecast

Year end June 30	2009A	2010F	2011F	2012F
NPAT (reported) (A$m)	-4.3	-6.7	15.8	0.9
NPAT (adjusted) (A$m)	-3.0	-4.7	17.4	2.7
EPS (adjusted) (cps)	-0.5	-0.9	3.3	0.5
EPS growth (%)	n/a	0.8	n/a	-0.8
PER (x)	n/a	n/a	4.8	32.0
P/CFPS (x)	n/a	n/a	2.9	6.0
EV/EBITDA (x)	n/a	n/a	2.3	6.5
Dividend (¢ps)	0.0	0.0	0.0	0.0
Yield (%)	n/a	n/a	n/a	n/a
ROE (%)	-8%	-15%	47%	6%

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Philippines oil cash flow within 6 months

Figure 1 - KIK's Philippines licenses



SOURCE: COMPANY DATA

Tindalo oil development approved

KIK will soon join the ranks of oil producing companies, which is a step change for any small exploration company. The Tindalo JV announced on 14 December 2009 that FID had been taken by the three partners Nido Petroleum (NDO) 50% acting as Operator, KIK 35% and Trafigura 15%.

The Tindalo discovery was made as recently as October 2008, and first production is expected to commence in the June Quarter of 2010, a very rapid schedule by any standard.

The development concept is very straightforward, simply re-entering the discovery well, which intersected a 124m-144m oil column in a pinnacle reef at a depth of 1741m. The carbonate reservoir looks very good on the logs, with large spaces known as “vugs” likely to enhance productivity. However, no flow testing was undertaken at the time of discovery, leaving some uncertainty on how high the flow rates will be. The production history from nearby oil fields such as Nido-A&B suggests that fractures in the carbonate reservoirs enables high initial production rates, but with rapid declines. The company believes the Tindalo reservoir has higher primary porosity than Nido A&B and therefore expects water cut and rapid oil declines to be less pronounced. The expected initial production rate of 7,000-15,000bopd looks reasonable, and we would in fact anticipate it to be at the upper end of the range. The more important question is how rapid the decline rate will be, and when will water production commence.

The above questions also lead to a wide range of recoverable reserve estimates. The upside potential is about 11mb, and a conservative downside case would be 2mb. Our assumption is 4.4mb, using a 40% recovery rate from the mid case of 11mb Oil-Initially-In-Place (OIIP).

The uncertainties over reserves and productivity precluded a commitment to any large capital commitments, and the JV has come up with a neat low cost solution to monetise the resource. Water depth is about 100m at this location, which is ideal for a jack-up rig and the leasing of the "Aquamarine Driller" will have production capacity up to 20,000bpd of fluids. The processed oil will be transferred via a floating hose to an adjacent oil tanker used as Floating Storage and Offtake (FSO). The rig has a minimum lease period of two months, with an option to extend up to two years.

The capital costs are estimated at US$20m gross while operating costs are fixed at US$250,000/day. This means the project will be breaking even at the current spot oil price of US$80 and a production rate of about 3,800bopd.

Our cash flow projections

We have modelled the Tindalo oil project at a capex of US$20m (US$7m net) but have delayed first oil to July 2010 to be conservative. We assume oil production to commence at 15,000bopd but to average just over 8,000bopd over FY11. This would recover 3.0mb of oil (1.1mb net to KIK), and generate cash flow for the company of A$29m in FY11 , followed by 1.4mb (0.5mb net) and A$14m in FY12.

The end of the field life is assumed during FY12 but the exact timing will depend on production rates and oil prices.

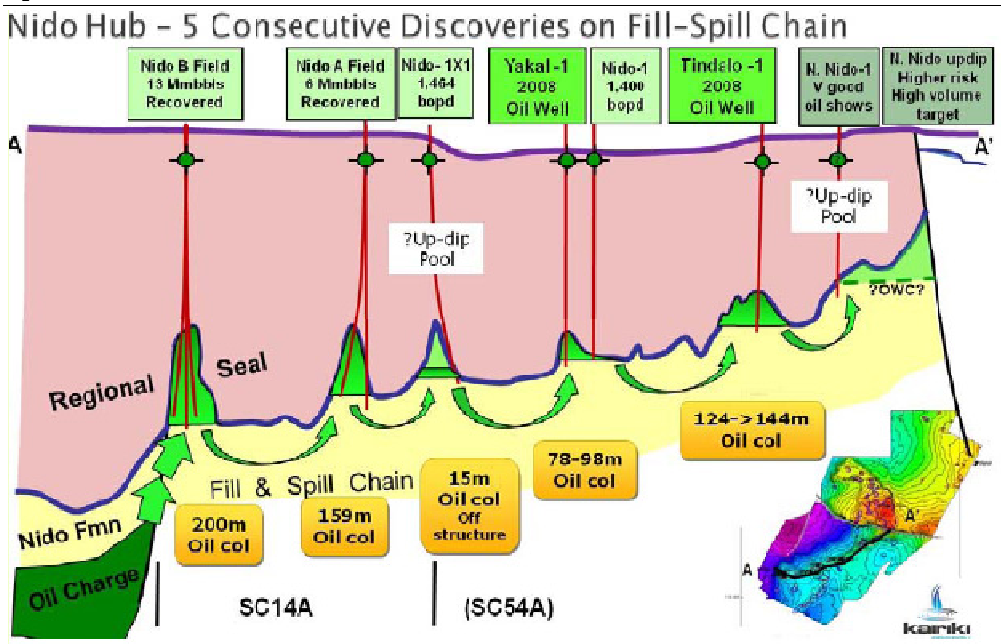
Funding for Tindalo

The company has $9m of cash at the moment, which is just enough to cover the US$7m capex for Tindalo. However it would leave working capital very low, and annual overheads are running at about $2m pa.

KIK may therefore need to raise some modest equity funds, although this could be avoided in two ways. The company could either do another small farm-out of its 35% interest in Tindalo, or if a farm-out of SC54B is executed in the near term and includes a cash reimbursement for past costs.

Repeatable success in the inboard area of SC54

Figure 2 - Pinnacle reef trend SC54A



SOURCE: COMPANY DATA

The geological cross section above shows the trend of oil fields in the inboard area. With the benefit of 3D seismic, the JV achieved a 100% success rate during 2008 with its drilling of Miocene pinnacle reefs at Tindalo and Yakal. The exploration risk appears much reduced along this trend, and we would anticipate further drilling to take place as cash becomes available.

The JV has only approved the Tindalo oil development, but we expect that a successful project at Tindalo will be followed by similar developments for the nearby Yakal and Nido-1X oil discoveries, and that these should be self-funding.

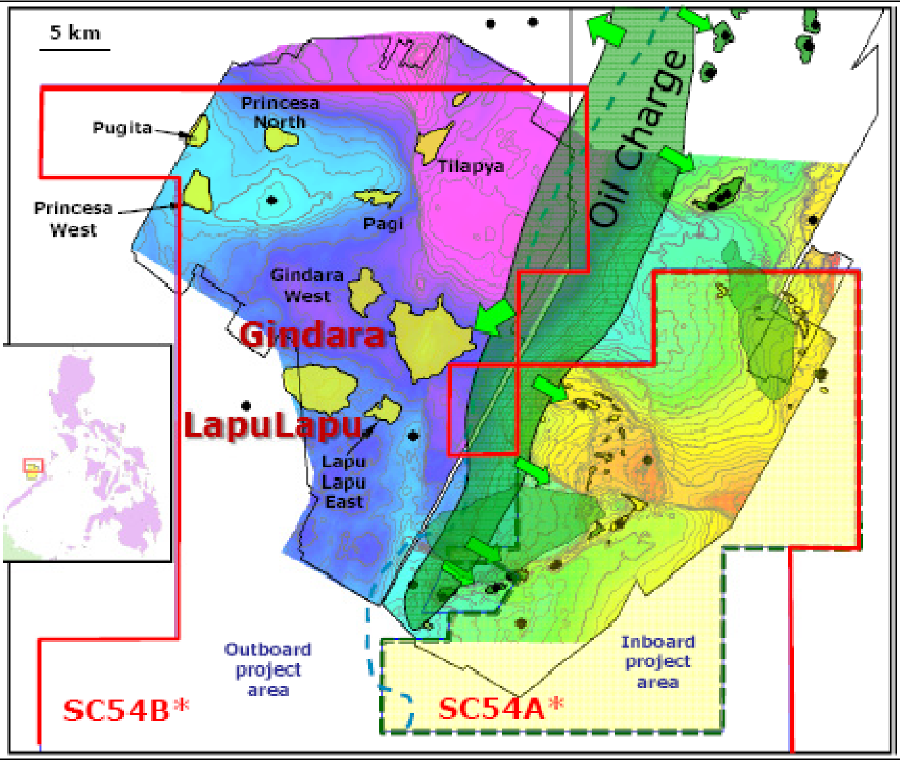
- The Yakal oil field is located to the south-west of Tindalo and intersected an oil column of 78-98m thickness. The OIIP is estimated to be between 2.4-10.7mb which is less than half of Tindalo's resource estimate. However, we would again expect the reservoir to support good production rates, starting at 10,000bopd, followed by rapid natural decline. We have assumed an extension of the rig contract, and that almost 2mb will be recovered in FY13, representing an average daily production rate of 5,500bopd. We assume lower capex of US$8m as Yakal would not have to carry the rig mobilization/de-mobilization cost incurred for Tindalo. However, opex assumptions of US$0.25m/day are the same as for Tindalo.
- The Nido-1X oil discovery is located on the license boundary of SC54A and the Nido A&B oil fields license SC14A. The field will require some reprocessing of 3D seismic and a new well to be drilled on the crest, as the discovery well intersected the oil column well down on the interpreted flank of the structure. We have included cash flow from a Nido-1X development in FY14, but have included a higher capex of US$20m to account for the new well to be drilled.

Big upside potential for the "outboard" area of SC54B

While the inboard area appears to have plenty of low risk opportunities to add small oil fields, the big upside for KIK is in the deeper water acreage called "outboard', and is designated as license SC54B. KIK retains a 40% interest in the outboard license, and NDO is the Operator with 60%. The companies have been marketing the outboard area to larger oil companies during 2009, to assist with funding of more expensive exploration wells.

The two larger and most attractive targets in the outboard area include Gindara (formerly known as Coron North), and LapuLapu, as shown in the map below.

Figure 3 - Outboard area SC54B



SOURCE: COMPANY DATA

The Gindara prospect is a very large target with potential for over 500mb OIIP, if filled to spill point. The water depth is 350m so will require a more expensive semi-submersible rig for drilling. The estimated dry hole cost is about US$30m, indicating a net exposure of US$12m for KIK at this stage. The company has stated a strategy to farm-down to enable the drilling of Gindara in 2010 if possible. We would expect that KIK (and NDO) can get a free carry on a 2 for 1 type of deal from one of the international oil majors. This means that KIK would reduce its 40% equity in SC54B to 20%, but won't have to contribute any funds for the drilling of Gindara.

If we use a nominal $10/barrel value for a 200mb oil discovery at Gindara, the retained 20% equity would be worth $400m or $0.76/KIK share. However, the risk associated with drilling such a large target is high, and we would only use a 1 in 10 chance for such a large oil discovery to be made. The history of drilling in the Philippines has never generated any large oil discoveries, and the biggest find to date is the 2.7Tcf gas field at Malampaya, operated by Shell. However, we note that ExxonMobil recently announced a new, potentially large oil discovery in the Sandakan basin to the south-west, which is good news, but in a different geological basin.

Summary of plans for 2010

KIK has a very exciting year ahead in 2010 and we expect the share price to increase as key objectives are achieved.

- Establish production at Tindalo, possibly as early as April 2010, but we have conservatively assumed a July 2010 start-up. Production rate is expected to start at a high rate (15,000bopd) but the key issue will be the timing and rate of decline.
- Execute a farm-out agreement on SC54B, and the sooner the better. This would be particularly positive if done with a major oil company with the technical capability to commercialise a large discovery and also included a cash reimbursement of past costs. And it would be really good if timing for drilling the Gindara prospect is confirmed in the near term.
- Initiate development plans for Yakal and Nido-1X, potentially contracting a second jack-up rig and FSO to accelerate oil production and cash flow.
- Re-commence exploration program for the inboard area, to identify additional oil fields for development after Tindalo, Yakal and Nido-1X.

Recommendation

KIK is a small oil company on the cusp of becoming a producer. We have valued the company's three known oil accumulations at $0.12/share so the market is valuing some of the exploration potential. We value this additional upside potential at $0.20 on a risked basis, but it would be much higher if Gindara is a large oil discovery. Adjusting for corporate costs and the convertible note/cash, we value KIK at $0.29/share, which is 81% above the current share price of $0.16. We believe the news flow over the next six months will be positive for the stock, but considering the risks associated with oil developments and the uncertainty over reserves and production performance, we continue to recommend a Spec Buy on KIK.

Kairiki Energy
as at 6 January 2010

Recommendation	Spec Buy
Price	$0.16
Target (12 months)	$0.29

Table 1 - Financial summary

Kairiki Energy (KIK) — As at 6/01/2010 — **Recommendation: Buy** — Share price: $0.16 — Market cap: $84m

Income Statement A$m					
Year end June 30	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Revenue	0.4	0.5	93.1	52.8	75.2
Philippines Govt take	0.0	0.0	-16.6	-6.2	-9.6
Operating costs	-1.6	-2.0	-39.5	-33.6	-44.8
EBITDA	-1.1	-1.5	37.0	12.9	20.8
DD&A	0.0	0.0	-4.9	-2.6	-3.7
Exploration write-off	-1.4	-5.0	-5.5	-6.1	-6.7
EBIT	-2.5	-6.5	26.6	4.3	10.4
Net interest	-1.8	-0.2	-1.7	-0.4	-0.2
Abnormals	0.0	0.0	0.0	0.0	0.0
Pre-tax profit	-4.3	-6.7	24.9	3.9	10.2
Tax	0.0	0.0	-9.1	-3.0	-5.1
Minority interests	0.0	0.0	0.0	0.0	0.0
Reported net profit	-4.3	-6.7	15.8	0.9	5.2
Adjusted net profit	**-3.0**	**-4.7**	**17.4**	**2.7**	**7.1**

(adjusted net profit = pre-tax profit before abnormals minus tax at marginal rate)

Cashflow A$m					
Year end June 30	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Reconciliation					
Net profit	-$4.3m	-$6.7m	$15.8m	$0.9m	$5.2m
Exploration write-off	1.4	5.0	5.5	6.1	6.7
Depreciation	0.0	0.0	4.9	2.6	3.7
Change in working capital	-0.9	0.7	2.3	4.4	2.7
Other	1.3	0.0	0.0	0.0	0.0
Net operating cashflow	-2.4	-1.1	28.6	14.0	18.3
Investing cashflow					
Capex	-15.2	-8.2	0.0	-0.9	-14.0
Exploration	-10.0	-10.0	-11.0	-12.1	-13.3
Other	-1.8	0.0	0.0	0.0	0.0
Net investing cash flow	-26.9	-18.2	-11.0	-13.0	-27.3
Financing activities					
Issue of shares	11.5	0.0	1.0	0.0	0.0
Buy backs	0.0	0.0	0.0	0.0	0.0
Dividends paid	0.0	0.0	0.0	0.0	0.0
Debt	12.2	14.2	0.0	-10.2	0.2
Others	0.0	0.0	0.0	0.0	0.0
Net financing cash flow	23.7	14.2	1.0	-10.2	0.2
FX impact	0.6	0.0	0.0	0.0	0.0
Net change in cash held	**-5.1**	**-5.1**	**18.5**	**-9.2**	**-8.9**

Balance Sheet					
Year end June 30	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Assets					
Cash assets	$10.1m	$5.0m	$23.5m	$14.3m	$5.4m
Receivables	1.2	0.0	22.2	11.0	13.4
Inventories	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	2.7	1.9	2.6
Total current assets	11.3	5.0	48.5	27.2	21.5
Plant and equipment	36.0	44.2	39.2	37.6	47.8
Investment	0.0	0.0	0.0	0.0	0.0
Intangible assets	0.0	5.0	10.5	16.6	23.2
Deferred tax assets	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Total non-current assets	36.0	49.2	49.7	54.1	71.0
Total assets	**47.2**	**54.2**	**98.2**	**81.3**	**92.5**
Liabilities					
Debt	1.0	15.2	15.2	15.2	15.4
Payables	0.6	0.0	22.7	14.3	17.8
Deferred revenue	0.0	0.0	0.0	0.0	0.0
Current tax liabilities	0.0	0.0	4.6	1.5	2.5
Provisions	0.0	0.0	0.0	3.8	5.2
Total current liabilities	1.6	15.3	42.5	34.8	40.9
Conv Notes	10.2	10.2	10.2	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0
Provisions	0.0	0.0	0.0	0.0	0.0
Total non-current liabilities	10.2	10.2	10.2	0.0	0.0
Total liabilities	**11.7**	**25.4**	**52.7**	**34.8**	**40.9**
Net assets	**35.5**	**28.8**	**45.6**	**46.5**	**51.6**
Equity					
Contributed equity	44.8	44.8	45.8	45.8	45.8
Reserves & outside equity	4.7	4.7	4.7	4.7	4.7
Retained earnings	-14.0	-20.8	-5.0	-4.1	1.1
Total equity	**35.5**	**28.8**	**45.6**	**46.5**	**51.6**
Diluted shares on issue	522.7	522.7	527.8	522.7	522.7
Weighted ave diluted shares	550.2	522.7	522.7	527.8	522.7

Valuation Data					
Year end June 30	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Adjusted NPAT	-3.0	-4.7	17.4	2.7	7.1
Adjusted EPS	-0.5c	-0.9c	3.3c	0.5c	1.4c
EPS growth	n/a	80%	n/a	-85%	180%
P/E ratio	n/a	n/a	4.8x	32.0x	11.4x
OpCFPS (excl. abnormals)	-0.4c	-0.2c	5.5c	2.6c	3.5c
Price/OpCFPS	n/a	n/a	2.9x	6.0x	4.6x
DPS (A$)	0.0c	0.0c	0.0c	0.0c	0.0c
Yield	n/a	n/a	n/a	n/a	n/a
EV/EBITDA	n/a	n/a	2.3x	6.5x	4.0x

Profitability Ratios					
Year end June 30	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
EBITDA/sales	n/a	n/a	40%	25%	28%
EBIT/sales	n/a	n/a	29%	8%	14%
Return on assets (avg.)	-6%	-9%	23%	3%	8%
Return on equity (avg.)	-8%	-15%	47%	6%	15%
Dividend cover	n/a	n/a	n/a	n/a	n/a
Tax take	0%	0%	37%	77%	50%

Liquidity & Leverage					
Year end June 30	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Net debt (cash)	$1m	$20m	$2m	$1m	$10m
Net debt/equity	3%	71%	4%	2%	19%
Interest cover	-0.6x	-8.2x	22.0x	33.8x	96.2x

Assumptions					
Year end June 30	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Tindalo prod (net)	0.0	0.0	1.1	0.5	0.0
Yakal prod (net)	0.0	0.0	0.0	0.0	0.7
Nido-1X prod (net)	0.0	0.0	0.0	0.0	0.0
Gindara prod (not included)	0.0	0.0	0.0	0.0	0.0
Total Production (mmbbl)	**0.0**	**0.0**	**1.1**	**0.5**	**0.7**
Price assumptions	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**
Oil price (US$/bbl)	70.11	65.00	75.00	80.00	80.00
A$/US$	0.748	0.850	0.850	0.750	0.750
A$ oil price/bbl	93.74	76.47	88.24	106.67	106.67

Valuation					
Oil Reserves	**Mb gross**	**Mb net**	**A$m**	**$/bbl**	**$/sh**
Tindalo	4.4	1.5	39	25.41	0.07
Yakal	2.0	0.7	12	16.52	0.02
Nido-1X	2.4	0.8	14	16.69	0.03
Total	8.9	**3.1**	55	20.99	0.12
Resource potential	**Mb gross**	**Mb net**	**$m**	**Risk**	
SC54A-Inboard (35%)	60	21	210	30%	0.12
SC54B-Outboard (20%)	200	40	400	10%	0.08
Assuming farm-out from 40%					
Corporate costs	$2m pa		-15		-0.03
Conv. Notes			-11		-0.02
Cash/(Net debt)			9		0.02
Total			**151**		**0.29**

Valuation sensitivity	$m		$/sh
Base case oil at US$80 long term	151		0.29
Oil price at US$100	178		0.34
Oil price at US$60	114		0.22
35% of 10Mb discovery	35		0.07
20% of 200Mb discovery	400		0.76
Discount rate + 2.5%	136		0.26
EPS sensitivity	**2010**	**2011**	**2012**
Base case	-0.9c	3.3c	0.5c
Oil price at US$100	-0.9c	2.9c	2.8c
Oil price at US$60	-0.9c	0.6c	-0.2c

Peer group Enterprise Value per reserves comparison	EV $m	2P Mboe	3P Mboe	EV/2P $/boe	EV/3P $/boe
CVN	308	17	46	$18.54	$6.67
HZN	368	21	57	$17.14	$6.44
NDO	159	5	11	$28.92	$14.23
NXS	370	109	137	$3.39	$2.70
TAP	124	6	16	$21.38	$7.73
Peer group average				$17.87	$7.56
KIK	85	3	5	$27.55	$16.74

Source: Coy data

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

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Southern Cross Equities Ltd and its associates hold 3,770,000 shares in KIK as at the date of this report. This position is subject to change without notice.

Disclosure: Southern Cross Equities Ltd assisted KIK with a placement of shares in May 2009 and received a fee for its services