

21 April 2009

## Buy

**Important:** The above recommendation has been made on a 12 month view and may not suit your investment needs or timeframe. The basis it is prepared on is summarised on the last page of this report. **PLEASE CONTACT YOUR ADVISER TO DISCUSS THIS GENERAL RECOMMENDATION BEFORE ACTING ON IT.**

### Mod-High Volatility

**Target price**  
A\$0.25 (from A\$0.23)

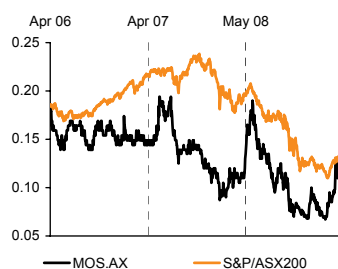
**Price**  
A\$0.13

**Short term (0-60 days)**  
n/a

MOS90421

### Price performance

	(1M)	(3M)	(12M)
Price (A\$)	0.09	0.09	0.12
Absolute (%)	44.4	47.7	13.0
Rel market (%)	32.8	36.3	62.9
Rel sector (%)	27.0	21.7	76.8



**Market capitalisation**  
A\$82.08m (US\$58.84m)

**Average (12M) daily turnover**  
A\$0.16m (US\$0.13m)

RIC: MOS.AX, MOS AU  
Priced at close of business 20 Apr 2009.  
Source: Bloomberg

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# Mosaic Oil

## Buying gas cheaply

**MOS acquired STO's interests in Surat gas at A\$0.10/GJ compared with recent trades valuing 3P CSG reserves at A\$1.09/GJ. The pipelines, processing plants and gas storage capacity should see MOS participate in the LNG development(s).**

### Key forecasts

	FY07A	FY08A	FY09F	FY10F	FY11F
EBITDA (A\$m)	3.81	7.10	8.03	9.73	10.80
Reported net profit (A\$m)	2.65	4.14	3.84 ▼	6.34	7.18
Normalised net profit (A\$m) <sup>1</sup>	2.65	6.69	5.29 ▼	6.34	7.18
Normalised EPS (c) <sup>1</sup>	0.55	1.06	0.84 ▼	0.97 ▼	1.10 ▼
Normalised EPS growth (%)	155.1	92.60	-21.0	16.20	13.30
Dividend per share (c)	0.00	0.00	0.00	0.00	0.00
Dividend yield (%)	0.00	0.00	0.00	0.00	0.00
Normalised PE (x)	23.60	12.30	15.50	13.40	11.80
EV/EBITDA (x)	20.30	8.05	7.17	5.84	5.15
Price/net oper. CF (x)	7.15	6.44	9.26 ▲	10.90 ▲	10.10 ▲
ROIC (%)	3.77	8.39	9.53	10.80	11.30

Use of ▲ ▼ indicates that the line item has changed by at least 5%.

<sup>1</sup> Pre non-recurring items and post preference dividends

Accounting standard: IFRS

Source: Company data, ABN AMRO Morgans forecasts

year to Jun, fully diluted

### The Mosaic/Santos deal – how does it stack up?

Recent trades in Surat CSG have a weighted average of A\$1.09/GJ of 3P reserves. Mosaic has acquired STO's gas interests in the Surat/Bowen fields for A\$0.10/GJ of 3P reserves. The acquisition is equally attractive on 2P numbers – A\$0.70 cf A\$2.85. MOS has 84PJ of 2P reserves, which, at A\$0.70/GJ, values the gas at A\$0.09ps. Valuing Mosaic's production assets at A\$0.50 of GJ capacity adds A\$0.08ps, taking our valuation to A\$0.37.

### Why is CSG priced so highly and conventional gas so cheaply?

The market values CSG reserves for delivery into a projected stronger gas market generated by the proposed Gladstone LNG plant(s). It believes conventional gas producers will not participate in these projected longer-term higher gas prices because: 1) the gas price will be weak in the short term with the availability of ramp-up gas from CSG field development; and 2) conventional gas-field decline will prohibit producers from participating in the higher prices.

MOS has 46 years of production from 2P reserves at current rates.

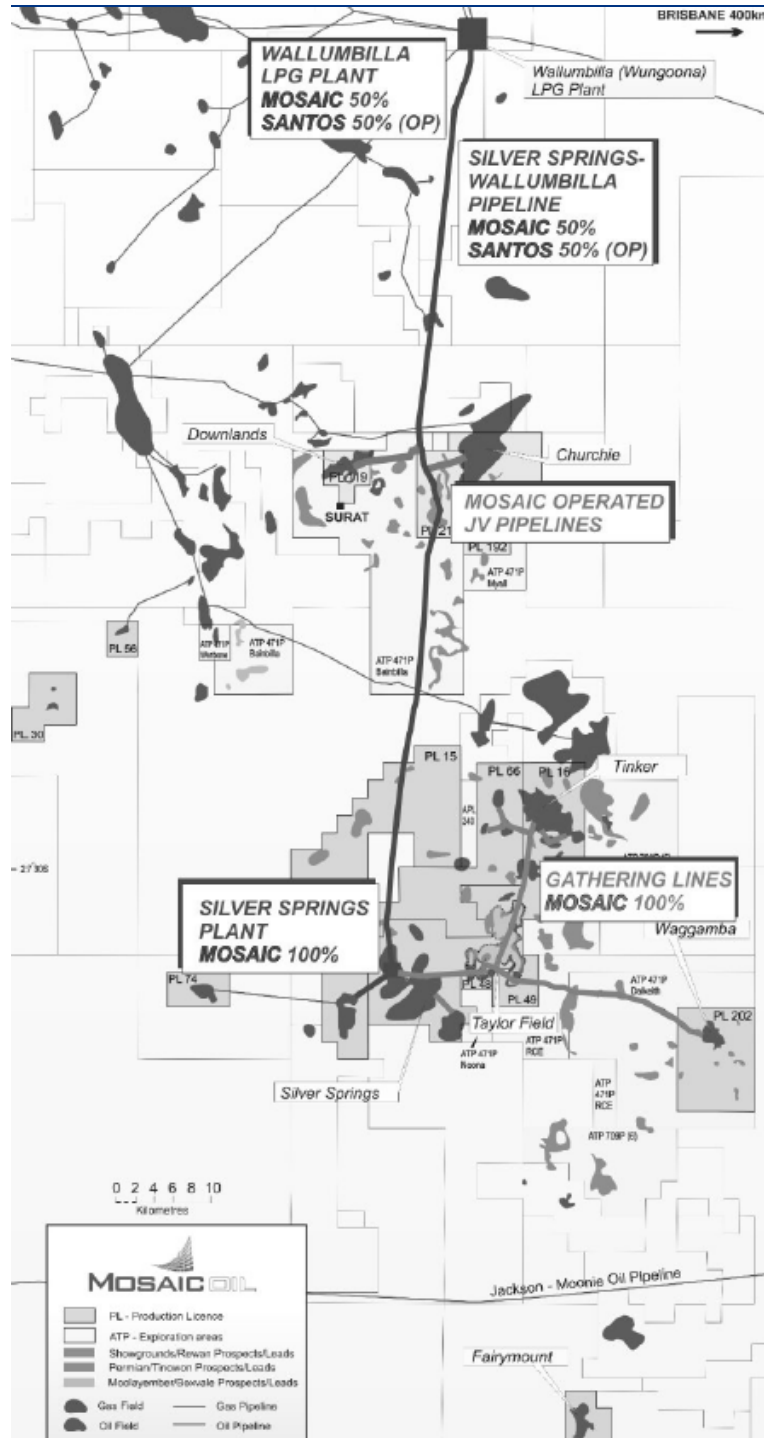
### Gas storage – what's it worth?

MOS is in discussions with potential customers for underground storage in the depleted Silver Springs gas field. Flexibility will evolve in CSG field developments and producers with GSAs (STO and ORG) can deliver ramp-up gas into these contracts. Initial LNG supply may be from shut-in conventional gas. Also, pipelines are simply horizontal storage tanks. However, depleted field storage will assist in smoothing CSG supply for the LNG development. Mosaic's 100PJ of storage will hold six months' supply for one 3.6Mtpy LNG train operating at capacity and can also provide a buffer against supply disruption.

## Company overview

Mosaic Oil (MOS) is an established junior oil & gas company with production, development and exploration in the Surat/Bowen Basin in Queensland. Production licenses cover the Churchie and Churchie West gas fields (100%), the Silver Springs Area (100%, including North Boxleigh, Taylor-Tinker, Taylor and Roswin), the Waggamba Gas Field (100%), the Downlands Oil and Gas Field (75.252%, including Downlands and Downlands East) and Spring Grove (77.5%). Gas production is also sourced from Fairymount (100%), Riverslea (10%) and the Major field (16%). The company has interests in production pipelines and equipment insured for more than A\$50m, with about 100PJ of depleted field capacity that may be used to store gas.

**Figure 1 : Mosaic's producing fields and productive infrastructure**



Source: Mosaic Oil

Mosaic has a 28.57% interest in PRL-08 (Kimu – operated by Oil Search), with an attributable 259PJ of 2P reserves in Papua New Guinea. Mosaic Oil is also listed on the Port Moresby stock

exchange. It has a 6% interest in the Hurricane oil & gas pool, offshore WA (operated by Santos), and a 50% interest (with operator L&M Petroleum) in tenements onshore Taranaki Basin, NZ.

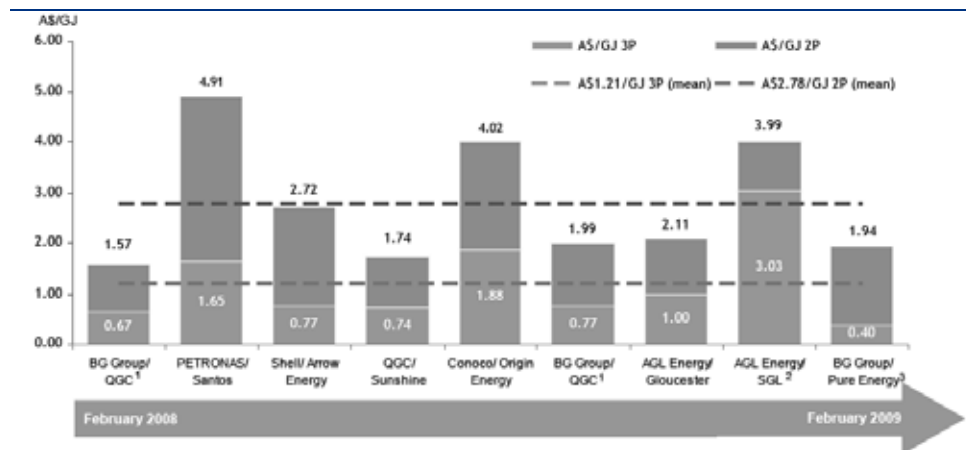
### Valuing gas reserves in the Surat Basin

Once a satisfactory completion technique is identified, Coal Seam Gas projects are long-life legacy assets. The value of recent transactions for CSG reserves in the Surat and Bowen basins, Queensland, anticipates they will participate in higher-priced gas markets, driven by the demand for gas from the LNG trains proposed for Gladstone and the effect that conversion into LNG will have on the gas supply price. Most analysts are projecting a price of about 85% of the often-quoted Henry Hub gas price.

The value of an accumulation of a natural resource depends on a number of factors including the level of endowment of the commodity in situ, the proportion that can be recovered, the capital and operating cost – including the discovery cost – and the cost of getting it to market. For CSG companies the relevant factors are the rate of gas flow, the rate of water flow, the cost of the well, the composition of the gas, the location of the field with respect to infrastructure and markets, and finally – estimated by flow rate decline in the initial stages of production, but confirmed only by extended operation of the field – the reserves ultimately accessed by each well.

Valuing CSG projects by applying a value to gas reserves encounters all these risks, but is commonly used to compare the value of projects and companies. It may be wrong, but it is easy. The chart below shows transactions on this basis. It does not include the recent acquisition by Arrow of a minority interest in its Tipton West project from Beach Petroleum, where it also held a pre-emptive right. It has paid A\$0.70/GJ of 2P reserves and A\$0.30/GJ of 3P reserves.

**Figure 2 : Valuing CSG projects on the basis of Reserves**



Source: Eastern Star Gas presentation – April 2009

### Mosaic's acquisition of STO's Churchie and Downlands

Mosaic is a conventional gas producer, but it has a large reserve base compared with its current production rate. The 2P reserves of 84PJ will support production for over 40 years at the current rate of production, and the 3P reserves for over 100 years. Production costs are low and are further enhanced by condensate produced with the gas.

The acquisition of STO's interests in the Churchie and Downlands fields and pipelines, and the Myall and Bainbilla blocks, has delivered 2P reserves of 29PJ of gas and 0.57mmbbl of oil, and 3P reserves of 64PJ and 1.1mmbbl to Mosaic. On the 2P reserves Mosaic has paid A\$0.70/GJ of gas, in line with the most recent Arrow acquisition of Tipton West, and well below the values shown in the chart above. On the basis of 3P reserves, Mosaic paid A\$0.10/GJ compared with Arrow's recent acquisition at A\$0.30/GJ and the average of A\$1.21/GJ.

## Valuation and risks

With the change in our valuation methodology, and the split into gas and liquids, our valuation of Mosaic's Surat reserves has increased, with A\$0.20 per share ascribed to the current 2P reserves of oil & gas.

**Table 1 : Valuation of MOS on 2P Reserves at A\$0.70/GJ and A\$20/bbl**

<b>Asset</b>	<b>A\$m</b>	<b>A\$/share</b>
Surat-Bowen 2P gas reserves #	58.7	0.09
Surat-Bowen 2P oil reserves *	71.6	0.11
Silver Springs assets and storage	50.0	0.08
Surat-Bowen exploration upside	26.1	0.04
Exploration	25.0	0.04
Net cash	20.0	0.03
Corporate & other	-20.0	-0.03
<b>Total valuation</b>	<b>231.4</b>	<b>0.37</b>

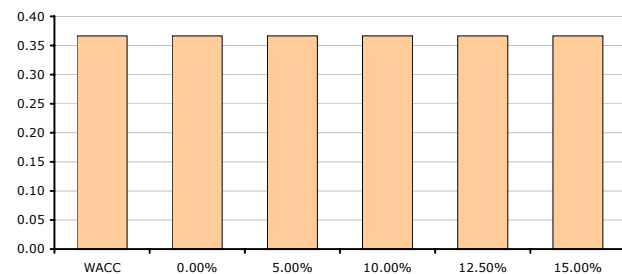
# Valued at A\$0.70/PJ of 2P reserves. \* Valued at A\$20/bbl of 2P reserves.  
Source: ABN AMRO Morgans estimates

We have also assigned a potential value for the storage of gas in the depleted Silver Springs gas field. This field has produced about 100PJ of gas, with the field gathering and production infrastructure largely still in place and insured for A\$23m. On the basis of A\$0.50/GJ of capacity, and excluding any separate value for this infrastructure, we value the depleted fields and associated infrastructure at A\$50m, A\$90.08 per share. We have assigned nominal values to Mosaic's stranded assets and exploration acreage outside the Surat-Bowen basins, and coupled with cash on hand, derive a sum-of-the-parts valuation of A\$0.37 per share. Our target price of A\$0.25 is at a one-third discount to our valuation, and is up from our previous valuation and target of A\$0.23 per share. Further weakness in the oil price and the strength of the AUD/USD exchange rate are risks to profitability and valuation. In particular a strengthening Queensland domestic gas price offers upside potential in the longer term. A weakening in the transaction price for Queensland gas assets would have a negative impact on our valuation, although we believe we have compensated for this in the discount between our valuation and target price.

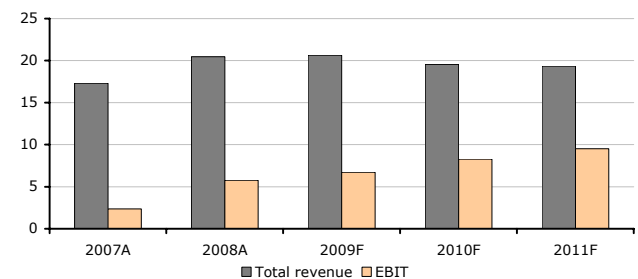
## MOS – financial summary

Year to 30 Jun (A\$m)	AIFRS	AIFRS	AIFRS	AIFRS	AIFRS	Valuation methodology	SOTP	Price target (A\$)	0.25	
Income statement	2007A	2008A	2009F	2010F	2011F			Val'n (A\$)	\$ 0.37	
Divisional sales	17.3	16.4	16.8	15.3	15.7					
Total revenue	17.3	20.5	20.6	19.5	19.3	<b>Valuation summary</b>	<b>A\$m</b>	<b>A\$ps</b>	<b>DCF valuation inputs</b>	
EBITDA	3.8	7.1	8.0	9.7	10.8	Surat-Bowen 2P Gas Reserves #	58.7	0.09	Rf 5.25%	
Depreciation & amortisation	-1.4	-1.3	-1.3	-1.5	-1.2	Surat-Bowen 2P Oil Reserves *	71.6	0.11	Rm-Rf 6.00%	
EBIT	2.4	5.8	6.7	8.3	9.5	Silver Springs Assets & Storage	50.0	0.08	Beta 1.58	
Net interest expense	0.3	0.9	0.8	0.8	0.8	Exploration	25.0	0.04	CAPM (Rf+Be) 14.7%	
Pre-tax profit	2.6	6.7	5.3	9.1	10.3	Net Cash	20.0	0.03	Tax rate (t) 30.0%	
Income tax expense	0.0	0.0	0.0	-2.7	-3.1	Corporate & Other	-20.0	-0.03	WACC 11.35%	
After-tax profit	2.6	6.7	5.3	6.3	7.2	<b>Total valuation</b>	<b>231.4</b>	<b>0.37</b>	<b>Shares</b> 631.4	
Minority interests	0.0	0.0	0.0	0.0	0.0					
NPAT	2.6	6.7	5.3	6.3	7.2	<b>Production (Mt)</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>
Significant items	0.0	-2.6	-1.4	0.0	0.0	Liquids mmbbl	0.08	0.08	0.09	0.08
NPAT post abnormalities	2.6	4.1	3.8	6.3	7.2	Gas Pj	2.14	1.83	2.01	1.71
<b>Divisional sales revenue</b>	<b>2007A</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>	<b>Key assumptions</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>
Liquids						A\$/US\$	0.90	0.75	0.72	0.72
Gas						Oil Price (US\$/bbl)	96.82	64.48	45.00	62.50
<b>Growth ratios</b>	<b>2007A</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>	Gas Price (AUD\$/Gj)	3.50	3.50	3.50	3.50
Sales growth	17%	-5%	2%	-9%	3%	<b>Per share data</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>
Operating cost growth		-31%	-6%	-36%	-11%	No. shares	631.4	631.4	651.7	651.7
<b>Cash flow statement</b>	<b>2007A</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>	EPS (cps)	0.7	0.6	1.0	1.1
EBITDA	3.8	7.1	8.0	9.7	10.8	EPS (normalised) (c)	1.1	0.8	1.0	1.1
Cash flow from ops (1)	8.8	12.8	8.9	7.8	8.4	Dividend per share (c)	0.0	0.0	0.0	0.0
Capex (2)	-10.3	-9.7	-7.0	-7.0	-7.0	Dividend payout ratio (%)	0.0	0.0	0.0	0.0
Disposals/(acquisitions)	0.0	0.1	0.0	0.0	0.0	Dividend yield (%)	0.0	0.0	0.0	0.0
Cash flow from invest (3)	-10.4	-9.7	-7.0	-7.0	-7.0	<b>Operating performance</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>
Incr/(decr) in equity	0.0	18.0	0.0	0.0	0.0	EBIT growth	144%	16%	23%	15%
Incr/(decr) in debt	0.0	0.2	0.0	0.0	0.0	NPAT growth	n.m.	n.m.	n.m.	n.m.
Ordinary dividend paid	0.0	0.0	0.0	0.0	0.0	Normalised EPS growth	93%	-21%	16%	13%
Other financing cash flow	0.0	-0.8	0.0	0.0	0.0	Asset turnover (%)	5.5	4.6	4.0	3.8
Cash flow from fin (5)	0.0	17.4	0.0	0.0	0.0	EBITDA margin (%)	22.1	43.4	47.9	63.7
Forex and disc ops (6)	0.0	0.0	0.0	0.0	0.0	EBIT margin (%)	13.7	35.3	40.0	54.1
Incr/(decr) cash (1+3+5+6)	-1.6	20.5	1.9	0.8	1.4	Net profit margin (%)	15.3	40.9	31.5	41.5
Equity FCF (1+2)	-1.6	3.0	1.9	0.8	1.4	Return on net assets (%)	7.8	8.6	9.8	10.4
<b>Balance sheet</b>	<b>2007A</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>	Net debt (A\$m)	-24.8	-24.4	-25.2	-26.6
Cash & deposits	4.6	25.1	24.7	25.5	26.9	Net debt/equity (%)	-33.4	-31.3	-29.9	-29.1
Trade debtors	2.3	3.8	3.8	3.8	3.8	Net interest/EBIT cover (x)	-6.6	-8.1	-10.5	-12.7
Inventory	2.1	2.7	2.7	2.7	2.7	ROIC (%)	8%	10%	11%	11%
Investments	0.4	0.4	0.4	0.4	0.4	<b>Comparable multiples (x)</b>	<b>2008A</b>	<b>2009A</b>	<b>2010A</b>	<b>2011A</b>
Other intangible assets	0.0	0.0	0.0	0.0	0.0	Mosaic Oil	EV/EBITDA	5.0	4.0	3.5
Fixed assets	39.0	42.9	48.6	54.1	59.9	Year to 30 Jun	PE	8.9	11.0	9.7
Other assets	12.3	13.6	12.1	12.1	12.1	Horizon Oil	EV/EBITDA	6.2	0.7	-0.1
Total assets	60.7	88.4	92.2	98.6	105.8	Year to 30 Jun	PE	-901.1	1.8	1.2
Interest bearing debt	0.0	0.2	0.2	0.2	0.2	Tap Oil	EV/EBITDA	0.1	-0.1	0.0
Trade payables	3.4	9.3	9.3	9.3	9.3	Year to 31 Dec	PE	11.0	16.4	40.5
Long-term borrowings	0.0	0.1	0.1	0.1	0.1	<b>Earnings Sensitivity</b>	<b>NPV \$ps</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>
Provisions	4.2	4.3	4.3	4.3	4.3	Oil sensitivity (+10%)	0.00	1.00	0.56	0.66
Other liabilities	0.3	0.4	0.4	0.4	0.4	Oil sensitivity (+\$US10/bbl)	0.00	1.44	0.80	0.94
Total liabilities	7.9	14.2	14.2	14.2	14.2	Gas sensitivity (+10%)	0.00	0.62	0.48	0.40
Share capital	70.7	87.9	87.9	87.9	87.9	Gas sensitivity (+US10c/GJ)	0.00	0.16	0.12	0.11
Other reserves	0.0	0.0	0.0	0.0	0.0	AUD sensitivity (+10%)	0.00	-0.91	-0.51	-0.60
Retained earnings	-17.9	-13.8	-9.9	-3.6	3.6	AUD sensitivity (+1c)	0.00	-0.11	-0.06	-0.08
Total equity	52.8	74.2	78.0	84.3	91.5					
Minority interest	0.0	0.0	0.0	0.0	0.0					
Total shareholders' equity	52.8	74.2	78.0	84.3	91.5					
Total liabilities & SE	60.7	88.4	92.2	98.6	105.8					

Valuation sensitivity to discount rate (A\$/share)



Total revenues and EBIT (A\$m)



Source: Company data, ABN AMRO Morgans forecasts

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Absolute performance, long-term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. The target price is the level the stock should currently trade at if the market accepted the analyst's view of the stock, provided the necessary catalysts are in place to effect the change in perception. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value the target price will differ from 'fair' value. Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

For listed property trusts (LPTs) the recommendation is based upon the target price plus the dividend yield, ie total return. A Buy implies a total return of 10% or more; a Hold 5-10%; and a Sell less than 5%.

Absolute performance, short-term (trading) recommendation: The Trading Buy/Sell recommendation implies upside/downside of 3% or more. The trading recommendation time horizon is 0-60 days.

Each stock has been assigned a Volatility Rating to assist in assessing the risk of the security. The rating measures the volatility of the security's daily closing price data over the previous year relative to other stocks included in either the S&P/ASX200 Index (large caps) or the Small Ordinaries Index (small caps) of which it is a member. This rating is a quantitative (objective) measure provided as an additional resource and is independent of the qualitative research process undertaken by our research analysts.

A rating of Low indicates very little movement in price over the previous year (Coefficient of Variation < 4 for small caps or < 5 for large caps). A Moderate rating implies average price movement over the previous year (Coefficient of Variation of 9 - 21 for small caps or 7.25 - 15 for large caps). A High rating implies significant price movement over the past year (Coefficient of Variation greater than 25 for small caps or 35 for large caps).

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Subject companies: MOS.AX

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