Southern Cross Equities

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Karoon Gas Australia (KAR)

Good reason to outperform as Browse drilling approaches

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Recommendation

Spec Buy

Price

2.90

Target (12 months)

4.50

KAR has outperformed the market as it enters the S&P/ASX 200 Index and its eagerly awaited Browse drilling program approaches. KAR is a well funded exploration play with great potential upside to the current share price due to its activities in the Browse Basin, Brazil and Peru. As an explorer, risks are high but so are the potential rewards.

Expected Return

Capital growth	55%
Dividend yield	0
Total expected return	55%

Company Data & Ratios

Enterprise value	301m
Market cap	432m
Issued capital	148.8
Free float	70%
12 month price range	$1.65-4.90
GICS sector	Energy

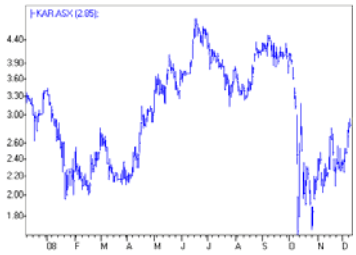
Browse drilling soon to commence

The Sedco-703 rig is due to arrive on site this month which should allow drilling to commence, weather permitting. The first prospect to be drilled will be Poseidon, which spans the boundary of WA-315-P (KAR 49%) and WA-398-P (KAR 40%). Poseidon has a P50 estimate of 7TCF and lies close to WPL's Torosa field that has reserves of 18TCF and 300mb of condensate. The rig is contracted for up to 225 days with at least three very large target wells to be drilled. This is a long and major program, consistent with the exploration scope of the permit partner and operator ConocoPhillips (COP)

Indicative Poseidon value $8.00ps

SCE estimates an indicative value of success of Poseidon at around $8.00 per KAR share, representing a multiple of the current share price, on the basis of 7TCF and just US$1.50/boe in place. Note that this is a very large target, equivalent to 1.3 billion boe. Our valuation of KAR's portfolio of prospects are summarised in the table below, which shows total risked value of $11.60 and total unrisked of $42.20. Our price target further discounts the value of this quality portfolio, indicating the risk to our target is clearly on the upside.

Absolute Price



SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

KAR Prospects Valuation Table

	Gas Tcf	Liquids MMbbl	Total Boe MMboe	KAR's share %	NPV/boe $/boe	Unrisked Value $M	Unrisked Value $/share	COS	Risked Values MMboe	Risked Values $/share
Prospects										
Unrisked P50 Reserve Potential										
Kon-Tiki	7		1280	40	2.34	1200	8.05	35%	179	2.82
Grace	5.7		1042	40	2.34	977	6.56	35%	146	2.30
Poseidon	7		1280	40	2.34	1200	8.05	35%	179	2.82
Duyfken	2		366	40	1.88	274	1.84	20%	29	0.37
Total Browse	**21.7**		**3968**				**24.51**		**534**	**8.30**
Tumbes Basin, Peru Z38	1	300	483	50	3.00	724	4.86	15%	36	0.73
Santos Basin, Brazil	2	400	766	50	5.00	1914	12.85	20%	77	2.57
Total South America		**700**	**1249**				**17.71**			**3.30**
Total							**42.21**			**11.60**

Notes: Brazil, Peru: assumes farm down to 50%

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Exploration fully funded

The total cost of the upcoming Browse program, including seismic, has been estimated at US$270m of which KAR's share would be US$72m. KAR has no debt and available cash of A$135m. KAR has been able to manage its exploration outgoings through well constructed joint ventures (with COP) while maintaining significant interests in its permits. This is a model that stands to be applied successfully in other areas such as South America.

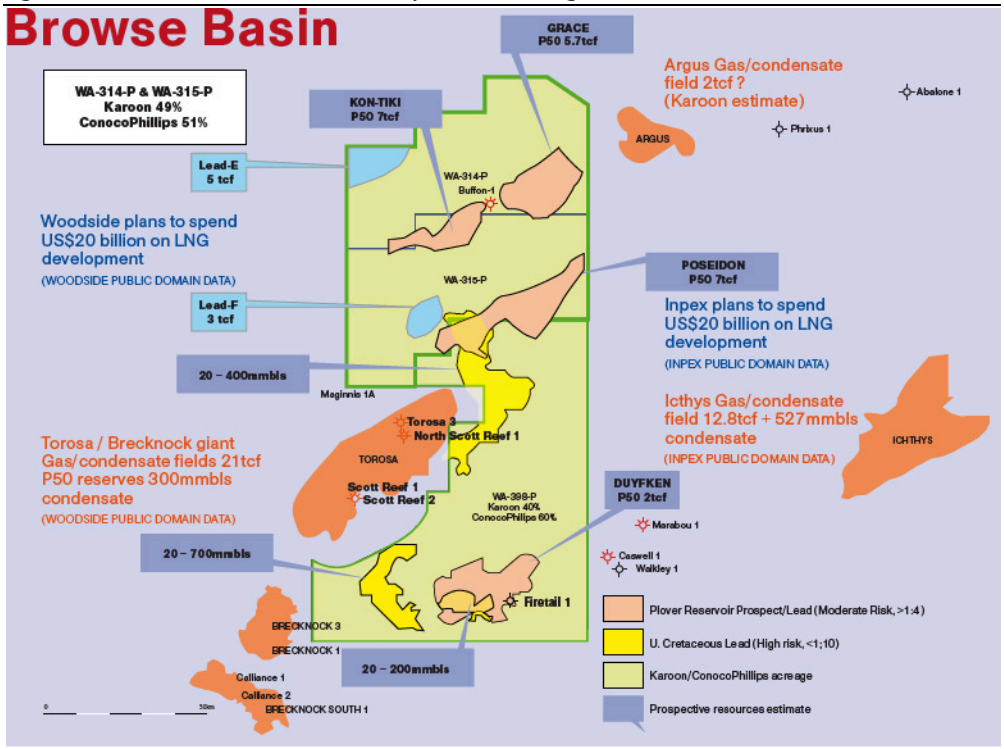
Opportunities in the Santos Basin, Brazil

KAR has 100% of five highly prized permits in the Santos Basin. These are in relatively close proximity to recent discoveries by Petrobras, of what is believed to be in the 150mmb range. These discoveries, of Eocene age fields, enhance the prospectivity of the same play type within KAR's acreage. KAR's early interest in the Santos Basin has enabled it to secure these now valuable permits nearby the major players, in particular Petrobras. The 2009 work plan for KAR will be to acquire 3D seismic, with drilling timed at this stage for 2011.

Valuable prospects also in Peru

KAR has an interest in the large block Z38 offshore Peru's Tumbes Basin, where it can earn up to 60% equity from funding of 2D and 3D seismic. The plan is to acquire 2D and 3D seismic in 2009 with drilling likely in 2010. This is an attractive region as evidenced by Shell's recent US$300m farm in to BPZ's adjacent Z1 permit.

Figure 1 – KAR's Browse Permits and Prospects – First target Poseidon (7TCF)



- A 200-225 day drilling program is expected to start in December 2008, drilling at least one well each of the three permits.
- Total cost estimate US$ 270 million. Karoon share US$ 72 million.
- NB. With respect Karoon's Browses Basin Joint Venture, the disclosures presented in this review do not necesarrily reflect the views of ConocoPhillips.
- Karoon will amend prospective reserve estimates as work on the prospects is completed.

SOURCE: COMPANY DATA

Recommendation structure

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

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

Fair Value: Expect total return between –15% and +15% 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 909744 shares in KAR as at the date of this report. This position is subject to change without notice..

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