

**13 October 2008**
**Change of target price**

# 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.**

## High Volatility

**Target price**  
A\$0.57 (from A\$0.64)

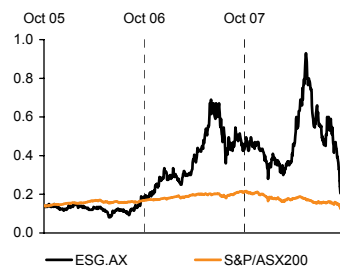
**Price**  
A\$0.270

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

ESG81013

## Price performance

	(1M)	(3M)	(12M)
Price (A\$)	0.55	0.58	0.49
Absolute (%)	-50.5	-53.8	-44.9
Rel market (%)	-38.6	-42.5	-6.3
Rel sector (%)	-29.6	-28.3	13.0



**Market capitalisation**  
A\$195.64m (US\$130.95m)

**Average (12 mnth) daily turnover**  
A\$0.83m (US\$0.76m)

RIC: ESG.AX, ESG.AU  
Priced at close of business 13 Oct 2008.  
Source: Bloomberg

## Analyst

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# Eastern Star Gas

## CSG in NSW - catching QLD?

**There's still a long way to go to demonstrate commerciality, but ESG now has certified reserves, the ground position to define substantial reserves, a market for its ramp-up gas production and has two MOUs to supply proposed gas fired power stations.**

## Key forecasts

	FY06A	FY07A	FY08F	FY09F	FY10F
EBITDA (A\$m)	-4.66	-6.59	-4.58 ▼	-2.60 ▼	0.67 ▼
Reported net profit (A\$m)	-12.6	-13.5	-2.76 ▼	-1.54 ▼	0.04 ▼
Normalised net profit (A\$m) <sup>1</sup>	-12.6	-13.5	-2.76 ▼	-1.54 ▼	0.04 ▼
Normalised EPS (c) <sup>1</sup>	-3.47	-2.50	-0.38 ▼	-0.20 ▼	0.01 ▼
Normalised EPS growth (%)	n/a	-27.8	-84.8	-47.6	60.9
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)	n/m	n/m	n/m	n/m	4756.8
EV/EBITDA (x)	n/m	n/m	n/m	n/m	91.0
Price/net oper. CF (x)	-21.1	-12.5	-22.6 ▼	-222.6 ▼	181.7 ▲
ROIC (%)	0.00	-36.3	-7.27	-3.25	-0.45

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

year to Jun, fully diluted

1. Pre non-recurring items and post preference dividends

Accounting standard: Australian GAAP

Source: Company data, ABN AMRO Morgans forecasts

## Wilga Park - earning money from ramp-up gas

The Bohena and Bibblewindi pilot areas south of Narrabri, NSW, within the 265 km<sup>2</sup> PAL 2 (ESG 65%), which is excised from the 9,100 km<sup>2</sup> PEL 238 (ESG 65%) have enabled ESG to obtain 2P reserve certification of 285PJ of Coal Seam Gas, with 185PJ attributable to ESG. This is from a minor portion of its prospective acreage. These reserves are more than adequate to support the potential demand for 3-4PJ/year from the proposed expansion of ESG's now 65%-owned gas-fired Wilga Park Power Station to 40MW, via a proposed 32 km pipeline. ESG has sold a 35% stake in Wilga Park to the Gastar Exploration, the holder of the 35% stake in PEL 238, to facilitate the commercialisation of the PEL with the monetisation of ramp-up gas through the power station.

## The regional NSW market, and beyond

The Narrabri CSG JV partners have entered into a gas transportation agreement with APA Group, the owner of the existing pipeline from the Moobma-to-Sydney gas pipeline to Dubbo, and Tamworth. Under this Heads of Agreement APA will undertake Front End Engineering Design (FEED) to connect the Narrabri CSG field to its pipeline. The regional markets may offer potential for another 5-8 PJ of gas per year, and will enable the Narrabri JV to monetise further development gas, substantiate a larger reserve base and justify access to the metropolitan markets. The JV has also entered into two MOUs for supply of up to 40PJ/year for a proposed power station to be built by Babcock & Brown and for supply of up to 500PJ of gas (in total) to the NSW Government-owned electricity generator Macquarie Generation for the expansion of its Bayswater Power Station.

## Other assets - including cash

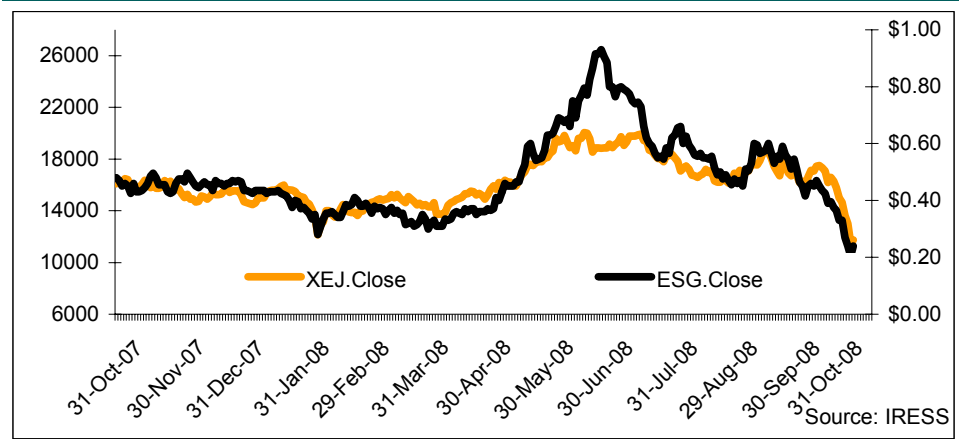
ESG is earning a 75% interest in PEL 427 and a 60% interest in PEL 428 in the Gunnedah Basin, NSW, has a 97.5% interest in PEL 6, and a 100% interest in PEL 455 which cover the southern extensions of the Surat and Bowen basins into NSW, and holds a 100% interest in PEL's 8, 422 and 424 as well as PEL Application 73 in the Darling Basin, NSW. It has a 23.1% interest in ASX-listed Orion Petroleum. ESG reported net cash of A\$38m at 30 June 2008.

**Valuation and risks**

Our valuation of Eastern Star Gas remains unchanged at A\$0.57. It is derived using a sum-of-the parts valuation. The bulk of the value – A\$0.32/share – is derived from assigning a value of A\$1.00/GJ to the anticipated 1,000PJ of gas to be identified in PEL 238, and risking this to 50%. We have also assigned value to Wilga Park Power Station and assumed an expansion of capacity to 40MW with ESG’s attributable 2P gas reserves of 185PJ. Successful delineation of gas reserves and the conversion of the MOUs to Gas Sales Agreements would add significantly to our valuation of Eastern Star Gas.

Below is a chart showing the performance of the ESG share price over the past 12 months, compared with the S&P ASX 200 Energy Index.

**Chart 1 : ESG share price relative to S&P ASX 200 Energy Index.**

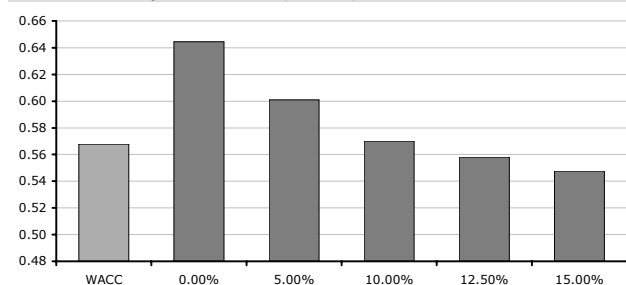


Source: Iress

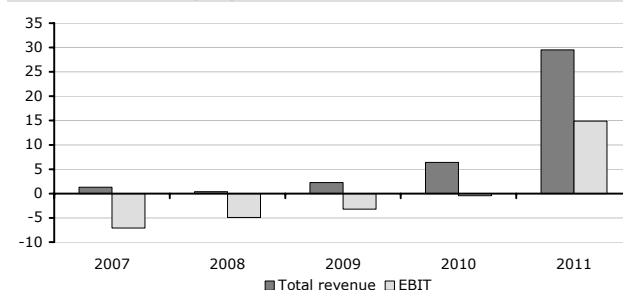
ESG – financial summary

Year to 30 Jun (A\$m)	AIFRS 2007A	AIFRS 2008A	AIFRS 2009F	AIFRS 2010F	AIFRS 2011F	Closing price (A\$)	0.27	Price target (A\$)	0.57	
<b>Income statement</b>						Valuation methodology	DCF	Val'n (A\$)	\$ 0.57	
Divisional sales	0.7	0.3	2.1	6.3	29.4	<b>Valuation summary</b>	<b>A\$m</b>	<b>A\$ps</b>	<b>DCF valuation inputs</b>	
Total revenue	1.3	0.4	2.3	6.4	29.5	Wilga Park Power Station	21.6	0.03	Rf 6.25%	
EBITDA	-6.6	-4.6	-2.6	0.7	17.7	PEL 238	31.2	0.04	Rm-Rf 4.50%	
Depreciation & amortisation	-0.5	-0.3	-0.6	-1.1	-2.8	MacGen CSG MOU (500PJ)	162.5	0.22	Beta 1.46	
EBIT	-7.1	-4.9	-3.2	-0.4	14.9	B&B CSG MOU (500PJ)	162.5	0.22	CAPM (Rf+B) 12.8%	
Net interest expense	-0.1	2.1	1.0	0.5	0.0	Exploration	15.6	0.02	Tax rate (t) 30.0%	
Pre-tax profit	-7.2	-2.8	-2.2	0.1	14.9	Net Cash	38.0	0.05	<b>WACC</b> 10.35%	
Income tax expense	0.0	0.0	0.7	0.0	-4.5	Corporate & Other	-20.0	-0.03	Shares 772.2	
After-tax profit	-7.2	-2.8	-1.5	0.0	10.4	<b>Total</b>	<b>411.4</b>	<b>0.57</b>		
Minority interests	0.0	0.0	0.0	0.0	0.0	<b>Production (Mt)</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>
NPAT	-7.2	-2.8	-1.5	0.0	10.4	Gas Pj	0.60	1.00	0.10	0.26
Significant items	0.0	0.0	0.0	0.0	0.0	<b>Key assumptions</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>
NPAT post abnormals	-13.5	-2.8	-1.5	0.0	10.4	A\$/US\$	0.79	0.89	0.90	0.86
<b>Growth ratios</b>	<b>2007A</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>	Oil Price (US\$/bbl)	63.50	83.37	80.75	65.00
Sales growth	-63%	-64%	706%	193%	367%	Gas Price (US\$/Gj)	4.53	7.27	5.69	5.56
Operating cost growth		-34%	-2%	19%	108%	<b>Per share data</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>
<b>Cash flow statement</b>	<b>2007A</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>	No. shares	724.6	772.2	772.2	772.2
EBITDA	-6.6	-4.6	-2.6	0.7	17.7	EPS (cps)	-0.4	-0.2	0.0	1.3
Cash flow from ops (1)	-11.7	-8.7	-0.9	1.1	13.2	EPS (normalised) (c)	-0.4	-0.2	0.0	1.3
Capex (2)	-2.8	-2.4	0.0	0.0	0.0	Dividend per share (c)	0.0	0.0	0.0	0.0
Disposals/(acquisitions)	0.9	0.0	0.0	0.0	0.0	Dividend payout ratio (%)	0.0	0.0	0.0	0.0
Cash flow from invest (3)	-1.7	-6.4	0.0	0.0	0.0	Dividend yield (%)	0.0	0.0	0.0	0.0
Incr/(decr) in equity	10.5	48.6	48.6	48.6	48.6	<b>Operating performance</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>
Incr/(decr) in debt	0.0	0.0	0.0	0.0	0.0	EBIT growth	-31%	-35%	-86%	84%
Ordinary dividend paid	0.0	0.0	0.0	0.0	0.0	NPAT growth	-62%	-44%	-103%	23677%
Other financing cash flow	-0.5	1.9	0.0	0.0	0.0	Normalised EPS growth	-85%	-48%	61%	23677%
Cash flow from fin (5)	10.0	50.5	48.6	48.6	48.6	Asset turnover (%)	0.1	0.4	0.9	3.1
Forex and disc ops (6)	0.0	0.0	0.0	0.0	0.0	EBITDA margin (%)	-893.8	-1721.7	-121.1	10.6
Incr/(decr) cash (1+3+5+6)	-3.4	35.5	47.7	49.8	61.8	EBIT margin (%)	-965.9	-1838.6	-149.1	-7.0
Equity FCF (1+2)	-14.4	-11.1	-0.9	1.1	13.2	Net profit margin (%)	-975.7	-1036.0	-71.8	0.7
<b>Balance sheet</b>	<b>2007A</b>	<b>2008A</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>	Return on net assets (%)	-4.6	-2.1	-0.2	5.7
Cash & deposits	2.1	37.5	85.2	135.0	196.8	Net debt (A\$m)	-37.5	-85.2	-135.0	-196.8
Trade debtors	0.0	2.0	2.0	2.0	2.0	Net debt/equity (%)	-35.6	-55.9	-67.1	-75.6
Inventory	0.3	0.0	0.0	0.0	0.0	Net interest/EBIT cover (x)	2.3	3.2	0.9	
Investments	0.0	0.0	0.0	0.0	0.0	ROIC (%)	-7.3	-3.3	-0.4	15.5
Other intangible assets	0.0	0.0	0.0	0.0	0.0	<b>Comparable multiples (x)</b>		<b>2009F</b>	<b>2010F</b>	<b>2011F</b>
Fixed assets	4.6	8.4	7.8	6.7	3.9	Eastern Star Gas	EV/EBITDA	18.1	6.4	4.0
Other assets	44.0	60.2	60.2	60.2	60.2	Year to 30 Jun	PE	46.8	29.1	15.7
Total assets	51.0	108.1	155.2	203.9	262.9	Queensland Gas Company	EV/EBITDA	35.2	28.3	26.6
Interest bearing debt	0.1	0.0	0.0	0.0	0.0	Year to 30 Jun	PE	58.0	50.8	70.3
Trade payables	1.5	1.6	1.6	1.6	1.6	Arrow Energy	EV/EBITDA	32.1	33.4	35.0
Long-term borrowings	0.0	0.0	0.0	0.0	0.0	Year to 30 Jun	PE	52.7	97.2	89.5
Provisions	0.6	0.8	0.8	0.8	0.8	<b>Earnings Sensitivity</b>	<b>2009F</b>	<b>2010F</b>	<b>2011F</b>	
Other liabilities	0.3	0.2	0.2	0.2	0.2	Gas sensitivity (+10%)	0.00	-45.62	-35.20	
Total liabilities	2.5	2.6	2.6	2.6	2.6	Gas sensitivity (+ 10c Gj)	-45.66	-45.62	-35.20	
Share capital	85.1	142.7	191.3	239.9	288.5					
Other reserves	3.3	7.0	7.0	7.0	7.0					
Retained earnings	-39.9	-44.1	-45.7	-45.6	-35.2					
Total equity	48.5	105.5	152.6	201.2	260.3					
Minority interest	0.0	0.0	0.0	0.0	0.0					
Total shareholders' equity	48.5	105.5	152.6	201.2	260.3					
Total liabilities & SE	51.0	108.1	155.2	203.9	262.9					

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



Total revenues and EBIT (A\$m)



Source: Company data, ABN AMRO Morgans forecasts

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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.

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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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