

1 February 2010

Produced and issued by: RBS Morgans Limited

Eastern Star Gas

Reserves on the Up and Up

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.**

Moderate Volatility

Target price
A\$1.17 (from A\$1.18)

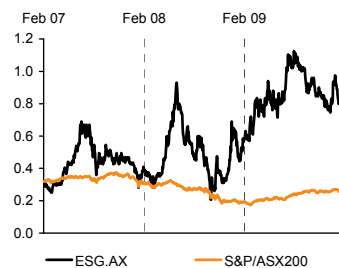
Price
A\$0.75

Short term (0-60 days)
n/a

ESG100201

Price performance

	(1M)	(3M)	(12M)
Price (A\$)	0.82	0.86	0.46
Absolute (%)	-9.1	-12.3	63.0
Rel market (%)	-3.6	-12.2	25.8
Rel sector (%)	-2.7	-10.4	16.4



Market capitalisation
A\$612.29m (US\$545.18m)

Average (12M) daily turnover
A\$2.66m (US\$2.16m)

Sector: BBG AP Oil & Gas
Part of: ASX/S&P 200
RIC: ESG.AX, ESG AU
Priced A\$0.75 at close 1 Feb 2010.
Source: Bloomberg

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ESG has announced a 152% increase in 2P reserves to 988 PJ (1,520 PJ at the JV level). Positive news flow should continue in 2010: further reserves upgrades, increasing pilot production rates and news on gas commercialisation. Despite general weakness among CSG stocks we retain Buy, with a A\$1.17 target price.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
EBITDA (A\$m)	-6	-6.36	-5.22	-1.65 %	3.49 %
Reported net profit (A\$m)	-4.18	-2.52	-3.13	-1.74 %	-1.15 %
Normalised net profit (A\$m) ¹	-4.18	-4.92	-3.13	-1.74 %	-1.15 %
Normalised EPS (c) ¹	0.58	0.56	0.35	0.2	0.13 %
Normalised EPS growth (%)	-76.9	-2.92	-38.2	-41.8	-34.1
Dividend per share (c)	0	0	0	0	0
Dividend yield (%)	0	0	0	0	0
Normalised PE (x)	n/m	n/m	n/m	n/m	n/m
EV/EBITDA (x)	n/m	n/m	n/m	n/m	188.4
Price/net oper. CF (x)	-62.8	-23.1	-32.1 %	-46.7	-258.1 %
ROIC (%)	-9.5	-6.98	-4.54	-1.81	0.62

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: IFRS

Source: Company data, RBS Morgans forecasts

Reserves upgrade is late, but is bigger than anticipated

ESG has announced that the 2P reserves in PEL 238 (in which it has a 65% interest) has increased by 152% to 1,520 PJ, versus ESG's own target of 1,300 PJ. 3P reserves have increased 43% to 2,979 PJ. The well-flagged reserves upgrade was more than a month late due to mechanical issues in the production pilot wells causing a delay to the dewatering process. We expect at least one more reserves upgrade before the end of CY2010 thanks to the improving performance from the production pilots.

CSG stocks are out of favour... but positive market sentiment could return soon

After a quiet nine months in the Coal Seam Gas (CSG) sector, we expect interest to return by 2H10 after the anticipated Final Investment Decision (FID) of the BG Group's Curtis Island LNG project, the AOE-led Fisherman's Landing LNG train 1 and Santos/Petronas GLNG project. Progress on CPRS and/or the NSW electricity privatisation process could also see interest returning to companies with uncontracted gas volumes, in particular those located in NSW, which currently relies on gas imports for more than 90% of its supply.

Increasing reserves base underscores company value – Buy and TP of A\$1.17

ESG's reserves underscore the company's valuation and with more than 15,000 PJ of estimated gas in place in PEL 238, substantial upside exists. We anticipate a continual stream of good news to come to the market over the next 12 months, with further reserves upgrades, improving pilot production performance and news on gas commercialisation opportunities. Our DCF valuation for ESG has increased following the reserves upgrade, but the dilutionary capital raising in late 2009 has seen our target price drop slightly to A\$1.17. Buy Retained.

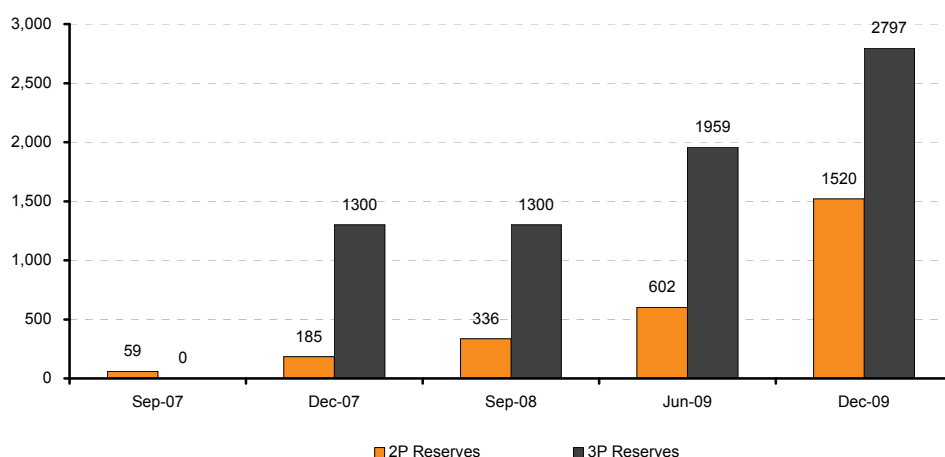
Reserves upgrade

PEL 238 now has more 2P reserves than the Cooper Basin

ESG has announced that 2P reserves at its Narrabri Coal Seam Gas Project in northern NSW (PEL 238) have been increased by 152 % to 1,520 PJ (of which ESG's 65% interest is 988 PJ), while certified 3P reserves have increased by 43% to 2,797 PJ (of which ESG's net interest is 1,818 PJ). Putting it in context, PEL 238 now has more 2P reserves than the Cooper Basin.

This increase continues the long history of reserves increases in the permit, as the chart below highlights.

Chart 1 : PEL 238 reserves history



Source: Eastern Star Gas ASX Release

The updated reserves estimate has taken into account pilot production and other exploration data up to the end of 2009 and exceeded ESG's stated 2P reserves target of 1,300 PJ.

ESG's CEO Casey stated that "the upgrade primarily reflects an increase in the extent of gas reserves certified for the Bohena coal seam but, for the first time, the Namoi coal seam has made a material contribution. The inclusion of the Namoi seam in independently certified gas reserves has been possible given the outstanding early performance of the Bibblewindi West production pilot, as announced late last year".

Where to from here?

This reserve upgrade has been an important target for the company, yet it represents just one point in its evolution to becoming a fully integrated CSG producer. Near-term catalysts include:

- **Further improvement in gas production rates from its production pilots** (currently the Bibblewindi multi-lateral pilot is at 0.6 mmscfd and the Bibblewindi-West tri-lateral pilot is at 2.0 mmscfd).
- **Further reserves upgrades** (we anticipate a further round of reserves upgrades by YE 2010).
- **Announcement(s) on gas commercialisation options.** ESG currently sells gas into its expanding Wilga Park power station, but ultimately the company needs to find a larger market for its gas. It has two MOU's for supplying gas into large scale gas-fired power generation, but these will likely be replaced at some stage given the amount of time that has passed since they were first announced. We anticipate that as an intermediate step, some gas may be sold into the NSW domestic gas market from 2011-12.

Why we continue to like the ESG story

ESG had a great run in 2009, but we believe further upside potential exists for the stock over the coming 12 months. Key reasons are as follows:

- **Positive forward news flow.** After six months of negative news associated with delays in dewatering the two key production pilots, we anticipate positive news to dominate over the next 12 months (see the points outlined in "Where to from here" above).

- **ESG has the most mature gas resource in NSW.** Current NSW gas demand is 140 PJ, with less than 8 PJ being supplied from NSW gas fields. The remainder is imported from Victoria, SA and Queensland. Two events may give rise to increasing demand for gas supplies: The introduction of a CPRS (Carbon Pollution Reduction Scheme) and the NSW electricity privatisation. Either or both events will see a rise in gas demand for gas-fired power generation, in particular in NSW. ESG's acreage is strategically located to supply gas into new power generation.
- **LNG supply potential.** With PEL 238 containing an estimated 15,000 PJ of gas in place, the current reserves position is a stepping stone towards the certification of a much larger gas resource. Assuming a 50% recovery factor, 7,500 PJ of recoverable gas volume is possible. At this scale, supply into LNG is achievable (large scale LNG requires approximately 200 PJ per annum over 20 years). With Santos a stakeholder in both PEL 238 (35% equity interest) and ESG itself (19.7%), the opportunity may rise where ESG could supply gas into LNG – either a standalone development in NSW or QLD, or possibly Santos' Gladstone LNG project.
- **Looks inexpensive compared with recent CSG transactions.** We estimate an average CSG reserves sales price of A\$1.53/GJ on 2P reserves and A\$0.55/GJ on 3P reserves. These imply an enterprise value range of A\$1 – 1.5 billion for ESG (versus current market capitalization of approximately A\$650m. Also, STO acquired an interest in PEL 238 in 2009 for the equivalent of A\$0.80/share, and a 20% interest in ESG for A\$1.00/share. ESG is currently trading at a discount to both of these prices, even though the company subsequently achieved commercial gas flows and increased reserves in the acreage.

Key risks

Some risks that investors need to be aware of:

- **Gas commercialisation.** PEL 238 is currently not connected to the East Coast gas pipeline network, so gas sales (outside of small scale volumes to Wilga Park Power Station) are not possible. Any gas sales agreement struck would be in competition with other potential gas suppliers, including those with uncontracted gas volumes in NSW, Victoria, SA and Queensland.
- **Pilot production results.** Further reserves increases are reliant on continued good performance from the production pilots. The early peaking of gas flow rates below a commercially acceptable level (given the level of expenditure on each pilot we estimate a gas flow rate > 3 mmscfd per pilot is needed).
- **Access to funds.** ESG is at the exploration/appraisal phase of its development, which has been relatively capital intensive to date. Whilst we believe the company has sufficient cash reserves to see it through to the end of 2010, the commercialisation phase will require additional capital at some stage. We anticipate a further equity raising by YE 2010.

Valuation summary

Our DCF valuation analyses three potential monetisation scenarios for ESG.

- Scenario 1: NSW gas and electricity – via arms-length contracts.
- Scenario 2: NSW gas and electricity – own power generation via gas swaps to Victoria.
- Scenario 3: Electricity and LNG – gas swapped with Queensland Producers and used as feedstock into Santos LNG Train 2.

Each scenario generates a value per GJ for gas in PEL 238, which are then averaged:

Table 1 : Scenario summary – NPV/GJ

Scenario	Peak gas production rate (PJ/annum)	Total gas produced (PJ)	NPV A\$m	NPV/GJ
1: 3rd party contracts	65 PJ	1,800 PJ	708	A\$0.38
2: Equity power generation	65 PJ	1,800 PJ	917	A\$0.49
3: LNG	140 PJ	3,000 PJ	1,692	A\$0.55
			Average	A\$0.47

Source: RBS Morgans estimates

The average value per GJ is applied to the potential future growth in PEL 238 2P reserves. We have conservatively assumed that ESG's existing 2P reserves will be sold to third party on an arms-length basis (ie, at a lower price than could be achieved through its own power generation or LNG).

We have not received any updated guidance on the company's contingent resource figures. Previous guidance was that PEL 238 had a combined 3P reserves + 3C resource of 8,087 PJ (ESG share 5,256 PJ). We valued this potential resource upside in two tranches, and risked tranche 1 at 50% and tranche 2 at 25%.

Table 2 : ESG valuation summary

Asset	Resource				Risky valuation	
	developed	NPV / GJ	Valuation	Applied		
	ESH share (PJ)	A\$ / GJ	A\$m	risking	A\$m	\$/share
Wilga Park	71	\$0.55	39	100%	39	\$0.04
2P reserves	917	\$0.38	346	100%	346	\$0.38
Tranche 1 growth	1482	\$0.47	697	50%	348	\$0.39
Tranche 2 growth	2405	\$0.47	1,131	25%	283	\$0.31
Net cash					55	\$0.06
Investments					5	\$0.01
Corporate					-20	-\$0.02
Total	4875				1,055	\$1.17

Source: RBS Morgans

Our risky valuation has increased since our previous research note; but the number of shares on issue has also increased after ESG raised A\$20.6m via an SPP announced in October 2009 at A\$0.85. This dilution results our retaining a Buy recommendation, but with a revised target price of A\$1.17.

About the production pilots

ESG has four production pilots online at present, with another two in the drilling and completion phase. Two of the production pilots were drilled a few years ago and utilised vertical drilling technology, now seen as being a sub-optimal drilling technique for the coals in the permit. Details of the other four production pilots are as follows:

Biblewindi multi-lateral production pilot

The Biblewindi multi-lateral production pilot comprises two adjacent twin-lateral pilots (each of which incorporates three vertical production wells) and two shield wells (each incorporating one lateral well and one production well). The function of the shield wells is to increase the overall area of greater hydrostatic pressure drawdown so that innermost lateral wells can more quickly achieve performance approximating that of a full-scale production development.

At last report, the pilot was producing gas at 0.6 mmscfd, with the rate expected to continue to increase over the next 12-18 months.

Biblewindi West tri-lateral production pilot

At the Biblewindi West production pilot, gas production has exceeded 2.0 million standard cubic feet per day (mmscfd) from the Namoi coal seam within the Maules Creek Formation. This gas production was achieved while water production from the pilot exceeded 3,500 barrels per day and with in excess of 550 metres of water pressure still on the coal. Gas production is expected to rise significantly as dewatering continues.

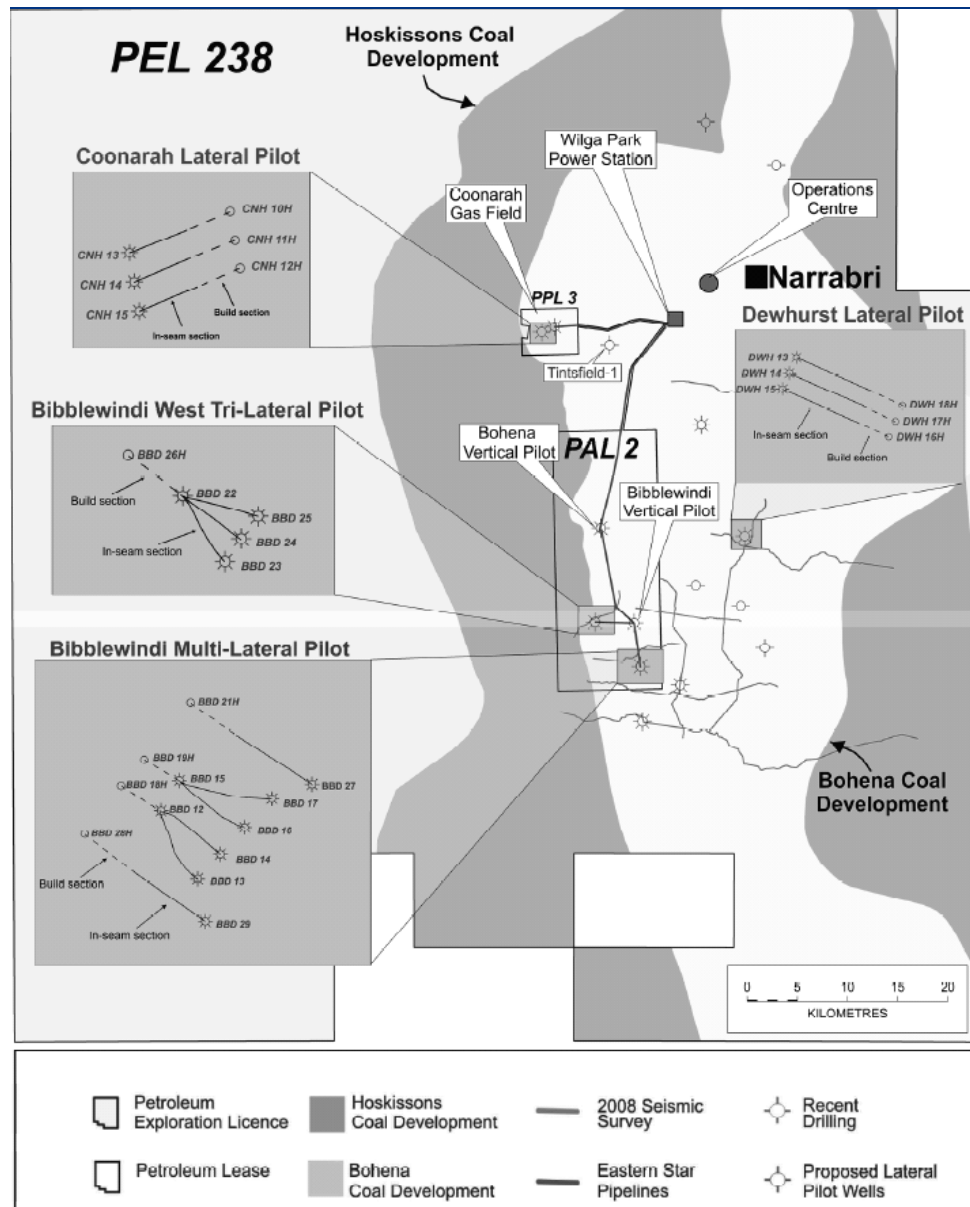
Dewhurst pilot

The Dewhurst pilot is located within PEL 238 but outside of PAL 2. It incorporates three parallel lateral wells, each intersecting a single vertical production well. The pilot has yet to be completed for production. Following completion, the Dewhurst pilot will be operated on a short-term basis to determine water and gas production profiles.

Tintsville pilot

A further production pilot has commenced at Tintsville, within PAL 2, during the December quarter. Like Dewhurst, the Tintsville pilot will incorporate three parallel lateral wells. However, the Tintsville pilot will target the Hoskissons coal seam within the Black Jack formation. The Black Jack formation is shallower than the Maules Creek formation targeted by all other production pilots.

Figure 1 : Location of production pilots – PEL 238



Source: ESG December Quarterly Report

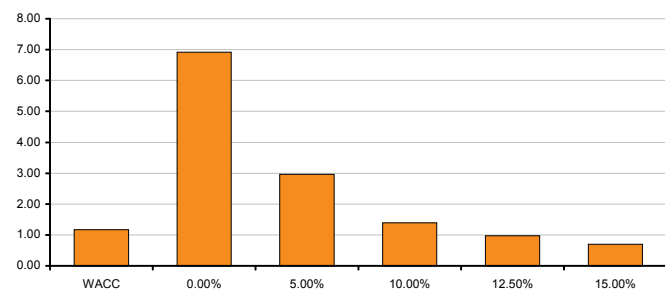
Company Overview

Eastern Star Gas (ESG) is an Australian coal seam gas (CSG) explorer, with its main exploration tenements located in New South Wales (NSW). ESG has been focussing on the exploration and appraisal of PEL 238, in which it has 65% equity (Santos 35%). Independently certified reserves for PEL 238 are now 33PJ of Proved (1P) reserves, 602PJ of Proved + Probable (2P) reserves and 1,959PJ of Proved + Probable + Possible (3P) reserves. The company is focussing on expanding its 2P reserves base to 1,300PJ by end of 2009. Initial gas production from the CSG pilot production wells will feed an expanded gas-fired power generator located at Wilga Park. The company plans to expand the capacity of Wilga Park Power Station from 7MW to 44MW over the coming few years as gas production increases from PEL 238.

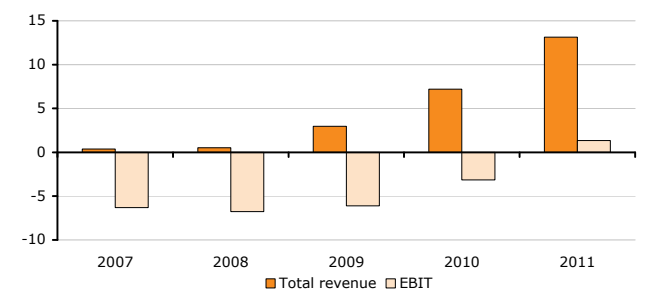
ESG – financial summary

Year to 30 Jun (A\$m)	AIFRS 2008A	AIFRS 2009A	AIFRS 2010F	AIFRS 2011F	AIFRS 2012F	Price target (A\$)	1.17
Income statement						Val'n (A\$)	\$ 1.17
Divisional sales	0.3	0.2	2.6	6.9	12.8	Valuation summary	A\$m A\$ps DCF valuation inputs
Total revenue	0.4	0.5	3.0	7.2	13.1	Wilga Park Power Station	38.8 0.04 Rf 5.25%
EBITDA	-6.0	-6.4	-5.2	-1.7	3.5	Existing 2P Reserves	345.6 0.38 Rm-Rf 6.00%
Depreciation & amortisation	-0.3	-0.4	-0.9	-1.5	-2.1	Resource Delineation	348.4 0.39 Beta 1.50
EBIT	-6.3	-6.8	-6.1	-3.2	1.3	Exploration Upside	282.7 0.31 CAPM (Rf+B) 14.2%
Net interest expense	2.1	1.9	3.0	1.4	-2.5	Net Cash	54.7 0.06 Tax rate (t) 30.0%
Pre-tax profit	-4.2	-2.5	-3.1	-1.7	-1.2	Corporate & Other	-15.0 -0.02 WACC 11.04%
Income tax expense	0.0	0.0	0.0	0.0	0.0	Total	1055.2 1.17 Shares 902.8
After-tax profit	-4.2	-2.5	-3.1	-1.7	-1.2	Production	2009A 2010F 2011F 2012F
Minority interests	0.0	0.0	0.0	0.0	0.0	Gas Production (PJ)	0.0 0.3 0.6 4.8
NPAT	-4.2	-2.5	-3.1	-1.7	-1.2	Electricity Sales (GW/hr)	0.0 0.0 40.3 100.7
Significant items	0.0	0.0	0.0	0.0	0.0	Key assumptions	2009A 2010F 2011F 2012F
NPAT post abnormal	-4.2	-2.5	-3.1	-1.7	-1.2	A\$/US\$	0.90 0.75 0.89 0.87
Growth ratios	2008A	2009A	2010F	2011F	2012F	Oil Price (US\$/bbl)	96.82 70.26 73.56 75.75
Sales growth	-64%	-41%	1551%	163%	87%	Gas Price (A\$/Gj)	5.50 5.75 6.00 6.30
Operating cost growth		4%	20%	9%	9%	Per share data	2009A 2010F 2011F 2012F
Cash flow statement	2008A	2009A	2010F	2011F	2012F	No. shares	878.3 902.8 865.2 865.2
EBITDA	-6.0	-6.4	-5.2	-1.7	3.5	EPS (cps)	-0.3 -0.3 -0.2 -0.1
Cash flow from ops (1)	-8.7	-28.5	-21.1	-13.9	-2.5	EPS (normalised) (c)	-0.3 -0.3 -0.2 -0.1
Capex (2)	-2.4	-3.5	-10.2	-16.7	-39.5	Dividend per share (c)	0.0 0.0 0.0 0.0
Disposals/(acquisitions)	0.0	0.0	0.0	0.0	0.0	Dividend payout ratio (%)	0.0 0.0 0.0 0.0
Cash flow from invest (3)	-6.4	2.6	-10.2	-16.7	-39.5	Dividend yield (%)	0.0 0.0 0.0 0.0
Incr/(decr) in equity	48.6	50.1	0.0	0.0	0.0	Operating performance	2009A 2010F 2011F 2012F
Incr/(decr) in debt	0.0	0.0	0.0	0.0	50.0	EBIT growth	7% -10% -48% -75%
Ordinary dividend paid	0.0	0.0	0.0	0.0	0.0	NPAT growth	-40% 24% -44% -34%
Other financing cash flow	1.9	-2.2	0.0	0.0	0.0	Normalised EPS growth	-50% 21% -42% -34%
Cash flow from fin (5)	50.5	47.9	0.0	0.0	50.0	Asset turnover (%)	0.0 0.4 1.1 1.8
Forex and disc ops (6)	0.0	0.0	0.0	0.0	0.0	EBITDA margin (%)	-2256.4 -4025.9 -200.1 -24.1
Incr/(decr) cash (1+3+5+6)	35.5	22.0	-31.3	-30.6	8.0	EBIT margin (%)	-2373.3 -4289.2 -234.0 -46.1
Equity FCF (1+2)	-11.1	-32.0	-31.3	-30.6	-42.0	Net profit margin (%)	-1571.8 -1594.3 -119.9 -25.5
Balance sheet	2008A	2009A	2010F	2011F	2012F	Return on net assets (%)	-4.4 -4.1 -2.1 0.9
Cash & deposits	37.5	59.6	28.3	-2.3	5.6	Net debt (A\$m)	-59.6 -28.3 2.3 44.4
Trade debtors	2.0	2.2	2.2	2.2	2.2	Net debt/equity (%)	-38.7 -18.8 1.6 30.0
Inventory	0.5	1.6	1.6	1.6	1.6	Net interest/EBIT cover (x)	3.6 2.0 2.2
Investments	0.0	0.0	0.0	0.0	0.0	ROIC (%)	-7.0 -4.5 -1.8 0.6
Other intangible assets	0.0	0.0	0.0	0.0	0.0	Comparable multiples (x)	2010F 2011F 2012F
Fixed assets	7.9	8.6	17.9	33.1	70.5	Eastern Star Gas	EV/EBITDA -114.1 -278.6 912.2
Other assets	60.2	88.1	106.9	120.6	124.1	Year to 30 Jun	PE -226.9 -407.5 -231.1
Total assets	108.1	160.0	156.9	155.1	204.0	Arrow Energy	EV/EBITDA 101.7 38.1 24.5
Short-term debt	0.0	0.0	0.0	0.0	0.0	Year to 30 Jun	PE -845.1 84.0 39.6
Trade payables	1.6	4.5	4.5	4.5	4.5	Origin Energy	EV/EBITDA 11.1 8.4 7.5
Long-term borrowings	0.0	0.0	0.0	0.0	50.0	Year to 30 Jun	PE 23.0 18.7 15.8
Provisions	0.8	1.4	1.4	1.4	1.4		
Other liabilities	0.2	0.4	0.4	0.4	0.4		
Total liabilities	2.6	6.3	6.3	6.3	56.3		
Share capital	142.7	190.7	190.7	190.7	190.7		
Other reserves	7.0	9.7	9.7	9.7	9.7		
Retained earnings	-44.1	-46.6	-49.8	-51.5	-52.7		
Total equity	105.5	153.8	150.6	148.9	147.7		
Minority interest	0.0	0.0	0.0	0.0	0.0		
Total shareholders' equity	105.5	153.8	150.6	148.9	147.7		
Total liabilities & SE	108.1	160.0	156.9	155.1	204.0		

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



Total revenues and EBIT (A\$m)



Source: Company data, RBS Morgans forecasts

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