

Eastern Star Gas (ESG.AX / ESG AU)

Rating	OUTPERFORM* [V]
Price (29 Jul 09, A\$)	1.10
Target price (A\$)	1.25 [†]
Market cap. (A\$m)	857.09
Yr avg. mthly trading (A\$m)	38
Last month's trading (A\$m)	96
Projected return:	
Capital gain (%)	14.2
Gross yield (%)	—
Total return (%)	14.2
52-week price range (A\$)	1.10 - 0.20

* Stock ratings are relative to the relevant country benchmark.

[†]Target price is for 12 months.

[V] = Stock considered volatile (see Disclosure Appendix).

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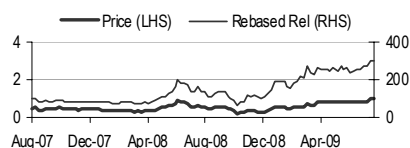
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QUARTERLY

June quarterly report

- **Event:** EasternStar Gas released its June quarterly result on 29 July, with no material news to change our outlook. ESG is still de-watering its Bibblewindi multi-lateral pilot, which consists of two twin-lateral pilots. The aggregate production rate from the pilot is 0.25mmcf/d, which we think is low given that the wells are multi-laterals.
- We have made some minor changes to our earnings forecasts. On a dollar basis, the changes are marginal, and represent a rebalance of our assumptions. We downgrade 2008-09 earnings by 4%, 2009-10 by 8% and upgrade 2010-11 by 4%.
- **View:** We see the company as a leveraged play on the NSW gas and power markets and although the CSG industry is significantly less developed than in Queensland, ESG, we think, is likely to demonstrate strong reserves and production growth over the next 12–24 months.
- **Catalyst:** Although the pilot programmes are delivering encouraging results, particularly the multi-lateral projects, we remain a little concerned at the time taken to deliver significant gas flows and suggest that strong flows of 1mmcf and above will be required to underpin our confidence in the commercial capacity of the area and reserves upside..
- **Valuation:** We have also adjusted our valuation marginally from \$1.25/share to \$1.23/share as a result of the downgrade in earnings. We leave our Target Price unchanged at \$1.25/share.

Share price performance



The price relative chart measures performance against the Australia S&P/ASX 200 index which closed at 4142.8 on 29/07/09

On 29/07/09 the spot exchange rate was A\$1.24/US\$1

Performance Over	1M	3M	12M
Absolute (%)	36.0	52.1	93.8
Relative (%)	27.6	35.7	126.8

Financial and valuation metrics

Year	06/08A	06/09E	06/10E	06/11E
Revenue (A\$m)	0.4	0.2	12.0	26.8
EBITDAX (A\$m)	-5.8	-5.2	2.4	11.7
EBIT (A\$m)	-6.3	-5.5	1.6	10.0
Net income (A\$m)	-4.2	-3.7	2.8	5.4
EPS (CS adj., Ac)	-0.62	-0.47	0.32	0.63
Change from previous EPS (%)	n.a.	-4.3	-8.4	3.9
Consensus EPS (Ac)	n.a.	-0.30	—	1.10
EPS growth (%)	n.a.	n.a.	n.a.	93.9
P/E (x)	NM	NM	337.3	173.9
Dividend (Ac)	—	—	—	—
Dividend yield (%)	—	—	—	—
EV / EBITDAX (x)	-140.99	-154.62	358.83	76.45
Net debt/equity (%)	net cash	net cash	net cash	24.1

Source: Company data, ASX, Credit Suisse estimates. * Adj. for goodwill, notional interest and unusual items. Relative P/E against ASX/S&P200 based on pre GW in AUD. Company PE calculation is based on displayed EPS Currency

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Figure 1: Financial summary

EASTERN STAR GAS LIMITED

In A\$m, unless otherwise stated

Year ending 30 Jun

Profit & Loss	2007A	2008A	2009F	2010F	2011F
Sales revenue	0.7	0.3	0.2	12.0	26.8
EBITDA	-13.3	-6.0	-5.2	2.4	11.7
Depr. & Amort.	0.5	0.3	0.3	0.8	1.7
Goodwill amort.	0.0	0.0	0.0	0.0	0.0
EBIT	-13.9	-6.3	-5.5	1.6	10.0
Equity adjustment	na	na	na	na	na
Net interest	-0.3	-2.1	-1.7	-2.4	2.2
Profit before tax	-13.5	-4.2	-3.7	4.0	7.8
Income tax	0.0	0.0	0.0	1.2	2.3
Profit after tax	-13.5	-4.2	-3.7	2.8	5.4
Minorities	na	na	na	na	na
Net profit after tax	-13.5	-4.2	-3.7	2.8	5.4
Preferred dividends	na	na	na	na	na
Net profit after tax	-13.5	-4.2	-3.7	2.8	5.4
Unusual item after tax	0.0	0.0	2.4	0.4	0.0
Reported profit after tax	-13.5	-4.2	-1.3	3.1	5.4
Balance Sheet	2007A	2008A	2009F	2010F	2011F
Cash & equivalents	2.1	37.5	59.6	21.9	23.7
Inventories	na	na	na	na	na
Receivables	0.4	2.0	9.0	9.0	18.9
Other current assets	1.6	0.3	0.0	0.0	0.0
Current assets	4.0	39.9	68.6	31.0	42.6
Property, plant & equip.	4.6	8.4	10.9	69.1	122.3
Intangibles	0.0	9.6	9.6	9.6	9.6
Other non-current assets	42.3	50.3	73.8	73.8	73.8
Non-current assets	47.0	68.3	94.3	152.4	205.6
Total assets	51.0	108.1	162.9	183.4	248.2
Payables	na	na	na	na	na
Interest bearing debt	0.1	0.0	0.0	13.5	61.7
Other liabilities	na	na	na	na	na
Total liabilities	2.5	2.6	17.5	31.3	90.6
Net assets	48.5	105.5	145.4	152.1	157.6
Ordinary equity	48.5	105.5	145.4	152.1	157.6
Minority interests	na	na	na	na	na
Preferred capital	na	na	na	na	na
Total shareholder funds	48.5	105.5	145.4	152.1	157.6
Cashflow	2007A	2008A	2009F	2010F	2011F
EBIT	-13.9	-6.3	-5.5	1.6	10.0
Net interest	0.3	2.0	1.7	2.4	-2.2
Depr & Amort	0.5	0.3	0.3	0.8	1.7
Tax paid	0.0	0.0	0.0	-0.6	-1.8
Working capital	0.1	-1.6	-7.2	0.9	-8.5
Other	4.0	2.7	8.6	-1.7	7.6
Operating cashflow	-8.9	-2.9	-2.0	3.4	6.8
Capex	0.0	0.0	-2.5	-46.8	-53.2
Acquisitions & Invest	-0.5	-3.1	-1.1	0.0	0.0
Asset sale proceeds	1.6	na	na	na	na
Other	-8.2	-9.0	-20.2	-11.4	0.0
Investing cashflow	-7.1	-12.2	-23.9	-58.2	-53.2
Dividends paid	na	na	na	na	na
Equity raised	10.5	48.6	47.9	3.6	0.0
Net borrowings	0.0	0.0	0.0	13.5	48.2
Other	-0.5	1.9	0.0	0.0	0.0
Financing cashflow	10.0	50.5	47.9	17.1	48.2
Net cashflow	-6.0	35.5	22.0	-37.6	1.8

Share Price: A\$1.10

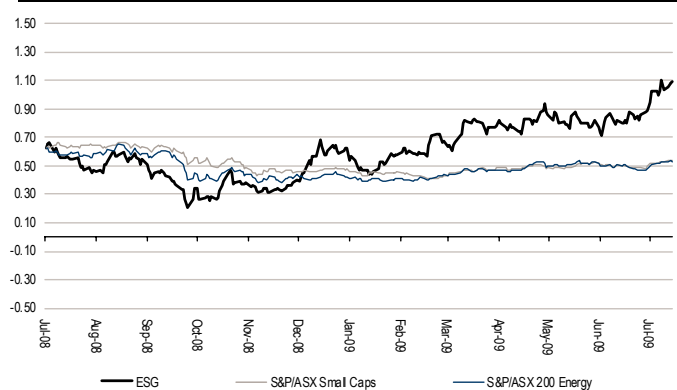
Financial Summary		2007A	2008A	2009F	2010F	2011F
NPAT	\$mn	-13.5	-4.2	-3.7	2.8	5.4
Credit Suisse NPAT	\$mn	-13.5	-4.2	-3.7	2.8	5.4
Credit Suisse EPS	c	-3.0	-0.6	-0.5	0.3	0.6
EPS growth	%	22.5	79.0	23.9	168.6	93.9
P/E	x	-36.9	-176.0	-231.2	337.3	173.9
P/Earnings Growth	x	na	na	na	na	na
Dividend payout ratio	%	0.0	0.0	0.0	0.0	0.0
Dividend	c	0.0	0.0	0.0	0.0	0.0
Yield	%	0.0	0.0	0.0	0.0	0.0
Franking	%	na	na	na	na	na
Operating CFPS	c	-2.0	-0.4	-0.3	0.4	0.8
P/OCF	x	-55.9	-257.3	-425.4	274.6	138.6
EV/EBITDA	x	-66.2	-147.0	-171.0	373.0	75.4
FCF yield	%	-1.8	-0.4	-0.5	-4.6	-4.9

Financial Ratios		2007A	2008A	2009F	2010F	2011F
Profitability Ratios						
EBITDA margin	%	-1808.8	-2256.4	-2301.7	19.6	43.6
EBIT margin	%	-1881.0	-2373.3	-2434.7	13.1	37.1
Return on equity	%	-27.9	-4.0	-2.5	1.8	3.5
Return on assets	%	-28.3	-8.9	-5.3	1.0	4.4
ROCE	%	-46.2	-11.0	-7.1	1.4	5.9
Effective tax rate	%	0.0	0.0	0.0	30.0	30.0

Balance Sheet Ratios		2007A	2008A	2009F	2010F	2011F
Net debt	\$mn	-2.0	-37.5	-59.6	-8.4	37.9
Net debt/Equity	%	-4.1	-35.6	-41.0	-5.5	24.1
Net debt/Capital	%	-4.2	-55.2	-69.4	-5.9	19.4
Interest cover	x	40.0	3.0	3.1	-0.7	4.6
Capex/Sales	%	0.0	0.0	-1134.8	-388.5	-198.2
Capex/Deprn	%	0.0	0.0	-8.5	-59.1	-30.4
Working capital/Sales	%	9.9	-610.2	-3215.4	7.8	-31.7

Share Items		2007A	2008A	2009F	2010F	2011F
Equiv. FPO (period avg.)	mn	456	672	783	852	864

Share Price Performance 52 week range: \$0.21 - \$1.11



Source: ASX Share price as of 29 Jul 09, 19:21 AET

Source: Company data, Credit Suisse estimates

June quarterly report

Eastern Star Gas released its June quarterly result with no material news to change our outlook.

Although the pilot programmes are delivering encouraging results, particularly the multi-lateral projects, we remain a little concerned at the time taken to deliver significant gas flows and suggest that strong flows of 1mmcfpd and above will be required to underpin our confidence in the commercial capacity of the area and reserves upside.

The stock is still a leveraged play on the NSW gas and power markets and although the CSG industry is significantly less developed than in Queensland, ESG, we think, is likely to demonstrate strong reserves and production growth over the next 12–24 months.

Narrabri

ESG is still de-watering its Bibblewindi multi-lateral pilot which consists of two twin-lateral pilots. The aggregate production rate from the pilot has peaked at 0.25mmcfpd for the time being, which we consider to be low given that the wells are multi-laterals. The company has commented that there have been pump drive rod failures which will require work-overs to replace the rods, after which dewatering should be accelerated and therefore lift gas flow-rates.

We would be looking for flow-rates to be over 1mmcfpd and note that ESG remains confident that it will deliver gross 2P reserves of 1300PJ (net of 845PJ) by the end of 2009.

In addition to the existing pilots, the company is developing pilots to test a new play concept in the Narrabri area. The drilling programme encompasses using a tri-lateral completion near the Bibblewindi 9-spot production pilot to test the Upper Mauls Creek coal seam, which is not included in its current gas resource assessment.

Wilga Park

The Wilga Park Power Station has commissioned 3MW of additional gas driven generators, increasing the capacity to 7MW. We expect that the new 3MW gas generator will commence power generation in 3Q09, which will lift cash generation and provide a commercial outcome for ESG's pilot production.

Earnings and valuation

We have made minor adjustments to our earnings forecasts. On a dollar basis, the changes are marginal and represent a rebalance of our assumptions. We downgrade 2008-09 earnings by 4%, 2009-10 by 8% and upgrade 2010-11 by 4%.

Figure 2: Earnings forecast

	08–09F	09–10F	10–11F
Gas Production (PJ)	0.2	3.1	5.2
Electricity Sales (GWhr)	3	34	131
Underlying NPAT (A\$mn)	-3.7	2.8	5.4
EPS (A cps)	-0.5	0.3	0.6
% change	-4%	-8%	4%

Source: Company data, Credit Suisse estimates

We have also adjusted our valuation marginally from \$1.25/share to \$1.23/share as a result of the downgrade in earnings. We leave our Target Price unchanged at \$1.25/share.

Figure 3: NAV valuation

Project	ESG share	A\$m	\$ps	Pr	Comments
Wilga Park	65%	23	\$0.03	100%	
Narrabri	65%	175	\$0.20	75%	Or B&B equivalent
Mac Gen MoU	65%	130	\$0.15	50%	Or Mac Gen equivalent
Uncommitted target Narrabri gas volumes		159	\$0.18	70%	The Narrabri JV is working to secure additional MoUs which could bring 2P reserves from its current target of 1300PJ to 2000PJ...we see the addition of STO gas marketing expertise to lift the probability of success here
PEL 434 and 433		10	\$0.01		Notional value only
Orion Petroleum		10	\$0.01		Notional value only
Underlying NPV		507	\$0.58		
Exploration upside		564	\$0.64	20%	We base our exploration assumption on the company's notional GIIP estimate
Total		1071	\$1.22		
Net cash		7	\$0.01		We forecast 12-month forward net debt after including the capex planned over the next 12 months
Total		1077	\$1.23		

Source: Company data, Credit Suisse estimates

The critical risk to our outlook and forecasts is the delivery of commercial outcomes from the Narrabri multi-lateral pilots. Partnering now with Santos, we see as adding significant additional commercial options for ESG, but ESG will still need to deliver robust flow-rates from its Narrabri pilots to underpin reserve upgrades.

Companies Mentioned (Price as of 29 Jul 09)

Eastern Star Gas (ESG.AX, A\$1.10, OUTPERFORM [V], TP A\$1.25)

Santos (STO.AX, A\$14.50, OUTPERFORM [V], TP A\$16.50)

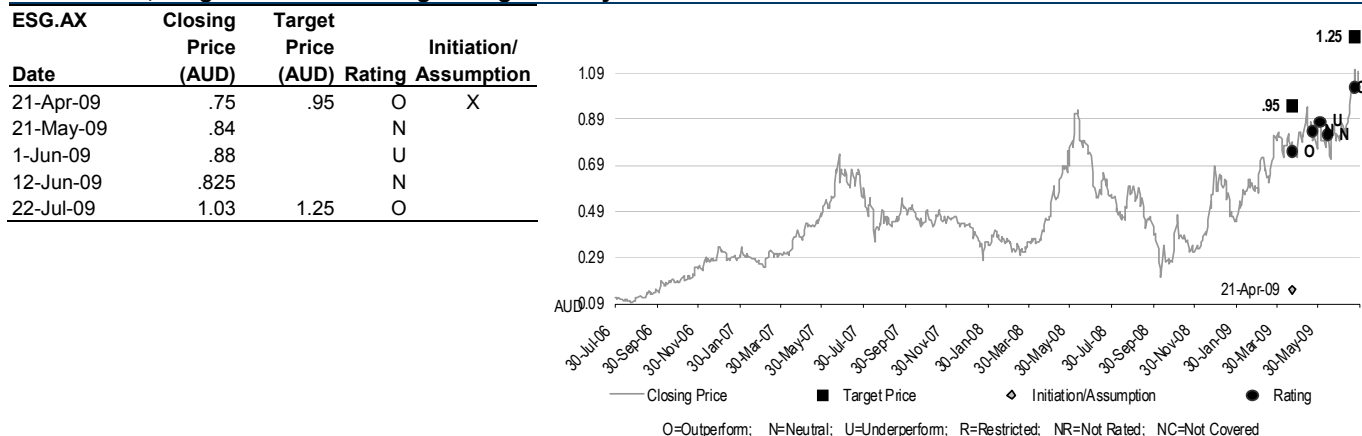
Disclosure Appendix

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3-Year Price, Target Price and Rating Change History Chart for ESG.AX



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Market Weight: Industry expected to perform in-line with the relevant broad market benchmark over the next 12 months.

Underweight: Industry expected to underperform the relevant broad market benchmark over the next 12 months.

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**The broad market benchmark is based on the expected return of the local market index (e.g., the S&P 500 in the U.S.) over the next 12 months.

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Neutral/Hold*	43%	(58% banking clients)
Underperform/Sell*	19%	(49% banking clients)
Restricted	2%	

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Price Target: (12 months) for (ESG.AX)

Method: We set our \$1.25 Target Price for ESG based on our valuation. We value ESG today at \$1.23/share using a discounted cashflow valuation derived valuation, the components of which lead to a discount rate of 11%. We model (where possible) domestic gas production and electricity generation; and applying risk weightings for the contracts where the MoUs are yet to be converted to Gas Sales Agreements

Risks: The critical risk associated with our \$1.25 ESG target is the assumption that ESG will be able to deliver commercial flow rates from its Narrabri field. The recently completed dual-lateral is currently de-watering and the company has yet to announce flow-rates. ESG's reserves goals will also depend on the success of its multi-lateral wells programme at Narrabri and will also require ESG to outline and complete commercial outcomes for its gas. The earnings are sensitive to changes in gas price assumptions, and the key risk (to either the upside or downside) to longer-term gas prices, in our view, will be the outcome of the CSG to LNG developments currently in planning. Although these projects are all based in Queensland, failure of these projects would release potentially over 2000PJ of gas into the east coast market. Under this scenario we'd expect that gas price along East-Coast Australia will face downward pressure or at the very least remain static for a significant period

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