

Eastern Star Gas (ESG)
3/06/2008

Speculative Buy
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Initiation of Coverage

Current Price \$ps **0.77**
Target Price \$ps **\$1.75**

Background

We met with Chief Operating Officer Peter Lansom & Exploration Manager Ashley Edgar recently. Both Peter & Ashley were instrumental in building ORG's CSM portfolio. Peter was Chief Petroleum Engineer for 10yrs, whilst Ashley was Head of Exploration 13yrs.

ESG is situated in the Gunnedah basin in northern NSW, 30km from Narrabri and has a 65% interest in PEL 238 which has 2P reserves of 185PJ & 3P reserves of 1300PJ, GIP is estimated at 17Tcf.

ESG has minor production, two MOU's with Macquarie Generation & BNB Power totalling 1300PJ (100%).

Currently ESG are undertaking a drilling program to prove up the 3P such that MOU's convert to 2P reserves.

The program entails 20 coreholes, seismic and 4 multi lateral wells.

The first two coreholes have indicated 18m coal thickness, whereas previous drilling by different management encountered only 3m coals, basically with new team they are hitting the right area.

No landholder issues, given the PEL 238 is within a state forest, basically scrub land.

\$40m cash should see them through until Q109.

Coal System

The key difference between Walloon coals and ESG's coals is the cleating system within the coals themselves, i.e fracturing system.

This enables gas to move within the coals. ESG cleats are less pronounced and thus ESG plans to drill horizontal wells, the permeability is still very good as the fracture sets, while widely spaced, still have a large aperture.

The cleating system is somewhat unique to the Bohena coals, depth does not appear to affect permeability as with other coals.

The ESG coals are at depth, 1000m, Walloon coals are typically between 300-600m.

No fracture stimulation is required..

Value

ESG has 3P of 845PJ, based on Santos/Petronas could be worth \$1.65GJ or \$1.75 per share (fully diluted). This forms the basis of our price target.

Some value uplift from 3P to 2P is possible perhaps another 0.50GJ equating to \$2.40ps.

We would anticipate that the contingent resource could be multiples of the 3P.

Whilst various CSM transactions have taken place recently, the Santos transaction is perhaps the largest and most reliable in terms of value.

Risks

No cashflow. ESG produces minor cashflow by selling some gas to its Wilga park power station, but certainly not enough to fund exploration & development.

Technical risk, can ESG extract the gas effectively? One would think so given calibre of team assembled, but geology can always disappoint.

The current program may not be successful and ESG may have to alter its development plans.

MOU risk with Macquarie Generation & BNB power.

Requirement to seek further funds.

No meaningful production until 2010-2012.

Unknown capex costs at this stage for development.

Upside

Potentially could find more gas from current program.

ESG has a farm in agreement with Sapex (SXP). 3 coreholes to be drilled next month. ESG gets 25% upon drilling 3 holes and then another 25% if pilot program occurs. No reserves/resources at the moment just lots of inferred coal (690mt) in the middle of nowhere, gas content unknown, never been tested.

Other

Santos has permits which back onto PEL 238.

TruEnergy is a 5% shareholder.

NSW power sale may have implications for ESG, buyers may need to increase upstream assets.

Recommendation

We recognise that momentum has pushed stock up quite rapidly in a short time, although value still exists should ESG hit certain hurdles, drilling, reserves etc, etc. Newsflow should be quite rapid over next few months with continuous program of drilling, laterals will be drilled at the end of the month.

We recommend a speculative buy for those advisors who understand the risks involved with exploration companies operating in the oil & gas industry.

The key reasons underpinning our recommendation are;

- Strong technical team with proven track record
- Potentially large resource
- Differentiated from CSM producers in Qld
- Good location and proximity to power markets
- Gas theme gaining further traction
- Undervalued based on recent transaction multiples for 3P