StockAnalysis

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By Peter Strachan

Indices & Prices

All Ordinaries	4,436.70
Energy Index	14,581.10
Brent AU$/bbl	87.52
AUS$/US$	0.8330

As at Close June 1st

In this Issue

RUDD DOES CHINA'S BIDDING: Reducing entry price to OZ resource projects

ANIMAL FARM: Government chants slogans!

ECONOMICS 101: Why doesn't Australia have advisors with front line experience?

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ANTARES: Rapid production decline – a caution.

Why the Chinese Government Loves Rudd & Swan

Prime Minister Rudd, along with Treasurer Wayne Swan, have just scored a huge own goal. Introduction of a swingeing new and incremental profits based tax on Australia's mining and resources sector has rendered local mining development projects 40% cheaper for Chinese State Owned Enterprises (SOEs) to purchase! Well done to the Labor Party and its army of acolyte advisors.

StockAnalysis expects that Chinese funds will play a more influential role in development of local natural resources, if the proposed RSPT is passed into law.

A cynical observer might say that Kevin Rudd's efforts to win a seat at the UN Security Council appear to know no limits.

Over the past decade, the Chinese Government has been sending its State owned mining and steel producing enterprises (SOEs) out to places like Africa and Australia in search of secure supplies of raw materials. However, these SOEs are not necessarily in the business to make money as project developers and miners, since their primary goal is to secure long term supply of food and fibre as well as the coal and iron ore needed to support Chinese domestic growth, along with the oil and LNG required to fuel and power this growth.

For example, over the past few years, oil contractors (both independent and national oil companies) have been invited to bid for oil exploration and production concessions offshore Libya. In general, the process for establishing such production sharing contracts (PSC) is that a contractor agrees to pay an entrance fee, which in many jurisdictions, inevitably ends up in a Swiss bank account belonging to a senior government official or officer of the National oil company in question. As an example, Angola's senior National Oil company executives are reported to be amongst the largest beef ranch owners in Brazil, while Indonesia's national oil company mysteriously nearly went broke last decade.

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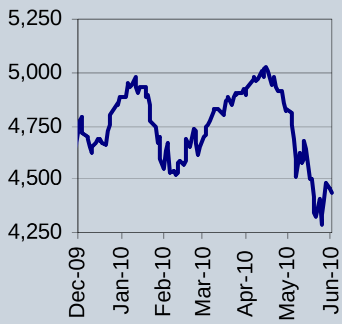
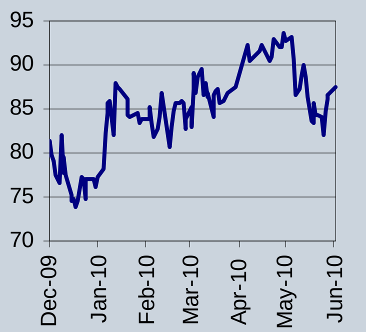
All Ordinaries

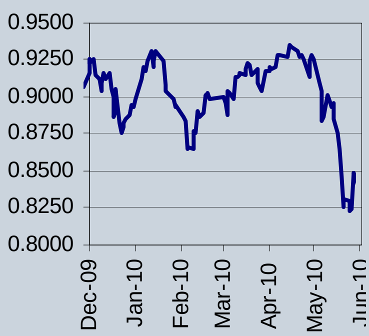


S&P ASX 200 Energy Index

Brent Crude Oil $A/barrel



A$/US$



The contractor then bids for a right to explore and develop petroleum resources. This bid will include a sign-on bonus (see: entrance fee) plus an agreement to spend a specified amount of dollars over a defined timeframe. The contractor then bids fiscal terms, which might include that profit oil is shared 80% or even 90% with the Government, so that the contractor is only entitled to receive 10%-20% of the profit oil. Profit oil is defined as that oil production occurring subsequent to the repayment of the contractor's exploration and development capital outlays from initial operating cash flows. So the contractor gets its risk capital back from initial production cash flow (or a portion of initial production), after which 90% of the oil is given to the Government and the contractor get to keep 10%.

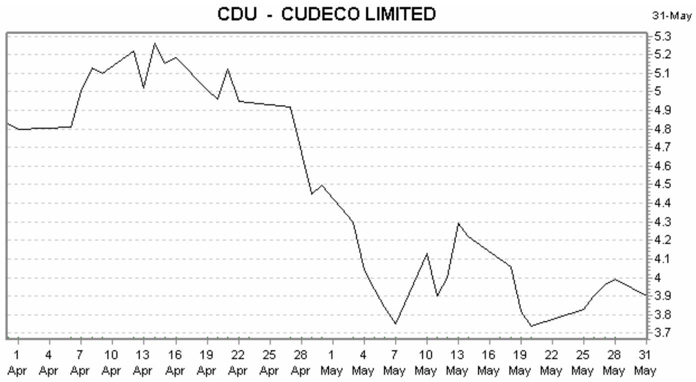
During the early stages of opening up Libyan offshore PSCs, China's National oil companies were reported to be bidding up to 100% of profit oil to the Libyan Government, so long as they had the right to market the oil. So it is clear that China's SOEs are primarily in the business to secure supply and they don't really mind too much if the act of developing and mining is cash flow neutral.

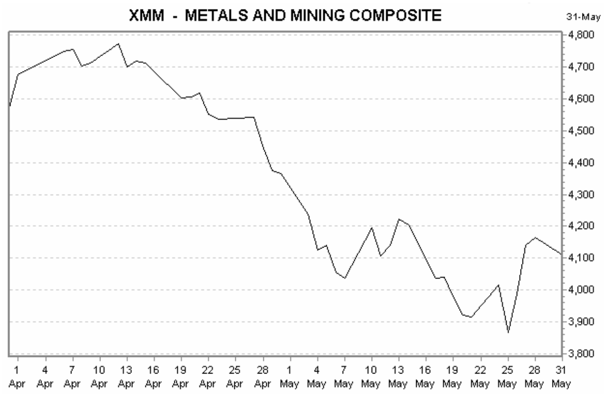
The same sort of thing applies to development and mining of Australian natural resources. The primary motivation for China's SOEs in Australia's mining industry is ensuring long term stable supply of raw materials. Making a profit as a miner is a side and subsidiary issue of less importance to Beijing.

Four Legs Good, Two Legs Bad

Recent commentary from Australia's Prime Minister appears to have come straight off the pages of George Orwell's Animal Farm. Rudd's intonation of ideas would certainly not be out of place in Castro's Cuba, Kim Jong-Il's North Korea or Hugo Chavez's Venezuela. The government has been using convoluted logic, backed up by 1960's class warfare rhetoric, while making personal attacks on anyone within capital markets or the resource industry.

To say that misinformation by Australia's mining industry is damaging the economy and forcing the stock market and the AUD lower is to miss the point that the proposed new tax is not the brainchild of the mining industry but a malformed foetus conceived by the Government. While there has been some impact on local shares as a result of sovereign debt risk in the Mediterranean nations, the main impact on Australia's resource sector has resulted from increased risks associated with a proposed resources, super profit tax (RSPT).





While the large miners such as **BHP** and **Rio Tinto** have experienced huge falls of 18% to 22% since early April, emerging project developers such as **Havilah, Exco, CuDeco, Curnamona Energy, Alkane** and **VMS Resources** have seen falls of up to 30% in response to the threat imposed by the proposed RSPT.

The charts above illustrate, with CDU down over 25% and the Metal & Mining Index down 18% since the RSPT was announced in the first week of April.

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Instead of addressing legitimate concerns held about his proposed RSPT by a large section of Australia's economy, Rudd and his running dogs have been playing the man instead of the ball. That is to say, they are attacking their critics and not the substance of the criticism. Senior mining executives have been called liars or ignorant. Rudd has begun to chant "scare campaign" or "scare tactics", reciting over and over "working families of Australia" and almost going into a trance with his mantra-like intonation of "multinationals", as if that is some sort of pejorative that makes his lack of business nous acceptable. It now appears as though our Prime Minister is indeed morphing into one of the pigs from Animal Farm!

Economics 101

Economists like Ken Henry assume that there are no limits to factor inputs into the resource and mining economy. Factor inputs include debt and equity capital, labour supply, technology and of course ore bodies. When Henry says that raising taxation on mining companies will not lift the price of the commodities they produce, he is making that theoretical assumption, which is not valid in the real world. Capital is rationed to those projects with lowest cost, highest returns and lowest political risk. Ore bodies are finite and at some point, no amount of new capital, increased labour or technology will be sufficient to coax additional supplies out of the earth's crust. Despite a rising price for gold, production peaked in 2001 and is now on a reducing trend, while oil supply is not far behind.

Commodity prices are determined by the interplay of supply and demand. Reduced supply in the face of steady or growing demand will lift prices to encourage more supply to enter the market, thus stabilising price. Of course in theory, raising taxes on its own does not lift cash operating costs of production and should not restrict supply. But in reality, higher taxes lift the cost of both equity and debt as providers of capital seek to offset higher risks associated with a larger government take of total operating cash flow. Capital dries up and fewer projects proceed, so that supply of mineral products falls, leading to higher prices. Dr Henry's high school economics teacher may well have imparted some basic theory to the young Ken, but by the time he reached university, Dr Henry should have gained a better grasp of the dynamics of industry. Perhaps if he had ever had a job in the real world of commerce, he would have learned a lesson that was not readily available from his economic professors.

Deepwater Horizon Implications for ASX Oilies

Oil Production to Fall, Exploration to be more Expensive

As President Obama extends a moratorium on new deepwater exploration permits in US waters, along with planned exploration in Alaska's Chukchi and Beaufort areas, it is certain that these restrictions will flow through to lower oil and gas production from US waters over the coming 6-12 months and beyond. The impact of the Deepwater Horizon oil rig catastrophe will be felt globally, not only in less drilling and lower oil production, but also in higher insurance costs for exploration companies. Increasing drilling costs may price some programmes out of the reach of smaller independents.

In the USA, GoM operators may redeploy financial and intellectual assets to shallow water projects or onshore while deepwater GoM restrictions apply. So far, my sources say that there has been little impact on rig rates and availability onshore, but that could all change if the situation persists for several months.

Certainly, after a brief sojourn below US$70 per barrel, the oil price has bounced to around US$74/bbl while the spot gas price looks solid above US$4/mmBtu.

Real Sovereign Risk

You've got to love those East Timorese. Here is a quote from the Associated Press by their Prime Minister Gusmao:

"I don't believe Woodside company because it is a liar"

"They intend to steal our oil and gas in the Timor Sea as they don't want to bring the pipeline to East Timor."

Oh well, I don't know how Mr Gusmao intends to extract that value for his citizens unless he is willing to at least look at the relative merits of differing development options. I wonder if Gusmao and Dr Ken Henry have been getting economic coaching from the same source.

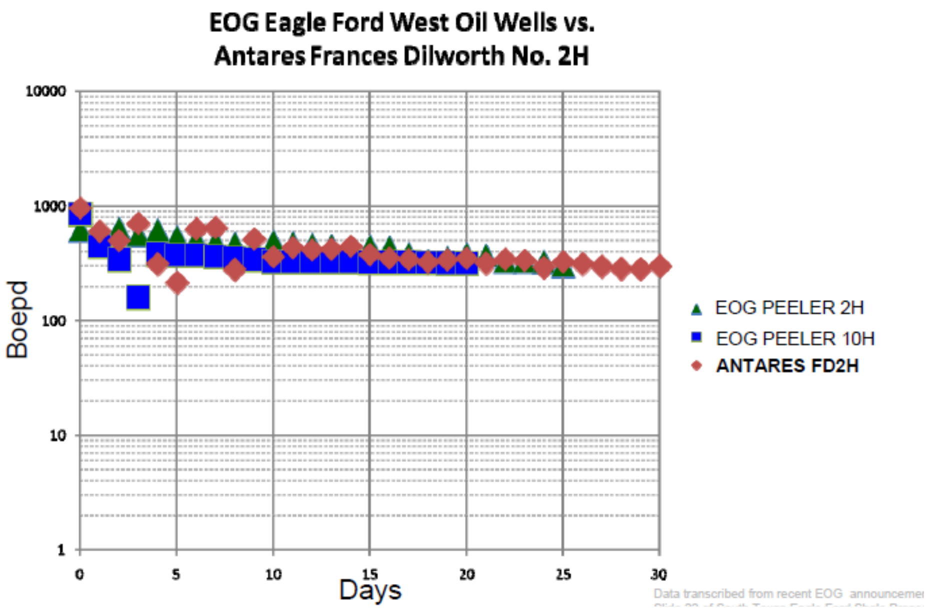
Antares Value Update

A note of Caution

Recommendation: *Antares may face some cautious selling following weak production data at the FD2H well. Longer term StockAnalysis continues to see relative value in AZZ and recommends buying any dips.*

Revelation of production decline rate data from Antares Energy's Frances Dilworth No 2H (FD2H) well last week, places a question mark over the profitability of this type of shale based resource play.

The graph below, used at AZZ's AGM presentation, shows production falling 68% in just 30 days from an initial rate of 940 barrels of oil equivalent per day (BOEPD) to around 300 BOEPD. Modelling by StockAnalysis has assumed a decline rate of 65% over the first 6 months, followed by a further decline of 45% in the subsequent 6 months, which in this case, would have resulted in a flow rate of 181 BOEPD after one year. Actual data indicates that the flow rate after one month is close to where StockAnalysis had expected it to be after 6 months, which means that my initial estimates for value may have been too optimistic.



Source: Antares Energy

The FD2H well flowed at a much higher oil to gas ratio (OGR) than was expected. Pre drilling, an OGR of 200 bbls per mmcuft might have been anticipated, rather than the +800 BOPD achieved. Well completion anticipating a lower OGR may have resulted in the performance seen at FD2H. Development of these shale plays relies on a lot of learning on the job. StockAnalysis suspects that performance of FD3H will be substantially better, but time will tell.

The company now estimates that average petroleum recovery per well will be 350,000 BOE, which would appear to be appropriate at this stage of field development and knowledge of recovery dynamics. Other operators in the region have assessed recovery of between 3 and 7 Bcfe per well. Given the high OGR in AZZ's permit areas, recovery of 350,000 BOE still provides financial incentive, even at US$60/bbl and US$4/mmBtu.

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What is apparent from the daily production chart is that FD2H has declined at a rate which is roughly in line with two of EOG's wells in the region and that the rate of decline appears to have moderated with time, indeed the flow rate appears to have increased slightly over the last two days of the study period.

The performance of different wells in this EFS play will vary greatly depending on the quality of shale intersected and well completion success. Data from **Adelphi's** Kennedy and Weston wells on its Sugarloaf permits shows vastly differing dynamics. Flow rates from the initial Kennedy well appear to have declined by about 70% over its first 60 day's of production, while flow rates from the Weston well only fell by an estimated 17% during that period. The Weston well exhibited almost no decline in flow rate between its averages over the first 30 and 60 days, while the Kennedy well saw a 21% decline in average rates between these two periods.

AZZ's FD2H well was drilled at the boundary of the oil and gas zones along the Eagle Ford Shale trend, so some variability is likely between that well and the three additional wells which are in various stages of drilling, completion and production. Last week Antares' second well, the FD3H, came on with a similar OGR and initial production of 1,207 BOEPD, which is 28% higher than its first production well. Flow dynamics from FD3H are likely to be different from FD2H and StockAnalysis will be keen to observe progress, so that more accurate modelling can be undertaken.

Resource plays, such as Antares' Eagle Ford Shale and Arrow Energy's Queensland coal seam gas plays have proven to be highly capital intensive. Plenty of capital is required to get these plays up to a stage where they can be self funding from operating cash flow. Antares is embarking on a programme to drill 10 wells this year. That campaign will cost AZZ at least US$45 million and will not be supported by operating cash flow until oil production reaches 2,500 BOPD, which is unlikely to be achieved until at least 10 wells have been drilled and completed, so the company will be coming back to the market for more capital during the September quarter, 2010. Given the dynamics of EFS development, some judicious use of additional debt might be appropriate, alongside new equity.

Alternatively, Antares could go and talk to AWE! Adelphi's Target Statement includes an independent valuation for the company of $106.8 million, or about A$45,000 per acre of EFS permits. If AZZ could attract a bidder on those terms, it would be worth about $3.60 per share and it is already valued at $2.55 per share on a look-through value, based on Adelphi's current market price per equity acre of EFS permits. **Selling out of its EFS operation would surely be the quickest and lowest risk approach to creating shareholder value for the company which presently trades at just 64 cents per share.**

2009 Champions – Losing Shine

In December 2008, StockAnalysis recommended a portfolio of stocks for the recovery, which did not arrive until March 2009. Recently this portfolio has taken some serious hits and its performance, while still above the general market, should provide a lesson to investors that it is always worth keeping an eye on value and selling stocks that look fully priced. The portfolio was not meant to be active, so other than taking up the recapitalisation opportunities which flowed, there have been no notional sales.

Company		Value $		Gain	Price $/share		Move
	Code	Purchase	Current	(loss)	Cost	01-Jun-10	%
All Ords	**XAO**				3515	4419	26%
Materials Index	**XMJ**				8668	11518	33%
2009 Champions							
National Australia Bank	NAB	9,988	12,480	2,492	$ 19.32	$ 24.14	25%
Oil Search	OSH	9,996	11,797	1,801	$ 4.72	$ 5.57	18%
Sonic Healthcare	SHL	9,997	7,866	(2,131)	$ 12.90	$ 10.15	-21%
Service Stream	SSM	9,999	3,603	(6,396)	$ 0.68	$ 0.25	-64%
Telstra	TLS	9,996	8,284	(1,712)	$ 3.56	$ 2.95	-17%
Transfield	TSE	9,999	22,967	12,968	$ 1.65	$ 3.79	130%
Transfield 1:1 @ $1.25	TSE	7,575	22,967	15,392	$ 1.25	$ 3.79	203%
United Group	UGL	9,996	18,545	8,549	$ 7.11	$ 13.19	86%
UXC	UXC	9,999	9,622	(377)	$ 0.53	$ 0.51	-4%
UXC	UXC	10,080	12,240	2,160	$ 0.42	$ 0.51	21%
WesFarmers	WES	9,993	17,295	7,302	$ 16.60	$ 28.73	73%
WESFarmers 3:7 @$13.5	WES	3,483	7,412	3,929	$ 13.50	$ 28.73	113%

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NAB shot up to $32, at which time it would have been OK to let some go and Oil Search got to $6.80, but has now been hit by political realities of operating in PNG, plus some poor exploration outcomes. Sonic has fallen from $15.40 highs and has now fallen back to buy territory on the back of a mild profit downgrade. The market always expects bad news to come in threes, so there may be further opportunities to buy as we come up to profit reporting. Service Stream was a speculative option and its fate is closely linked to that of Telstra, while Transfield's $4.70 high was unsustainable and the stock is now being impacted by the RSPT.

Summary	Move %	Annualized %
All Ords	26%	18%
Materials Index	33%	23%
2009 Champions	40%	37%
Out Performance	54%	108%

NB: Begun 17th December 2008

United remains a top performer and solid long term hold, while UXC Ltd is recapitalised and repairing its EBIT line. Wesfarmers is down from $33 and looks like excellent value any time it approached $27 per share.

Top of the Market Buy on Wseakness Recommendations

From late 2009

To remain consistent, StockAnalysis took a view in late 2009, that the market was looking toppy and there were not a lot of standout buys at the prevailing prices. Stocks were selected on the basis that investors would do well to standby for bargain stocks, should they fall.

These companies are listed below, along with their prices in December 2009, current price and comments on outlook. Some stocks have fallen to or below my recommended buy point, while others are still to retreat as expected.

Remarkably, even the resource power houses have capitulated in the face of the RSPT proposal and should it be dismissed by an incoming Liberal government, as looks increasingly likely, buying Resource stocks during the current gloom looks like being a reasonable punt.

Company	ASX Code	Price $/share 02-Dec-09	Price $/share 02-Jun-10	Comment
Industrials				
Adelaide Brighton	ABC	$2.59	$2.72	Fell below $2.40 buy target, bounced off 200 day moving average. Cement & lime, major inputs to construction & mining industries, so consolidating while RSPT is resolved. Cyclical improvement to top line expected in 2011. Gearing reasonable at 32% while interest cover (I/ EBIT) is comfortable @ 7.7 times. Expect EPS of 18 cps & DPS of 13 cts
AGL	AGK	$13.89	$14.09	Moved over $15.50, but back near $13.50 buy support. Longer term target of $18. Premier utility with upstream gas & wind power operations. Low gearing & low risk earnings of 98 cps with dividend of 60 cps. Buy
Mermaid Marine	MRM	$2.88	$2.50	GoM oil spill could cut offshore activity. Stock nearing buy target. Gearing of 35% with interest cover of >5 times, expect earnings to rise 25%, close to 18 cps with 8 cps dividend. Wait for buy target for entry at $2.20
Neptune Marine	NMS	$0.65	$0.24	Suffering from lack of earnings & risk to offshore activity from RSPT & GoM fallout. Runs the risk of tripping on too much debt & poor project delivery. Provides global offshore engineering services to energy & infrastructure sectors. Well placed as oil & gas prices rise to gain traction in Asia & with LNG developments offshore WA. Speculative BUY
PrimeAg	PAG	$1.04	$1.08	Bounced over $1.15 following rains, rising cotton price & arrival of Food & Fibre fund & GPG as new shareholders. Farming assets in SE Queensland and NE NSW. Recent rain over properties sets up great 2010/11 seasons. Cotton price is supportive but grains remain subdued. Diversified cropping with 27% of land irrigable, large leverage to cotton price, plus crops of wheat, corn, sorghum, chickpea & beef. Net cash of ~$12m. And NTA of $1.92/share but downward pressure on farm prices. Possible 7-9 cps in FY '11. Target $1.35: Buy

(Continued on page 7)

Company	ASX Code	Price $/share 02-Dec-09	Price $/share 02-Jun-10	Comment
RCR Tomlinson	RCR	$1.03	$0.85	RSPT taking its toll as new management sets about task of rejuvenation for Perth based, engineering services company, focused on energy & mining sectors, maintenance & fabrication strengths. May take a year to implement improvements. Modest gearing, focused on improving margins, target earnings of 15 cps in FY 10/11 with dividend of 7 cps. Buy for value at $1.50.
Transfield Services	TSE	$3.97	$3.78	$3.60 may have been its low point. Strong AUD/USD is a negative for earnings. Well placed engineering services & asset management company with diverse operations across mining, energy, utilities & infrastructure in NZ, Canada & Australia. EPS of 31 cents with 12 cps dividend, gearing at top level of 41% with comfortable interest cover of 5.8 times. Buy dips
UXC	UXC	$0.77	$0.51	Utilities services & IT consulting business, caught in a downwind as environmental businesses suffer from low REC price . Also expectation of negative earnings surprise as margins weaken. Gearing of 32% with strong interest cover. Speculative buy
Wesfarmers	WES	$29.29	$28.69	Retail competition hotting up for well managed, diversified company. Retail via Coles, Bunnings, Target & Kmart, plus energy via its coal & LPG operations. Exposure to rural & industrial activities. Gearing down to 18%, interest cover at a healthy 5 times. Earnings will recover into 2011 as coal price lifts, rural focus improves with a better season in SE Aust & Coles continues rejuvenation. Lifting earnings from around $1.50 this year toward $2 per share by 2013. Buy dips
Oil & Gas				
AWE	AWE	$2.69	$2.06	Premier oil & gas producer with value target value of +$4/share. Active exploration in Taranaki & Perth Basins plus Indonesia. Tui offset drilling. Self funding from operations with net cash position. BUY
Horizon Oil	HZN	$0.34	$0.28	Stock hit by PNG turmoil & Beibu Gulf development uncertainty. PNG condensate drilling H2 '10. Growth in China & PNG, plus Taranaki & PNG exploration appeal. Value below 40 cents. Debt free and self funding.
Oil Search	OSH	$5.84	$5.56	PNG country risk remains real with recent political assassination attempts, but has underlying value of +$8 per share for LNG & existing oil & gas business. Recent PNG gas discovery. Long term assets with over $1.3bn of net cash. Buy
Woodside Petroleum	WPL	$49.18	$43.42	Standout buy below $43. Major energy company with strong growth path. There is a finite amount of oil & gas on the planet & WPL has a good chunk of it! Box seat for new LNG projects: Buy
Speculative Explorers				
Antares Energy	AZZ	$0.42	$0.64	Texan oil & gas developer. Potential for >$2 per share value. Strong IP from Eagle Ford wells, funding now in place for next 3 wells. Buy any dips
Cooper Energy	COE	$0.50	$0.45	Value underpinned by cash, oil in the ground & exploration upside, setting target price of over 70 cps. Drilling high profile Fuschia in Tunisia holds strong, relatively low risk upside to success. Strong spec BUY
Nexus Energy	NXS	$0.33	$0.27	Undervalued assets, but lacking funding leverage and supporting cash flow. Longtom gas project on ice while mercury removal module installed. Corporate breakthrough needed at Crux to catalyse new growth phase. Stock surrounded by uncertainty on funding with $311 million net debt plus contingent liabilities. Wait as this one could go down to nothing
Miners				
Alkane	ALK	$0.40	$0.30	Emerging NSW gold & rare earth producer, held back by RSPT & funding needs 2010. Value below 56 cps. Great takeover target for Chinese end user, but lacks top-down drive for Tomingley gold, which lacks grade & tonnage. Spec buy
Integra	IGR	$0.29	$0.25	Well run, emerging gold producer with low cost, high grade gold resources in WA & strong exploration appeal for long life, open pit plus underground operations. Production by September to boost shares beyond 40 cps in 2010/11
Mirabela	MBN	$2.61	$2.13	Commissioning issues at long life, low cost Brazilian nickel/copper mine. Need to see steady-state opex. Nickel price has boomed on strong steel industry, buy dips for value of over $4/share.
Western Areas	WSA	$5.34	$4.09	At buy target for bounce to $4.80. One of the world's lowest cost nickel producers, cash cost of <A$2.80/lb (A$6260/t). Huge exploration upside at depth & along strike from existing operations in WA. Hold
BHP Biliton	BHP	$41.11	$38.04	Smacked by RSPT. World's largest mining company, copper, iron ore, coal, base metals, oil & gas, aluminium, diamonds, phosphates. Low gearing earnings rebound into 2011. BUY
Rio Tinto	RIO	$71.13	$67.00	Gap at $72 to fill. Similar story to for BHP. Iron ore, copper, coal, diamonds & aluminium form base of earnings. Spinning off non-core assets to repair balance sheet.

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The author has small holdings in shares of BRU, SRI. Modest holdings in ABC, ADX, ROC, NMS, OEL, OSH, CWP, NXS, UXC, MGR, COF, PAG, SUN, COE, HZN, RCR, TAP, AWE, TLS, PTM, WPL, & GLH and larger holdings in ACE, HAV.