



# Molopo Australia Limited

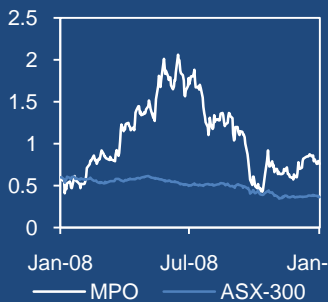
ASX: MPO

**Recommendation**

## Buy

**Volatility**

## High

**Trading Price for the  
22 Jan 2009**
**\$0.69**
**Target Price in 12 Months:**
**\$1.20**
**Price Performance**

**Industry Group:** Energy

**Market Cap:** \$120.87

**Total Issue:** 182.84m

**12m High/Low:** \$2.06/\$0.41

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**Overview**

Molopo Australia Limited (MPO) is an Australian resources company involved in exploration, appraisal, development and production of unconventional gas. The company predominantly focuses on coal seam gas (CSG) with projects in Australia including New South Wales and Queensland, and overseas in the United States, South Africa and China. The qualitative analysis of Molopo highlights its strategy to have a diversified asset portfolio. Downside risks such as uncertainty in reserves and inefficient utilisation of cash have been considered in the company valuation. The company was valued using *reserves multiple* methods. In addition to this, the 12 month target share price also accounts for the possibility that Molopo is acquired by another energy firm.

**Company History**

The company originally started as a diamond explorer in Botswana and a copper explorer in Mongolia in 1986, under the sponsorship of Paringa Mining and Exploration Company Plc and the Southern Prospecting group. In August 1986, Molopo was incorporated in NSW and listed on the ASX. In 2001, the company moved their operations towards the energy sector and changed its industry classification to Diversified Resources Energy. Currently, the company's operations involve upstream non-conventional gas projects with a focus on coal seam gas in Australia and overseas. In January 2009, company market capitalization reached \$126 million. Company shareholding is spread across a large base of shareholders with the largest one being ANZ Nominees Limited (4.83%), followed by National nominees Ltd (3.8%).

Top ten Shareholders	Percentage of ord. share
ANZ Nominees Limited (Cash Income A/c)	4.83%
National Nominees Limited	3.80%
HSBC Custody Nominees (Australia) Limited	3.61%
M F Custodians Ltd	2.77%
Beck Corporation Pty Limited	2.19%
Hochlunch Pty Ltd (Daleham Super Fund A/c)	1.91%
Fadmoor Pty Ltd (John Rubino Superfund)	0.98%
Citicorp Nominees Pty Limited	0.92%
HSBC Custody Nominees (Australia) Limited	0.91%
Equity Trustees Limited (ACF Lowell Resources)	0.85%

Figure 1: Top Ten Molopo shareholders

**The Coal Seam Gas Industry**

CSG is an emerging industry having started in the late 1990s. Since then, the industry has become increasingly competitive due to a large number of companies being attracted to the industry. Players in the industry are generally classified into three

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groups according to their stage in asset development. This includes start-ups, transition firms, and mature firms<sup>1</sup>. Companies in the start-up group are generally those that entered the sector in the early 2000s. Companies classified as transition firms are those with longer operational history, usually having established gas reserves and moving toward production phase. The last group, mature companies, is comprised of large gas players that have grown both in size as well as experience. As at December 2006, the mature group had produced up to 62.8PJ, accounting for nearly 78% of the Australian CSG produced<sup>2</sup>.

Classification	Companies
Start-up Firms	Eastern Gas, Sunshine Gas, Pure Energy, Beach Petroleum, Metgasco, Blue Energy, Bow Energy
Transition Firms	Molopo, CS Energy, Helm, Sentiment and Sydney Gas
Mature Firms	Origin, Santos, Queensland Gas Corporation and AGL

The CSG industry in Australia has shown a trend of consolidation and collaboration between companies in the industry, as well as participation from large global energy firms. Conoco Philips, BG Group, and Royal Dutch Shell have collectively invested approximately \$20 billion in the sector. These global firms see the potential to convert CSG into LNG for exporting, allowing firms to tap into the three-billion dollars strong Asian market<sup>3</sup>. In terms of collaboration, the industry has witnessed a \$7 billion deal between Malaysia Petronas Group and Santos to build a LNG plant in Gladstone, and a deal between Arrow Energy and Shell to build a third LNG plant in Gladstone.

As a result of this trend, market values of companies in this sector have been boosted significantly. A good example of this was Origin's rejection of a \$13 billion takeover bid by BG Group, followed by a deal with Conoco Philips which subsequently put a higher benchmark for the valuation of CSG companies. This trend was expanded in 2008, with junior firms joining in the consolidation game. Examples of this trend included Arrow Energy taking over CH4 Gas Limited and Pure Energy, Queensland Gas Company acquiring Sunshine Gas and Roma Petroleum, and QGC itself being acquired by BG Group. The trend is expected to continue, bringing reducing the number of CSG players to only a few big players<sup>4</sup>.

## Industry position

Molopo is a small firm operating at the transitional phase of CSG development. Its market capital is \$126m and accounts for approximately 0.4% of the total sector capitalisation.

<sup>1</sup> Santos & Coal seam gas company presentation, 21<sup>st</sup> November 2006

<sup>2</sup> State of the Energy Market 2007, Australian Energy Regulator

<sup>3</sup> Coal seam gas comes of gas, Australian Financial Review, 7<sup>th</sup> January 2009

<sup>4</sup> BG to lobby Origin investors, The Australian Business, July 05 2008 <http://www.theaustralian.news.com.au/story/0,25197,23970536-5012439,00.html>



What differentiates Molopo from the rest of CSG peers, is its asset portfolio, which is diversified across different project maturities and locations.

Companies	Market Cap (\$m)	2P Reserves (PJ)	Market Operation Focus
<b>Origin</b>	13258	4751	Australia & New Zealand
<b>Santos</b>	10501	5112	Australia, South East Asia
<b>QGC</b>	5542	2415	Australia
<b>Arrow Energy</b>	1154	2247	China, India and Indonesia
<b>Pure Energy</b>	482	288	Australia
<b>Eastern Star Gas</b>	161	210	Australia
<b>Molopo</b>	126	88	Australia, South Africa, China, Canada, USA
<b>Megasco</b>	118	287	Australia
<b>Sydney gas</b>	117	87	Australia
<b>Planet Gas</b>	66	7	Australia
<b>Blue Energy</b>	57	0	Australia
<b>BOW</b>	44	0	Australia

\* Figure 2: Selected Australian CSG companies  
Sources: Financial Analysis Database & Company reports

As the consolidation trend continues, there is possibility that Molopo will be taken over by one of the large energy firm. In that case, Molopo share price is likely to increase. Recent merger activities in the industry have shown more than 50% increase in share value of target firms after the announcement of a takeover. Therefore, we discuss below factors that could foster and hinder this possibility, as input for establishing possibility parameter for company valuation in the later part of this report.

Junior CSG companies	2P Reserves (PJ)	Production (bcf/a)
<b>BOW</b>	0	0
<b>Blue Energy</b>	0	0
<b>Planet Gas</b>	7	0
<b>Molopo</b>	88.20	297.90
<b>Eastern Star Gas</b>	210	0
<b>Metgasco</b>	287	127

\* Figure 3: Junior CSG companies

There are three key factors that make the takeover scenarios possible: (1) Molopo has built up a substantial amount of reserves in Australia and has infrastructure ready to move toward CSG production (figure 3), (2) Queensland assets are close to Gladstone where LNG is manufactured and exported, and (3) Molopo's fragmented ownership structure (figure 1).



However, the company may be less attractive to the acquirer due to its diversified portfolio with significant overseas exposure with 43% of 2P reserves located overseas. At the moment though, the companies looking to acquire seem to be more interested in strengthening their resource base in Australia. This could explain why firms without international exposure such as Sydney Gas and Pure Energy got into the consolidation earlier. Beside that, other reasons include the small size of the firm and uncertainty associated with project development.

Accordingly, we believe Molopo is an attractive business to other businesses looking to expand, but the takeover scenario is less likely, especially in the next short period of time.

### Company Strategy

Molopo has been following the strategy of building up a diversified petroleum portfolio, focusing on large scale proving up and commercializing of unconventional gas resources. The company has 10 projects that are located in five different countries, at various stages of development.

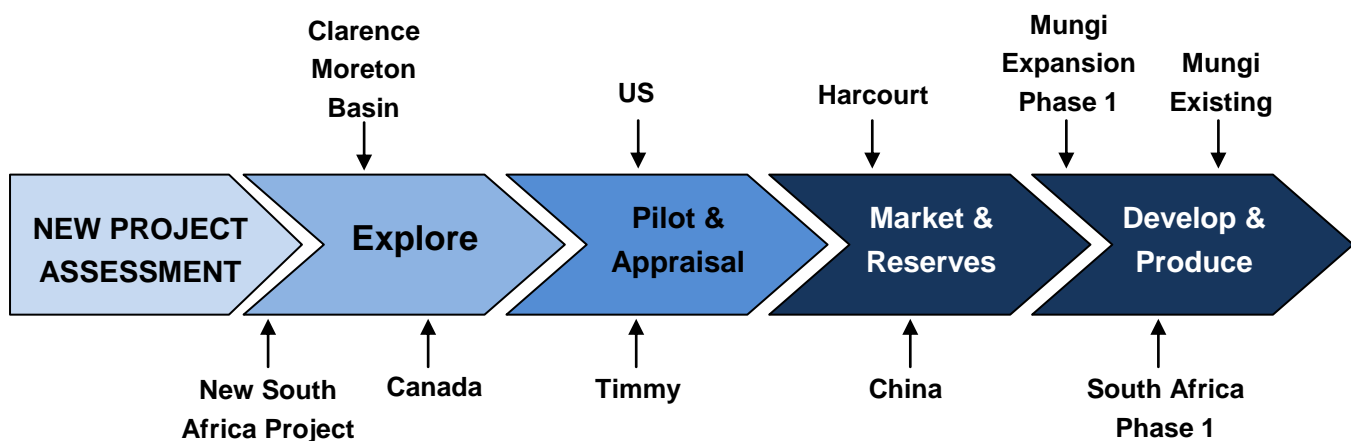


Figure 5: Molopo's projects and stages of development

This diversity of assets has come under criticism from the market. As a small-cap firm, Molopo's diversified asset portfolio is perceived by the market that it may lack the organizational and financial capability to nurture all of these assets, especially in the current financial and credit crisis. Therefore, the company strategy has been adjusted to adapt to the current situation. Their key initiatives include:

***"The company strategy has been adjusted with key initiatives in order to adapt to the current situation"***

- cashing out and boosting cash reserves;
- reducing capital expenditure while maintaining very substantial upside on core projects; and
- being insulated from the uncertainty surrounding access to equity share markets

More specifically, the company will focus its resources on projects in which it has a 50% or greater stake holding as well as operational control . These are projects that have target



gas resources of over 1000PJ. Four core projects identified are Mungi and Harcourt in Queensland, Virginia in South Africa, and Quebec in Canada. Non-core projects include Timmy, QLD, Lilyvale/Oak Park, QLD, Clarence Moreton Basin, NSW, Liulin, China and Mason County, West Virginia.

## Key Assets – Highlight and Updates

### Mungi & Harcourt in Queensland (50% Interest)

These two projects have a high ranking in the company portfolio due to their ease of access to existing pipeline infrastructures (i.e. Wallumbilla-Gladstone and Dawson Valley) and the reserve capacity to support both local demand usage and exportation. A recent potential reserve upgrade represents five times increase with target development of 2P to 1400 bscf. In addition, an initiative trial to use multi-lateral wells in Mungi field with the completion of the first well – Mungi 22, has resulted in a production rate higher than previous methods.

### Virginia in South Africa (100% Interest)

Virginia has recorded a strong and stable production flow rate at 1.05 mmscf/d. A Memorandum of Understanding (MOU) for potential gas supply in South Africa in LNG form has been signed. Molopo is currently seeking a BEE (Black Economic Empowerment) partner in South Africa. The effect, we believe, is beneficial to the firm in terms of image enhancement and country risk reduction as it proves the company commitment to local investments

### Quebec in Canada (100% Interest)

This project is currently in exploration phase but presents a potential long term legacy asset as the acreage is situated with pipeline infrastructure and high priced gas price markets. The prospective reserves of the project are 5-6 Tscf of recoverable gas. More pilots are planned to be conducted in 2010 and early development is expected to be in 2012

Current certified reserves (bscf) of Molopo	1P	2P	3P	Total Recovery
Queensland	11	48	231	959
South Africa	0	36	112	742
Canada	0	0	0	0
China (non-core)	0	0	6	132
<b>Total</b>	<b>11</b>	<b>84</b>	<b>349</b>	<b>1833</b>

Figure 6: Molopo's current certified reserves

## Company Management & Personnel

The board of directors has extensive experience in both commerce and technical field. Their commercial strengths mostly lie in corporate advisory, banking, finance and



*“The addition of in-house expertise is a great plus to the company in terms of better control over work programs”*

management. In the technical aspect, three directors have had long established core exploration and geological team with approximately 90 years of experiences. As the company moved from exploration-based portfolio to a strong production-based portfolio, it is worth noting that the company took on a new technical team originally from the core of BHP Billiton’s Coal-Bed Methane team in the year 2007. The new team of eight technical personnel have a combined experience of over 300 years in geology development, petroleum engineering, drilling, operations, and mining. We believe that the addition of in-house expertise is a great plus to the company in terms of its better control over work programs. Specifically, it means less dependency on subcontractors, improved control for project timelines, and better work coordination.

## Company Growth Drivers

*“Company’s growth is driven by industry demand as well as its ability to develop more proved reserve”*

The company’s growth is driven by industry demand as well as its ability to prove up more reserves and increase production. Firstly, the CSG industry looks forward to a continuing increase in demand both in Australia and overseas. Domestically, governments have certain incentives to boost gas-fired energy. For example, Queensland energy policy requires fifteen percent of electricity sold in Queensland to be sourced from domestic gas-fired generation<sup>5</sup>. In overseas markets, gas demand remains strong due to high oil prices and increasing world electricity demand. Also, the increasing demand for LNG has led to a sharp increase in CSG demand as a feedstock to LNG. This increase in demand subsequently pushes up gas price domestically and internationally. We see Molopo as being capable of capturing this growth opportunity because the company, unlike most other gas companies, has positioned itself in short-term gas sales contracts.

Secondly, company growth is underpinned by the growth in the proved reserves that are commercially viable. As at the end of 2008, the company had reserves of 3990 bscf, of which 1833 bscf was recoverable. This represented a sixteen fold increase in the booked reserves and contingent resources over the previous 18 months. Molopo is planning to spend around \$100 millions on the four core projects over the next 2-3 years. This represents a huge increase in investment when compared to the \$18m budgets for exploration, evaluation and development cost during the last two years. The investment plan to upgrade reserve is highly possible thanks to the recent sale of their assets in Gloucester Basin.

## Company Risks

### Mungi Project

Molopo, like many other CSG companies, encounters the risks associated with reserves estimates and assurance on the amount of recoverable reserves. More specifically, the risks highlights in the deployment of “sole-risk” new lateral drilling technology at the Mungi site. Due to the low level of coal seam permeability in Mungi area, traditional vertical wells

<sup>5</sup> Queensland’s petroleum – Exploration and development potential  
[www.dme.qld.gov.au/zone\\_files/Petroleum\\_and\\_Gas\\_PDFs/q\\_petroleum\\_2008\\_3.pdf](http://www.dme.qld.gov.au/zone_files/Petroleum_and_Gas_PDFs/q_petroleum_2008_3.pdf)



do not result satisfactory production rate. The performance of new lateral drilling wells, therefore, is critical to the success of the projects. Given the higher investment cost compared to the traditional wells, the flow rate associated with these new wells is critical to decide whether it is commercially viable to extract the target reserves. In addition, Molopo own 100% of this project and therefore bears the full cost of the investment. Poor outcomes would likely hurt the company's financial health and future reserves development.

### Other Project Risks

Other general project risks for Molopo include being exposed to risks associated with operating in foreign countries such as in Virginia projects (South Africa) and Quebec project (Canada), where the firm has 100% ownership. This risk may be minimized if Molopo establishes Joint Ventures with the local firms. In addition, the company is exposed to the risk of ineffective utilization of the available cash on hand as the result significant cash inflow from the sale of Gloucester Basin project.

### Valuation

We have valued Molopo using three approaches. The first approach uses sum of parts approach between cash per share and gas reserves per share with the latter being valued using *reserve multiple analyses*. The second approach also uses the sum of parts approach between cash per share and gas reserves per share, but the price of gas reserves per share this time is calculated using *transactional acquisition multiple*. Third, we value the company based on the probability of Molopo being taken over by larger gas companies.

#### Method 1: Cash per share + Enterprise Value/2P reserves

<b>Cash Ended 30<sup>th</sup> September</b>	<b>\$ 15,670,000.00</b>
<b>Less Estimated Cash Flow for the Fourth Quarter</b>	<b>\$ 8,117,000.00</b>
<b>Less Projected Cash Expenditure for January</b>	<b>\$ 2,705,666.67</b>
<b>Add Sale of Gloucester in Cash</b>	<b>\$ 111,000,000.00</b>
<b>Equal Projected Cash on Hand as at 22<sup>nd</sup> January</b>	<b>\$ 115,847,333.33</b>
<b>Shares Outstanding</b>	<b>182,841,145</b>
<b>Cash per Share</b>	<b>\$ 0.63</b>

ASX Code	Company Name	Enterprise Value	1P	2P	3P	EV/2P
AOE	Arrow Energy Limited	\$1,611,000	427	2247	5084	\$717
ESG	Eastern Star Gas Limited	\$360,000	53	210	2835	\$1,714
MEL	Metgasco Limited	\$46,000	0	287	1538	\$160



<b>MPO</b>	Molopo Australia Limited	\$112,000	11.06	88.2	366.45	\$1,270
<b>ORG</b>	Origin Energy Limited	\$16,576,000	1375	4751	10138	\$3,489
<b>PES</b>	Pure Energy Resources Ltd	\$467,000	0	288	0	\$1,622
<b>SGL</b>	Sydney Gas Ltd	\$162,000	62	87	111	\$1,859
<b>STO</b>	Santos Limited	\$10,501,000	2821	5112	15093	\$2,054
<b>QGC</b>	Queensland Gas	\$4,840,000	609	2415	7163	\$2,004
<b>Average Multiple</b>						\$1,654
<b>Implied share value</b>						\$0.95

Target price (sum of parts) under EV/Reserves Multiple approach: \$0.95 + 0.63 = \$1.58.

As the cash per share is so close to the current share price at \$0.70, we see Molopo has significant upside potential. Subtracting from the cash per share, the market currently values the reserves at \$0.07 per share, while the reserves multiple analysis value the reserves at \$0.95 per share.

### Method 2: Cash per share + Reserves under acquisition multiple

<b>Cash Ended 30<sup>th</sup> September</b>	<b>\$ 15,670,000.00</b>
<b>Less Estimated Cash Flow for the Fourth Quarter</b>	<b>\$ 8,117,000.00</b>
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Reserves Category	Origin	Arrow	QGC	Santos	Sunshine	Molopo - Gloucester	Average
<b>2P (\$/GJ)</b>	2.99	2.71	2.05	4.91	1.77	2.07	2.75
<b>3P (\$/GJ)</b>	1.41	0.77	0.78	1.65	0.76	0.98	1.06

\*Multiple is calculated as the value of acquisition deal divided for number of GJ reserves

\*Source: MPO AGM Presentation

Molopo Reserves	Net Value PJ	Implied Asset Value	Implied Reserves/Share
<b>2P</b>	88.2	\$243	\$1.33
<b>3P</b>	366.45	\$388	\$2.12

Target price/ sum of parts: \$1.33 + \$0.63 = \$1.96.



As the price is based on acquisition scheme, the price is 24% increase over the previous target price at \$1.58. This increase represents the premium paid by the acquisition party.

### Method 3: Consideration of takeover potentiality and share price impacts

While we believe the inherent value of Molopo is \$1.58 as shown in approach 1, Molopo market price maybe different in the next 12 months if Molopo is targeted for a takeover.

According to our discussion above, the takeover scenario is less likely to happen in the next 12 months and perhaps quantified at 40% chance. *If Molopo is to be taken over*, the takeover announcement is believed to drive the share close to the company true value as \$1.58. Towards the end of the deal, we believe Molopo will be valued as the transaction price of \$1.96 per share. However, *if Molopo is not to be taken over*, the current share price of \$0.70 implies that the market is currently undervaluing Molopo. It is perhaps explained by low market confidence in this current financial crisis. In addition, the market might not recognize Molopo's full value for the international portfolio. While we believe the market will react to change Molopo value; it does take time to adjust the price accordingly. We conservatively set the price at the extreme end at \$.70.

Scenarios	Share price	Probability
MPO is taken over	\$1.96	40%
MPO is NOT taken over	\$0.70	60%
Target price		\$1.20

\* Prices are based on a 12 month merger and acquisition targets

Weighting up the aforementioned possibility of Molopo being taken over, the target price for the next 12 month period is calculated as \$1.20 which is 24% downgrade from our true value and 71% upside compared to the current share price.

### Target Price

Overall, we find the significant upside for Molopo in all of the above valuations. Our inherent value for Molopo stays at \$1.58 and the share price forecasted in the next 12 months is \$1.20, reflecting the market sentiment toward the takeover potentiality. We recommended a *strong buy* on the security at the current market prices.



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SUBJECT COMPANIES: MPO.AX, Molopo Australia Limited

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