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Liquefied Natural Gas Ltd (LNG)

Risks evident but options to consider

Recommendation

Spec Buy

Price

$0.51

Target (12 months)

$1.54

AOE and LNG have extended their HoA until 30 June and made it non-exclusive. This follows the Shell & PetroChina proposal to acquire AOE. The extension allows LNG to seek alternative gas supply and funding options. However, upside also exists if AOE rejects the bid and proceeds as planned or Shell & PetroChina commit to Fisherman's Landing. It's risky, but Spec Buy maintained.

Expected Return

Capital growth	**201%**
Dividend yield	**0%**
Total expected return	**201%**

Company Data & Ratios

Enterprise value	**$72.5m**
Market cap	**$108.5m**
Issued capital	**212.7m**
Free float	**100%**
12 month price range	**$0.45 - $1.95**
GICS sector	**Energy**

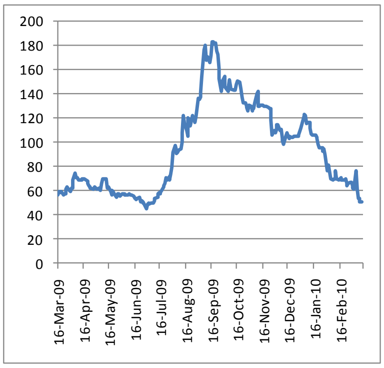
Shell/PetroChina appear to be major party poopers

Shell/PetroChina's proposal to acquire Arrow Energy's (AOE) Australian assets is likely to see the Fisherman's Landing (FL) development canned or delayed. We agree with the market that a mid-scale LNG project at FL is unlikely to fit with Shell's large scale LNG plans for Curtis Island, which would be a major setback for LNG's agreements to develop FL with AOE.

All is not lost however

LNG's price has fallen 74% from a high of $1.95 in September 2009, and its Enterprise Value has fallen to $72m as the company holds $36m in cash. Although the path to commercialising its mid-scale LNG concept is less clear, we recommend a Spec Buy. The market has understandably taken fright, but it may have pushed the share price too low. What if AOE cannot reach an agreement with Shell/PetroChina and proceeds with FL? Or what if FL goes ahead because Shell/PetroChina actually likes the mid-scale LNG concept? Such an endorsement would be hugely positive. Lastly, if FL does not proceed as planned, alternative gas suppliers and funding options may be found, which would take time but it would have value.

Absolute Price



SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Earnings Forecast

Year end 30 June	2009A	2010F	2011F	2012F
NPAT (reported) (A$m)	-20.4	53.7	5.0	14.3
NPAT (adjusted) (A$m)	-14.3	53.7	5.0	14.3
EPS (adjusted) (cps)	-7.8	26.4	2.4	6.8
EPS growth (%)	n/a	n/a	-0.9	1.9
PER (x)	n/a	1.9	21.3	7.5
P/CFPS (x)	n/a	2.3	5.6	14.7
EV/EBITDA (x)	n/a	-0.7	n/a	14.7
Dividend (¢ps)	0.0	0.0	0.0	0.0
Yield (%)	n/a	n/a	n/a	n/a
ROE (%)	-76%	56%	3%	8%

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

LNG project hooked but not landed

LNG may need to start again at Fisherman's Landing

With the prospect of AOE being taken over it is quite likely that LNG will need to find new gas supply arrangements and partners to fund the development of FL. This would be a very disappointing and frustrating setback for the company, as it has worked hard to get AOE committed to the project. This commenced as a gas supply agreement and a 20% option for AOE to participate in the FL LNG plant, progressing to AOE taking 100% ownership of LNG Trains 1 & 2 plus equity in an "Infrastructure Co". The latest agreement between LNG and AOE proposed that the entire project comes under AOE's ownership, with technology fees and royalties payable to LNG.

A "fresh start" could be less time consuming than perceived by the market

If AOE or its new owners do not proceed with the proposal to acquire FL, it is almost back to "square one" for LNG. However, it should be noted that LNG has progressed the project on a number of fronts, making a "fresh start" less time consuming than possibly perceived by the market. These include:

- A license agreement with the Gladstone Ports Corporation (GPC) for 25ha of reclaimed land at Fisherman's Landing for 20 years plus options to extend.
- Commencement of early site works, with a focus on ground improvement. (work has been halted to assess the implications of the proposal from Shell/PetroChina, but can be quickly re-started)
- Agreement with GPC regarding the required dredging so LNG ships can reach Jetty #5 and a "swing basin".
- The appointment of key engineering consultants to assist with construction and project execution, including SK Engineering and Construction (SKEC) providing a performance guarantee on the company's proprietary OSMR® LNG process, plus Laing O'Rourke (LOR) and Chicago Bridge & Iron (CBI).
- All regulatory approvals are essentially in place, including the EIS and for the LNG tank design.
- A pipeline license to transport the gas from the Surat basin to Gladstone has been granted, although this right resides with AOE.

New gas supply and funding needs to be secured

The two fundamental items that would be missing if the AOE agreement falls over is gas supply and funding.

LNG has held discussions with possible gas suppliers

To put new gas supply arrangements in place will take some time, but we think a range of options are available to LNG. The company has held discussions with all the possible gas suppliers in Queensland for some time, just in case the deal with AOE fell through for whatever reason. We envisage two types of gas supply:

- Utilising ramp-up gas from the large LNG developers on Curtis Island, who will have a problem with the gradual build-up of gas deliverability prior to the LNG plants being completed. The company could probably buy such ramp-up gas at a discounted price but only for relatively short term periods of 6-18 months and the quantities would be "lumpy" in character. However, as there are as many as four different large scale proposals for Curtis Island, LNG could create a portfolio of gas supply from some or all of the parties, which would cover all the gas requirements for the first couple of years, and some of the needs for the next few years, as expansions are brought on–line.
- In parallel with the "existing" LNG developments, there are a range of up-and-

coming CSG producers, who will be very keen to lock in longer term gas supply with prices tied to LNG. This list of companies is lengthening but obvious candidates include Bow Energy (BOW), Blue Energy (BUL), Icon Energy (ICN), Comet Ridge (COI), Molopo (MPO), Victoria Petroleum (VPE) etc.

A possible portfolio of gas supply agreements could look something like the following table, showing ramp-up gas from BG in the first instance, while Shell and APLNG could also contribute to FL. The table also assumes that FL gets underway in 2014, not in late 2012 as currently planned. A second Train could come on-stream in 2016.

Figure 1 - Hypothetical gas supply aggregation for Fisherman's Landing

PJ	2014	2015	2016	2017	2018	2019
BG	90		60			
APLNG				100		
GLNG						
Shell		90	120		100	
Other				80	80	180
Fisherman's Landing requirements	90	90	180	180	180	180

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

We have excluded GLNG as a supplier partly because they are short of gas, and also to demonstrate that a mid-scale LNG project at FL doesn't need all the large developers to be part of a supply matrix. The 1.5mtpa Trains for FL require 90PJpa compared to the larger Trains on Curtis Island requiring 200-240PJpa. The need for other gas supply may not be required until 2017, providing ample time for the smaller companies to build their capacity to deliver. As an example, BOW has recently upgraded its 3P reserves to more than 2,300PJ, which is enough for 25 years of supply for one LNG Train at FL.

Funding becomes another challenge

We can only envisage a go-ahead if a financially stronger "big brother" assists

The MD of LNG, Mr Maurice Brand has stated in the media that if FL does not proceed as currently envisaged, that the company will push ahead on its own. However, with $36m of cash on the balance sheet, we can only envisage a go-ahead if a financially stronger "big brother" assists the development.

The FL LNG plant has been costed at US$600-700m (A$670-780m). Upstream costs have been estimated at A$900m by AOE, while the transmission pipeline has a capex of about A$550m.

There are a number of parties potentially interested in the development of FL with LNG. We discuss a few:

- Toyota Tsusho would presumably be interested in supporting the project, as they have a HoA to buy 1.5mtpa from the first LNG Train. We also note that in December 2009, Toyota Tsusho paid $98.5m for 15% of CSG license ATP651 operated by BG. The most recently stated net reserves were 40PJ of 2P and 121PJ of 3P reserves. The transaction values in $/GJ are therefore $2.46 for 2P and $0.81/GJ for 3P. These are quite high values, particularly compared to the proposed AOE transaction at $0.88/GJ for 2P and $0.56 for 3P and the fact that it's a minority stake. The point we are making is that Toyota Tsusho is prepared to put serious dollars into CSG-to-LNG, and could well become a more important partner with LNG.
- Golar LNG is the other party originally involved through a 40% equity stake in the FL project, and as the shipper of the product. The HoA with Golar has expired, but with Golar as a shareholder in LNG, they would seek to enhance the value of their investment, and the current situation may get them directly

involved in the project again.

- Sojitz of Japan has shown interest in CSG-to-LNG, notably through a JV proposal with Sunshine Gas, which was acquired by QGC/BG. We understand the company still has the rights to the remaining land at Fisherman's Landing, and an enlarged LNG development based on the combined sites would be value enhancing for both parties.
- Other Asian LNG buyers such as PTT of Thailand, which was an underbidder for the LNG offtake agreement at FL and is actively seeking new sources of LNG, with mid-scale projects of particular interest.
- Korea Gas (KOGAS) is one of the world's largest LNG buyers, and has demonstrated its positive interest in CSG by taking a $12.5m placement in BUL in mid-2009. BUL has not booked any reserves as yet, but is hoping to do so during 2010.
- BP has reportedly set up an office in Brisbane to review opportunities in CSG-to-LNG and would be watching the current situation with interest. BP is not big in LNG compared to most oil majors, and they may see the Australian CSG-to-LNG industry as an opportunity to get bigger.

These are just some of the parties possibly interested in joining LNG in a development at FL. Most of them have very strong balance sheets, which is exactly what LNG needs. There would be many other interested corporations, and it's hard to predict who/how/when any developments could take place, but the discussion above should demonstrate that good potential exists for a "big brother" to join LNG in its pursuit of FL LNG in the case of AOE not proceeding.

Valuation for LNG

The valuation is based on the most concrete proposal that we have

The SCEQ valuation is $1.54, which is down from $1.58 to reflect lower cash of $36m, compared to $48m at 31 December 2009. At this point, we have not changed our project valuation for FL. We acknowledge that the project may not proceed according to the plans made by AOE and LNG, but until a different development plan or schedule is made public, the analysis is based on the most concrete proposal that we have. We would also make the point that our valuation has discounted the expected income streams at a high 15% discount rate, reflecting the relatively high risk. If we risked the project at 50% our valuation would be $0.76, still 49% above the last closing price.

Figure 2 - LNG Valuation (based on AOE agreement)

Valuation (payments discounted @ 15%)		A$m	$/sh
Fisherman's Landing royalties	0.8%	219	1.00
Fees/milestone payments		70	0.32
Other LNG prospects		10	0.05
GasLink Global		5	0.02
Refund Dev costs		45	0.20
Corporate costs	$5m pa	-47	-0.22
Cash/(Net debt)		36	0.16
Total		**338**	**1.54**
Current share price:			$0.51
Difference in %			201%

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Summary and Recommendation

Our LNG note on the 18th February 2010 acknowledged the risk that AOE could become the subject of a takeover prior to FID, and that this could impact development plans at Fisherman's Landing and LNG.

The future has become less clear for the project and the company

This risk has come to the fore, and the future has become less clear for the project and for the company.

While the risk of FL not proceeding according to plan has risen, we believe that the market has pushed LNG's share price too low. The market capitalisation of $108m leads to an EV of $72m after the company's cash position of $36m is deducted. This is too low in our opinion, as the company has a project almost ready to go, and the project may in fact proceed, if Shell/PetroChina cannot reach an agreement with AOE, or if Shell/PetroChina decide to develop FL in a similar fashion. The option to seek new gas suppliers and new funding partners would take longer, but has some value.

We maintain a Spec Buy on LNG, with a price target of $1.54/share. This valuation assumes that FL proceeds according to the AOE plan. Other development options would lead to different valuations, and we again highlight the risks of investing in a speculative stock like LNG.

Liquefied Natural Gas Ltd

as at 16 March 2010

Recommendation	Spec Buy
Price	$0.51
Target (12 months)	$1.54

Table 1 - Financial summary

LNG Ltd (LNG)			Share price:	$0.51
As at 16/03/2010	Recommendation:	Spec Buy	Market cap:	$112m

Valuation Data									
Year end June 30	**2008A**	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**	**2016F**
Adjusted NPAT	-4.7	-14.3	53.7	5.0	14.3	28.1	25.3	81.4	43.5
Adjusted EPS	-2.8c	-7.8c	26.4c	2.4c	6.8c	13.3c	12.0c	38.6c	20.7c
EPS growth	n/a	n/a	n/a	-91%	186%	96%	-10%	222%	-47%
P/E ratio	n/a	n/a	1.9	21.3	7.5	3.8	4.3	1.3	2.5
OpCFPS (excl. abnormals)	-3.5c	-8.0c	22.5c	9.2c	3.5c	13.2c	12.6c	40.2c	20.2c
Price/OpCFPS	n/a	n/a	2.3	5.6	14.7	3.9	4.1	1.3	2.5
DPS (A$)	0.0c	0.0c	0.0c	0.0c	0.0c	0.0c	0.0c	0.0c	0.0c
Yield	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
EV/EBITDA	n/a	n/a	-0.7x	n/a	14.7x	-3.9x	-6.2x	-2.2x	-6.5x

Profitability Ratios									
Year end June 30	**2008A**	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**	**2016F**
EBITDA/sales	n/a	n/a	94%	n/a	59%	83%	79%	94%	87%
EBIT/sales	n/a	n/a	94%	n/a	59%	83%	79%	94%	87%
Return on assets (avg.)	-29%	-68%	51%	3%	7%	13%	10%	27%	12%
Return on equity (avg.)	-31%	-76%	56%	3%	8%	13%	11%	28%	12%
Dividend cover	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Tax take	43%	-4%	28%	253%	47%	37%	41%	33%	41%

Liquidity & Leverage									
Year end June 30	**2008A**	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**	**2016F**
Net debt (cash)	-$9m	-$13m	-$165m	-$183m	-$190m	-$217m	-$242m	-$326m	-$367m
Net debt/equity	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Interest cover	n/a	n/a	n/a	n/a	n/a	13920x	10860x	51578x	20428x

Assumptions									
Year end June 30	**2008A**	**2009A**	**2010F**	**2011F**	**2012F**	**2013F**	**2014F**	**2015F**	**2016F**
LNG Train 1 (mtpa)	0.0	0.0	0.0	0.0	0.0	0.7	1.5	1.5	1.5
LNG Train 2 (mtpa)	0.0	0.0	0.0	0.0	0.0	0.0	0.7	1.6	1.6
Total LNG output (mtpa)	0.0	0.0	0.0	0.0	0.0	0.7	2.1	3.1	3.1
Royalty (%)	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%	0.8%
Royalty ($m)	0.0	0.0	0.0	0.0	0.0	7.4	25.6	40.6	44.2
LNG price (US$/mmbtu)						9.13	9.30	9.53	9.77
Oil price equivalent (US$/bbl)						80.00	81.51	83.56	85.66

Valuation (payments discounted @ 15%)		A$m	$/sh	Value in 12 months	A$m	$/sh
Fisherman's Landing royalties	0.8%	219	1.00		252	1.15
Fees/milestone payments		70	0.32		70	0.32
Other LNG prospects		10	0.05		10	0.05
GasLink Global		5	0.02		5	0.02
Refund Dev costs		45	0.20		0	0.00
Corporate costs	$5m pa	-47	-0.22		-47	-0.22
Cash/(Net debt)		36	0.16		93	0.42
Total		**338**	**1.54**		**383**	**1.74**
Current share price:			$0.51			$0.51
Difference in %			201%			241%

Valuation sensitivities	A$m	$/sh	12 month sensitivities:	A$m	$/sh
Base case	338	1.54		383	1.74
Royalty at 0.7%	-27	-0.12		-30	-0.14
Royalty at 0.9%	27	0.12		30	0.14
Discount rate 12.5%	69	0.31		69	0.31
Oil price US$10 higher	78	0.35		84	0.38

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Recommendation structure

Spec Buy: Expect >30% total return on a 12 month view but carries significantly higher risk than its sector

Buy: Expect >15% total return on a 12 month view

Accumulate: Expect total return between 0% and +15% on a 12 month view

Reduce: Expect -15% and 0% total return on a 12 month view

Sell: Expect <-15% total return on a 12 month view

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