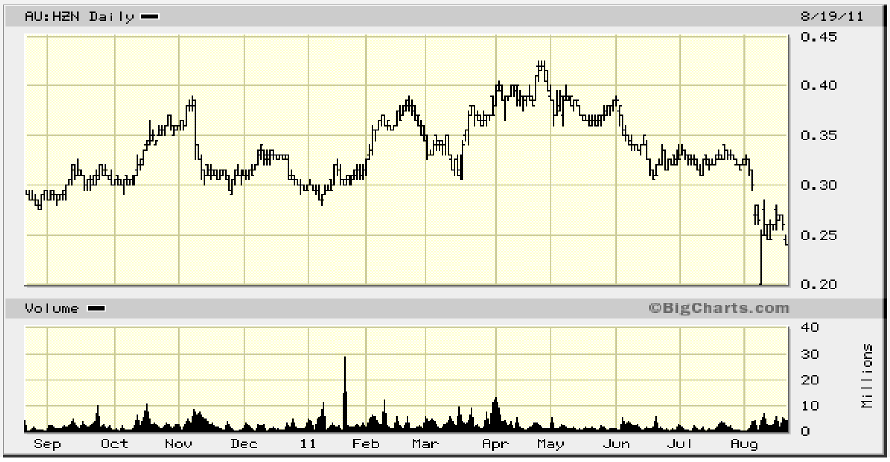
Horizon Oil (HZN) – Hold around $0.24

An established oil producer with a key stake in the Maari field offshore New Zealand. The company has an aggressive but low-risk growth strategy aimed at commercialising its existing reserves in China and PNG.

Corporate Details

Status*:* Established Producer
Size: Small Cap
Commodity Exposure: Oil & Gas
Share Price: $0.24
12-month Range: 20c – 42.5c
Shares: 1,131m, Options: 54m
Top 20: 56%
Net Cash: -$24m
Market Value: $271m

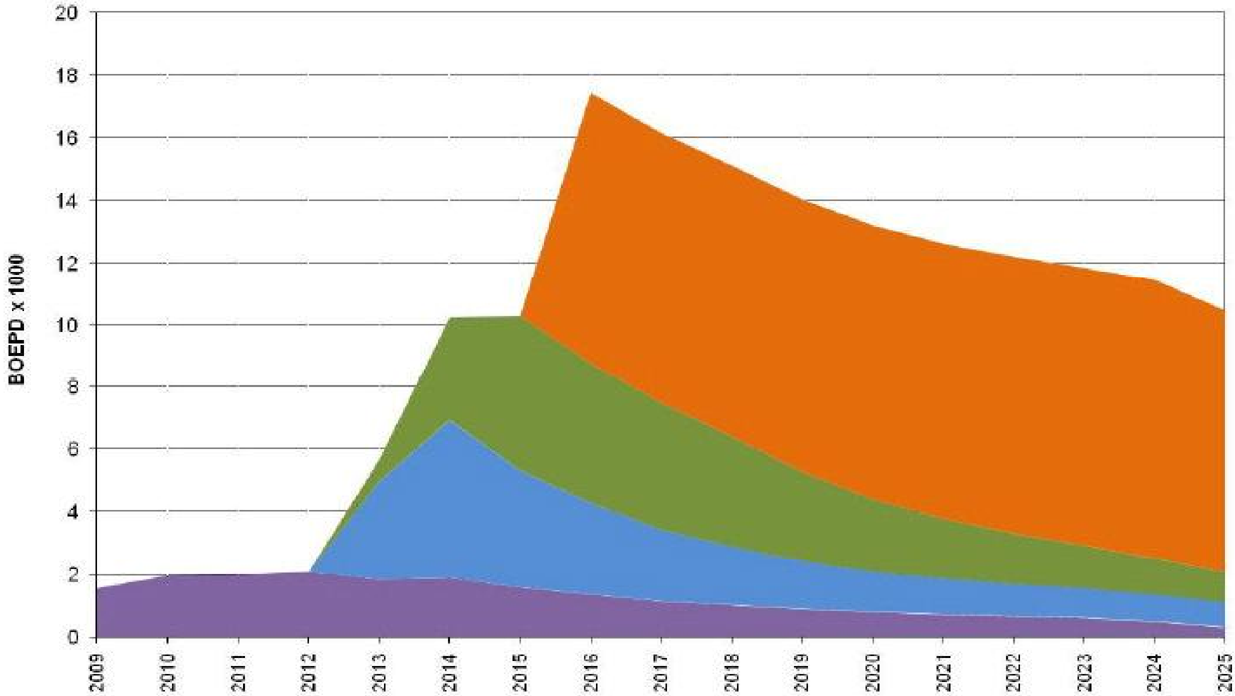


	Rating (✓out of 5)
Management Quality	✓✓✓✓✓
Financial Security	✓✓✓✓
Project Quality	✓✓✓✓✓
Exploration / Resource Potential	✓✓✓✓✓
Project Risk	✓✓✓✓

Our preferred emerging oil producer, Horizon Oil, recently announced its June quarter production report, which revealed a solid quarter, particularly on the project development front. On the oil production front however there was some near-term output weakness related to reliability issues. Let's begin by examining the strong progress made by the company from a medium to longer-term development perspective

Firstly, Horizon has boosted its stake in China's offshore Block 22/12 through the purchase of ASX-listed Petsec Energy's stake, lifting its stake from 14.7% to 26.95%. The deal, which also includes a 12.25% interest in the WZ6-12/12-18 oil development, is priced at $A38 million plus options with a three-year term and exercise price of 37 cents each over 15 million Horizon shares.

The deal is a sound one from my perspective for several reasons. Firstly, it gives HZN greater exposure to a developing project that it already understands well by way of existing participation. Secondly, Horizon has acquired the Petsec stake at a price that appears to be materially accretive to Horizon's net asset value. Finally, the larger project stake should be well received by investors due to its material size and the experience and capability of the operator. As a sanctioned project, much of the technical risk has already been removed. The impact of the enhanced production exposure is reflected in the schedule below.



[1]Reduced to allow for CNOOC participation at 51%
[2]Reduced to allow for PNG State Nominee participation at 22.5%

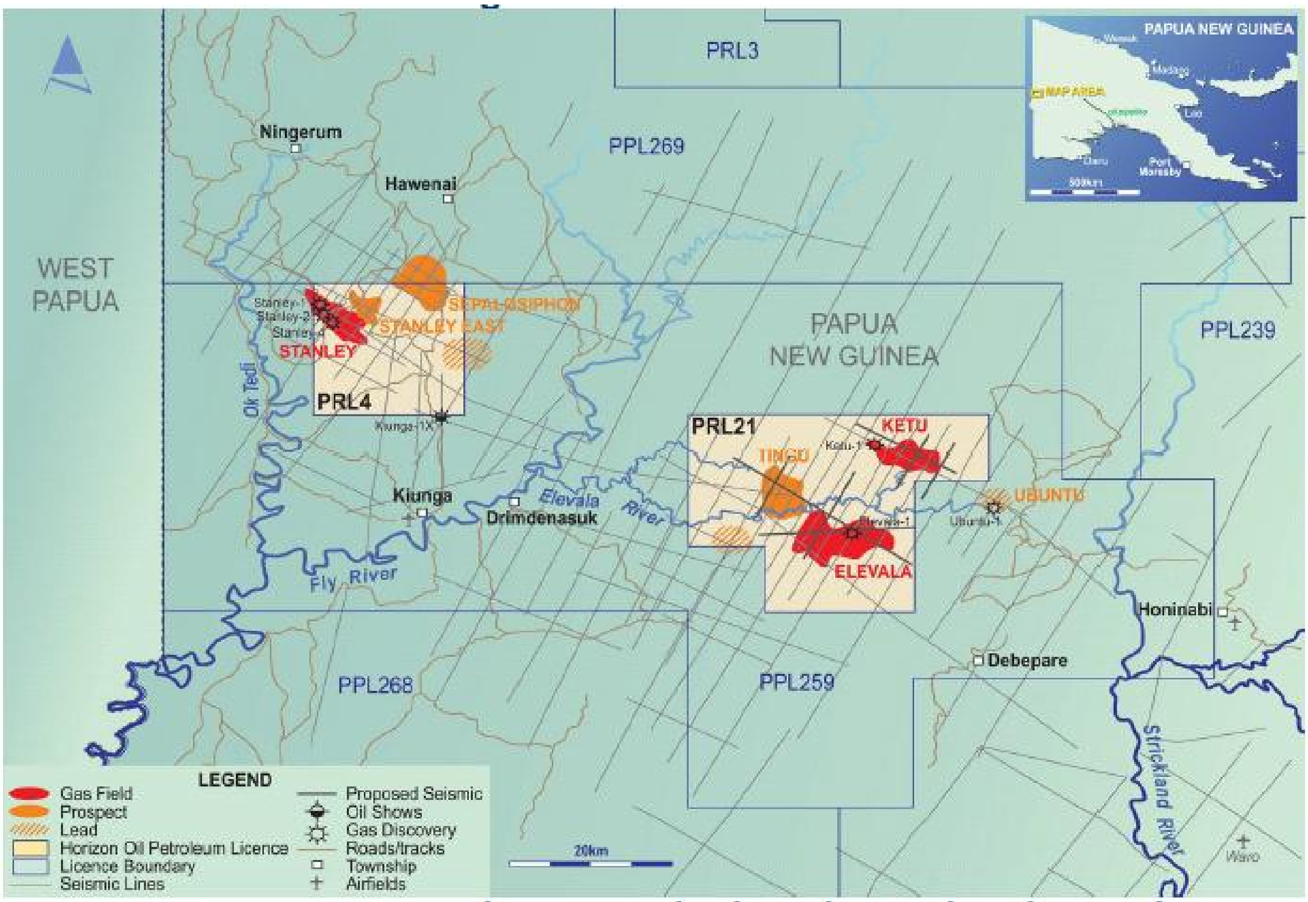
Following Final Investment Decision on the US$300 million Phase I of the project in February 2011, China National Offshore Oil Corporation (CNOOC) as project operator has begun development work. Contracts have been let for design, procurement and construction of the three platforms required for Phase I, which means that more than one third of the estimated project cost of US$300 million is now subject to fixed price contract.

First oil production is scheduled for late 2012. During 2012 and 2013, 11 development wells will be drilled, with the potential to drill three to four exploration wells targeting potential reserves of 20-40M bbls.

With certified gross proven and probable reserves for the WZ6-12 and WZ12-8 West fields to be developed in Phase I of 24 million barrels of oil (mmbo) and Phase II reserves in the WZ12-8 East accumulation (currently the subject of a feasibility study) estimated by Horizon Oil to be 18 mmbo, this acquisition increases Horizon Oil's net reserves in Block 22/12 from 6.2 mmbo to 11.3 mmbo.

In Papua New Guinea, Horizon has also acquired Elevala Energy's 10% stake in PRL 21, boosting its stake in the onshore PNG permit to 45%. The company is planning to drill the Elevala-2 and Ketu-2 wells in the permit after Talisman Energy completes drilling of the Stanley-4 and Sepalosiphon wells. The joint venture will also shortly be embarking on a seismic program over the Elevala and Ketu structures to further define drilling locations.

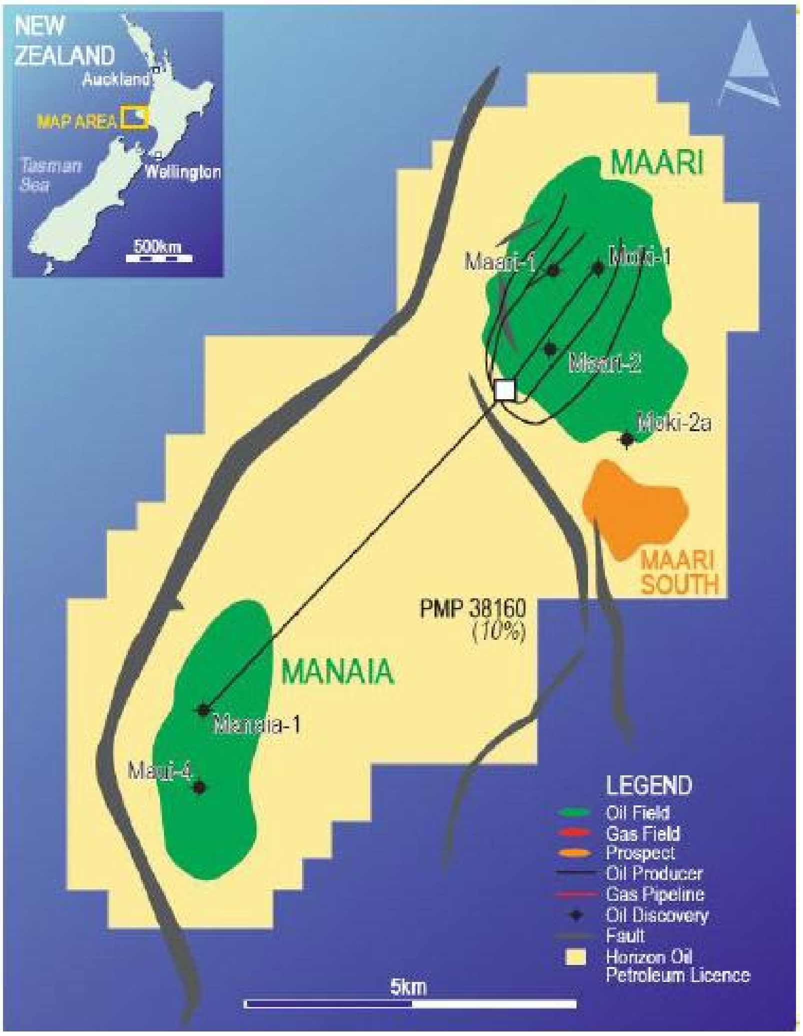
Turing our attention now to the company's production performance during the June quarter, Horizon's working interest share from its 10% stake in the Maari field, offshore New Zealand was 120,089 barrels of oil. Crude oil sales were 128,807 barrels at an average price of US$122.27 per barrel and cumulative oil production from the field through to 21 July 2011 was 14.8 million barrels.



As has been reported previously, production was hampered by frequent failures of electrical submersible pumps (ESPs) and scaling observed in the pumps and well completion components. Production was also curtailed for a planned maintenance shut-down of the facilities, completed during the period from 20th to 25th June.

The field operator is working to address both the ESP failure and the scaling issues and good progress is being made. An acid treatment has been designed to remove scale without causing formation damage, whilst a procedure has been instigated to remove existing scale and prevent further scaling by way of a regular maintenance program that does not require work-over. This should result in less damage to the ESPs. In addition the operator has engaged with the pump supplier to improve ESP performance and maximise run-time. Currently eight of nine available production wells are producing at 17,000 bopd.

Planning for further development of the shallower M2A reservoir (MR9 well) at Maari and the Mangahewa reservoir (MN1 well) at Manaia is continuing. Reservoir studies indicate additional reserves can be obtained with further producing and water-injection wells. Additionally, an assessment is being made of the other hydrocarbon accumulations at Maari and Manaia as well as close-in and deeper prospects, with the objective of designing an appraisal/development drilling.



With respect to the funding for both the recent China and PNG expansion deals, Horizon has undertaken a US$80 million convertible bond issue into the Hong Kong and European convertible bond markets.

The five-year Convertible Bonds will be issued with an initial conversion price of US$0.52, equivalent to A$0.49 based on exchange rates at the time of pricing. The Convertible Bonds will carry a coupon of 5.5% per annum.

If the prevailing share price converted to US Dollars at the prevailing exchange rate (Average Market Price) is less than the conversion price on a reset date in June 2013, 2014 and/or 2015, then the conversion price will be adjusted to the Average Market Price (subject to a floor of 80% of the initial conversion price).

Reflecting the impact of the convertible bond issue, the recent production issues and Horizon's increased equity stake in the Beibu Gulf project, I have revised down near-term earnings forecasts for 2011 and 2012 by 5% and 9% respectively (due to the bond issue dilution), but raised my 2013 earnings forecast by 30% (due to the increased Beibu equity stake). Accordingly, for 2011 I estimate EPS of 2c, for 2012 EPS of 3c, and for 2013 EPS of 6c.

Horizon Oil is an established oil producer with strong growth potential. It maintains a specific exploration and development focus on South East Asia, where there is currently strong and growing demand for oil and gas, a mature operating environment and limited competition from larger competitors. The company's drilling program currently revolves around appraisal and development work, rather than wildcat exploration.

The company has also been able to utilize its existing production and cashflow to expand its exposure to relatively low-risk projects in which it's already involved and has a solid understanding. Unlike other stocks in the sector, which have a much greater exploration exposure, Horizon presents a much lower-risk opportunity. Horizon is a rare type of emerging oil play that actually allows you to sleep at night!

I maintain a Hold recommendation on HZN.

Disclaimer: Gavin Wendt, who is a Financial Services Representative of Summit Equities Ltd ACN 097 771 634, and is a director of Mine Life Pty Ltd ACN 140 028 799, compiled this document. In preparing the general advice of this report, no account was taken of the investment objectives, financial situation and particular needs of any particular person. Before making an investment decision on the basis of the advice in this report, investors and prospective investors need to consider, with or without the assistance of a securities adviser, whether the advice is appropriate in light of the particular investment needs, objectives and financial circumstances of the investor or the prospective investor. Although the information contained in this publication has been obtained from sources considered and believed to be both reliable and accurate, no responsibility is accepted for any opinion expressed or for any error or omission in that information.

MineLife Portfolio: Please refer to our Portfolio page for a full listing of all our stocks held, including initial entry prices and purchase dates.