

2 February 2010

Produced and issued by: RBS Morgans Limited

Horizon Oil

A pretty good quarter

Buy

Important: The above recommendation has been made on a 12 month view and may not suit your investment needs or timeframe. The basis it is prepared on is summarised on the last page of this report. **PLEASE CONTACT YOUR ADVISER TO DISCUSS THIS GENERAL RECOMMENDATION BEFORE ACTING ON IT.**

High Volatility

Target price
A\$0.45 (from A\$0.48)

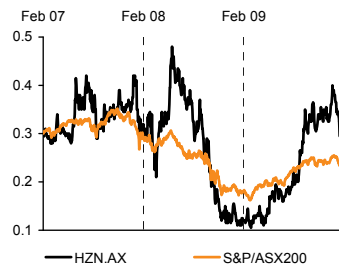
Price
A\$0.315

Short term (0-60 days)
n/a

HZN100202

Price performance

	(1M)	(3M)	(12M)
Price (A\$)	0.37	0.31	0.12
Absolute (%)	-13.7	3.3	173.9
Rel market (%)	-7.1	6.0	114.4
Rel sector (%)	-5.7	7.4	98.9



Market capitalisation
A\$348.94m (US\$307.99m)

Average (12M) daily turnover
A\$1.07m (US\$0.92m)

Sector: BBG AP Oil & Gas
Part of: ASX/S&P 300
RIC: HZN.AX, HZN AU
Priced A\$0.31 at close 2 Feb 2010.
Source: Bloomberg

Analyst

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Drilling and completion of wells and demobilisation of the drill rig interrupted production from Maari (HZN 10%). The value of Maari/Manaia is confirmed by cash flow. We retain our Buy recommendation on HZN, with upside potential from offshore China and PNG gas.

Key forecasts

	FY08A	FY09A	FY10F	FY11F	FY12F
EBITDA (US\$m)	-16.1	2.42	56.5 &	72 &	90.9
Reported net profit (US\$m)	-16.2	-2.04	33.4 &	42.3 &	54.8
Normalised net profit (US\$m) ¹	-16.2	-2.04	33.4 &	42.3 &	54.8
Normalised EPS (US\$) ¹	0.02	0	0.03	0.04	0.05
Normalised EPS growth (%)	680.5	-91.1	n/a	26.6	29.7
Dividend per share (US\$)	0	0	0	0	0
Dividend yield (%)	0	0	0	0	0
Normalised PE (x)	n/m	n/m	9.22	7.29	5.62
EV/EBITDA (x)	n/m	151.4	5.9	3.99	2.31
Price/net oper. CF (x)	-80.2	98	6.19 &	5 &	3.97 &
ROIC (%)	-35.9	-1.09	23.5	30.9	41

Use of & indicates that the line item has changed by at least 5%.

year to Jun, fully diluted

1. Pre non-recurring items and post preference dividends

Accounting standard: IFRS

Source: Company data, RBS Morgans forecasts

Offshore NZ – Maari, Manaia (HZN 10%) and exploration (HZN 30%)

Production from the Maari Well Head Platform was disrupted with the completion and tie-in of Manaia MN#1 to access the Manaia structure and the MR#9 well into the M2A sands at Maari, and the demobilisation of the Ensco 107 rig – all one-off events. The MR#1 well was worked over, and MR#3 and 5 were shut in for remedial work, with MR#1 back on line during the December quarter. Attributable production for the December quarter was down to 180,703bbl (from 222,598bbl). The field was shut in for 20 days in January, with planned inspection and maintenance of the FPSO vessel, and installation work on the WHP for the work-over rig. The MR#3 well is back on line, but replacement of the MR#5 well pump will await commissioning of the work-over rig. In the adjacent PEP51313, a 3D seismic survey will be acquired over up-dip prospects in 2010/11, with drilling scheduled for late 2011.

Stanley and Elevala/Ketu, and the Talisman deal (HZN 50%)

After its deal with Talisman Energy, HZN holds a 50% interest in both Stanley and Elevala/Ketu in PNG. The mean resource potential for Stanley is estimated at 261bcf of gas and 8mmbbl of condensate, and for Elevala/Ketu, 480bcf and 25mmbbl of condensate. Horizon will operate a proposed liquids-stripping operation at Stanley, producing 4,000bpd of condensate commencing 2011. Talisman is undertaking a five-year gas commercialisation project incorporating these assets into its broader position in the PNG foreland.

China and the balance sheet

Approval of the plan for development of the Beibu Gulf Block 22/12 (HZN reducing from 30% to 14.7%, with CNOOC moving to 51%) is anticipated in 1QCY10, followed by Chinese Government approvals and financial investment decision. With the completion of the Maari/Manaia field development, cash flow is expected to fund the equity components of the Beibu and Stanley developments. Our valuation of A\$0.45ps, down from A\$0.48, is a function of the cumulative effect of minor adjustments to operating costs. Buy.

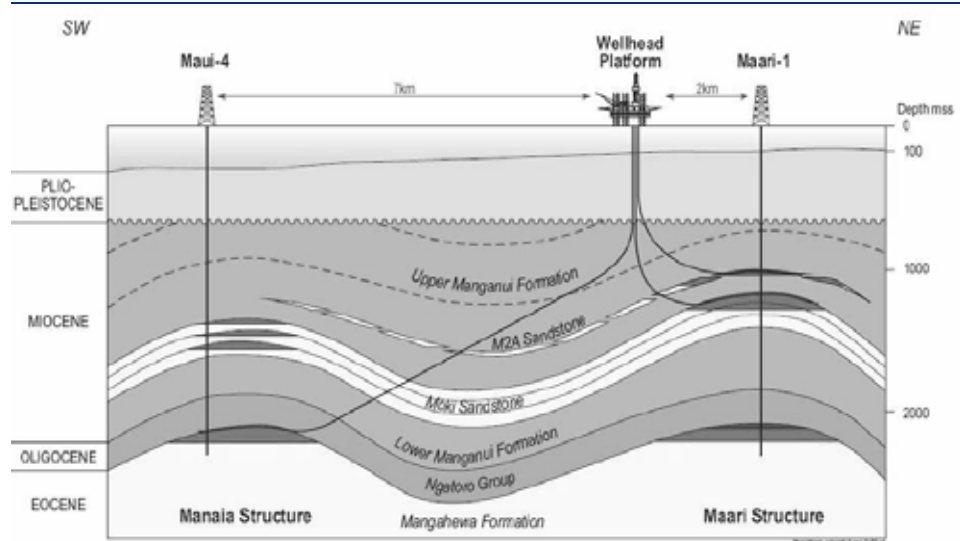
Company overview

Horizon has a 10% interest in the Maari oil field, offshore New Zealand, with 2P reserves of 61mmbbl of oil and a projected plateau rate of 35,000bopd from five production wells. There is upside potential with production from the M2A sand on the Maari structure, and from the Manaia structure, 10km to the southwest, with one well completed for production. Horizon also has a 30% interest in PEP51313, south of Maari. In the Beibu Gulf, offshore China, Horizon has a 30% interest in the 12-8-West oil field, with combined net recoverable reserves of 8mmbbl of oil. The China National Offshore Oil Corporation (CNOOC) has the right to take a 51% interest, with HZN's interest expected to reduce to 14.7%. CNOOC has now agreed the integration of the development with CNOOC's Wei 12-1 platform and infrastructure, and 16-inch pipeline. The third area of focus is PNG, where HZN has a 50% interest in the Stanley wet gas reserves, and a 50% interest in Elevala and Ketu, in the PNG foreland with Talisman Energy, an integrated international energy company. It is monetising what were stranded assets, with an intention to produce condensate and re-inject the gas from 2011, and developing a local gas market. Talisman will undertake a five-year review of the commercialisation of its extensive gas assets in the PNG foreland, with Stanley and Elevala/Ketu the key resources for Talisman in this region.

December-quarter production, development and exploration

Production commenced from the Maari platform (HZN 10%) in February 2009, and has achieved a peak production rate of 40,000bopd from the five production wells and three water-injection wells accessing the Moki sand. In the December-quarter 2009, Horizon's attributable production was 180,703bbl of oil (September-quarter 2009 222,598bbl). The production cost, including amortisation, was US\$4.25m (US\$5.38m), a cost of about US\$23.50, marginally below the previous US\$24.20, and generating a strong operating profit margin.

Figure 1 : The Maari Platform Offshore NZ – Moki, M2A and Mangahewa



Source: Horizon Oil

As shown on the section above, a well was drilled from the Maari platform into the M2A sand that overlies the Moki sand on the Maari structure, and the well was completed for production and tied in to the platform during the December quarter. Also, during the September quarter a well was drilled to the Manaia structure. Subsequent to the end of the September quarter the well was completed in the Mangahewa horizon on the Manaia structure. The drilling of these wells resulted in considerable disruption to production, as did the demobilisation of the Ensco 107 jack-up rig used to drill the development and water-injection wells.

As well as these one-off events, MR#1, #3, and #5 were shut in for remedial work. MR#1 was brought back on line during the December quarter, and #3 in January 2010. MR#5 remains shut in awaiting the repair of the down-hole pump, which will be completed once the work-over rig is commissioned. These problems generated an average daily production rate marginally below 20,000bopd for the December quarter, compared with the designed plateau rate of 35,000bopd, and the achieved peak of 40,000bopd. We have incorporated this lower production rate into our 2009/10 forecasts.

We had previously modelled production at 35,000bopd for the balance of the year, however since the end of the December quarter, production was shut in from 8 January to 28 January for a planned inspection and maintenance work on the FPSO vessel, Raroa, and for installation of the work-over drill rig unit on the Well Head Platform. As previously noted, MR#5 will remain shut in until the work-over unit is operational. We have reduced our expectation of production to an attributable 1mmbbl of oil for the full year. This is not oil or income foregone, but it is delayed. With the tie-in of the M2A well, MR#9, and the Manaia MN#1 well scheduled for tie-in in the June quarter, we anticipate production will be maintained at the budgeted 35,000bopd subsequently.

Offshore New Zealand upside

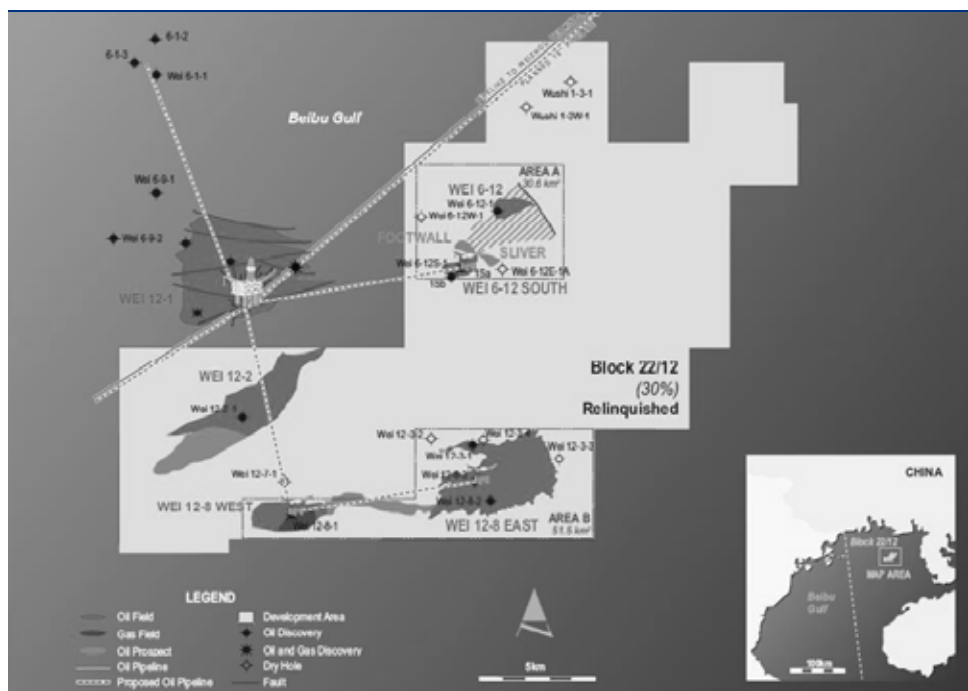
Horizon has a 10% interest in the Maari and Manaia oil fields, within PMP 38160, and in PEP 38413. Current drilling techniques are such that it is not possible to turn the drill string to access the Moki sands on the Manaia structure from the Maari platform. In the longer term it is anticipated that a separate drilling program will access both the Mangahewa and the Moki sand at Manaia, with the flow lines tied in to the Maari platform. The section above also shows a gas cap on an oil leg in the Mangahewa at Maari. Longer term it is expected that this will also add to reserves accessible from the Maari platform.

On the exploration front, Horizon has a 30% interest in PEP 51313, south of, and up-dip from the Maari and Manaia structures. With these structures filled to spill point at a number of stratigraphic horizons, structurally higher traps in PEP 51313 have high prospectivity. Existing seismic data is being reprocessed, and a new 3D data will be acquired in the June-quarter 2010. The Pike, Te Whatu and Matariki prospects will be assessed, and a number of other leads evaluated for upgrading.

Beibu Gulf development

CNOOC retains an option to take a 51% stake in Beibu Gulf Block 22/12, which would reduce HZN's interest from the current 30% to 14.7%. At the current level of interest, the best estimate of contingent resources net to Horizon (at 30%) is 3.9mmboboe. CNOOC has now approved integration of the Wei 6-12, 6-12S and 12-8 oil fields with its existing infrastructure, and negotiations with CNOOC are in the final stages, with most commercial terms agreed. Completion of the economic section of the overall development plan is anticipated in the March-quarter 2010, followed by formal Chinese Government approval and the financial investment decision.

Figure 2 : Beibu Gulf



Source: Horizon Oil Ltd

The development envisages two remote well-head platforms and a processing platform. This will be linked by bridge to CNOOC's Wei12-1A platform, and will use its gas processing and water-injection facilities. A second development phase is planned for 12-8E and 12-3.

The PNG Basin foreland

Horizon now holds a 50% interest in both Stanley and Elevala/Ketu in PNG, after the sale of part of its interests to Talisman Energy Inc, such that Talisman now holds the other 50% in both assets. Horizon received US\$30m in September 2009, and a further US\$30m in staged payments to be drawn down against capital expenditure in the licences. A balance of US\$28.5m remained to be drawn down at 31 December 2009.

The mean resource potential for Stanley is estimated at 261bcf of gas and 8mmbbl of condensate, and for Elevala/Ketu, 480bcf and 25mmbbl of condensate. Under the agreement Horizon will operate a proposed liquids-stripping operation at Stanley producing 4,000bpd of condensate commencing 2011, with Talisman undertaking a five-year gas commercialisation project incorporating these assets into its broader tenement position in the PNG foreland. Our valuation of the PNG assets is based on the price paid by Talisman to acquire its 50% interest in the projects, plus the undrawn capital commitment.

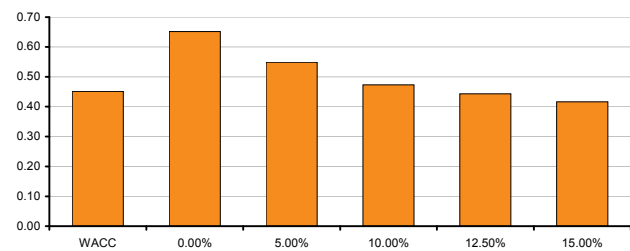
Valuation and risks

Our valuation has declined from A\$0.48/HZN share to A\$0.45 largely as a function of the cumulative effect of minor changes in the cost structures of all the projects. Despite the temporary shut-ins of production in the December 2009 and March 2010 quarters, we assess the Maari value at A\$0.19/HZN share. We assign a value of A\$0.05ps to the Manaia development. We have also reviewed and revalued the Beibu Gulf project, which remains A\$0.08ps, with the anticipated FID now in mid 2010. With the acquisition of matching interests in its PNG acreage by Talisman Energy, we value HZN's tenements on a comparable trade sale basis at A\$0.11ps. There is substantial upside potential should the oil price trend to the oil futures curve, rather than our estimates, and from other exploration offshore New Zealand. Downside risk lies with a weak oil price and a substantially stronger AUD/USD exchange rate, and from cost increases at the proposed Beibu gulf and PNG developments.

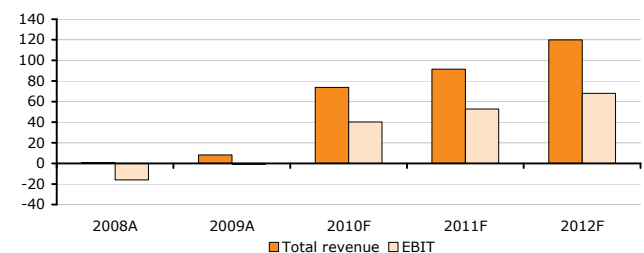
HZN – financial summary

	AIFRS 2008A	AIFRS 2009A	AIFRS 2010F	AIFRS 2011F	AIFRS 2012F	Price target (A\$)	0.45
Income statement						Valuation (A\$)	\$ 0.45
Divisional sales	0.1	8.2	73.7	91.5	119.9		
Total revenue	0.9	8.2	73.7	91.5	120.0		
EBITDA	-16.1	2.4	56.5	72.0	90.9	Valuation summary	A\$m A\$ps DCF valuation inputs
Depreciation & amortisation	0.0	-3.4	-16.4	-19.3	-22.8	Maari Oilfield Reserves	211.0 0.19 Rf 5.25%
EBIT	-16.1	-1.0	40.1	52.7	68.0	Maari Project Resources	55.1 0.05 Rm-Rf 6.00%
Net interest expense	-0.1	-2.2	-3.0	-3.0	0.5	Beibu Gulf 6-12 & 12-8	95.1 0.08 Beta 164.51%
Pre-tax profit	-16.2	-3.5	37.1	49.7	68.5	Stanley/Elevala	122.2 0.11 CAPM (Rf+Be) 15.12%
Income tax expense	0.0	1.5	-3.7	-7.5	-13.7	Net cash, Corporate & Other	24.7 0.02 Tax rate (t) 30.00%
After-tax profit	-16.2	-2.0	33.4	42.3	54.8	Total valuation	508.0 0.45 WACC 11.60%
Minority interests	0.0	0.0	0.0	0.0	0.0	Shares (m)	1,126
NPAT	-16.2	-2.0	33.4	42.3	54.8	Production (Mt)	2009A 2010F 2011F 2012F
Significant items	0.0	0.0	0.0	0.0	0.0	Oil (mmbbl)	0.05 1.02 1.21 1.65
NPAT post abnormalities	-16.2	-2.0	33.4	42.3	54.8	Gas (PJ)	0.00 0.00 0.00 0.00
						Cash Cost (A\$/bbl)	16.03 8.33 8.20 10.02
Growth ratios	2008A	2009A	2010F	2011F	2012F	Total Cost (A\$/bbl)	23.33 24.33 24.20 23.88
Sales growth	-40%	10095%	803%	24%	31%	Key assumptions	2009A 2010F 2011F 2012F
Operating cost growth	#NAME?	-65%	199%	13%	50%	USD / AUD exchange rate	0.90 0.75 0.77 0.72
						Oil Price (US\$/bbl)	96.82 69.81 72.00 75.75
						Gas Price (US\$/GJ)	8.46 6.03 5.13 6.25
Cash flow statement	2008A	2009A	2010F	2011F	2012F	Per share data	2009A 2010F 2011F 2012F
EBITDA	-16.1	2.4	56.5	72.0	90.9	No. shares	1125.6 1125.6 1125.6 1125.6
Cash flow from ops (1)	-2.7	3.1	49.8	61.6	77.7	EPS (cps)	-0.2 3.0 3.8 4.9
Capex (2)	-44.1	-44.1	-44.1	-44.1	-44.1	EPS (normalised) (c)	-0.2 3.0 3.8 4.9
Disposals/(acquisitions)	0.0	0.0	0.0	0.0	0.0	Dividend per share (c)	0.0 0.0 0.0 0.0
Cash flow from invest (3)	-44.1	-44.1	-44.1	-44.1	-44.1	Dividend payout ratio (%)	0.0 0.0 0.0 0.0
Incr/(decr) in equity	17.9	25.5	0.0	0.0	0.0	Dividend yield (%)	0.0 0.0 0.0 0.0
Incr/(decr) in debt	29.1	5.6	-10.0	-10.0	0.0	Operating performance	2009A 2010F 2011F 2012F
Ordinary dividend paid	0.0	0.0	0.0	0.0	0.0	EBIT growth	-94% n.m. 31% 29%
Other financing cash flow	-0.5	-0.9	0.0	0.0	0.0	NPAT growth	n.m. n.m. 27% 30%
Cash flow from fin (5)	46.4	30.2	-10.0	-10.0	0.0	Normalised EPS growth	-91% n.m. 27% 30%
Forex and disc ops (6)	0.1	-0.4	0.0	0.0	0.0	Asset turnover (%)	1.7 12.1 12.7 13.4
Incr/(decr) cash (1+3+5+6)	-0.3	-11.2	-4.3	7.5	33.6	EBITDA margin (%)	-20153.7 29.7 76.7 78.8
Equity FCF (1+2)	-46.8	-40.9	5.7	17.5	33.6	EBIT margin (%)	-20266.2 -11.9 54.5 57.6
						Net profit margin (%)	-20266.2 -25.0 45.3 46.2
Balance sheet	2008A	2009A	2010F	2011F	2012F	Return on net assets (%)	-1.6 42.7 38.7 35.6
Cash & deposits	19.6	10.0	33.7	69.2	146.8	Net debt (A\$m)	59.0 25.3 -20.2 -97.8
Trade debtors	0.9	0.8	0.8	0.8	0.8	Net debt/equity (%)	97.4 26.9 -14.8 -51.2
Inventory	0.0	0.1	0.1	0.1	0.1	Net interest/EBIT cover (x)	-0.4 13.2 17.6 -136.0
Investments	0.0	0.0	0.0	0.0	0.0	ROIC (%)	-1% 23% 31% 41%
Other intangible assets	0.0	0.0	0.0	0.0	0.0	Comparable multiples (x)	2010F 2011F 2012F
Fixed assets	40.8	92.7	92.4	89.2	66.4	Horizon Oil	EV/EBITDA 4.4 3.4 1.8
Other assets	33.4	36.5	36.5	36.5	36.5	Year to 30 Jun	PE 6.9 6.5 5.1
Total assets	94.7	140.2	163.5	195.8	250.6	Mosaic Oil	EV/EBITDA 4.0 4.1 5.5
Short-term debt	18.7	34.2	34.2	34.2	34.2	Year to 30 Jun	PE 8.6 10.7 14.9
Trade payables	9.9	6.5	6.5	6.5	6.5	Texon Petroleum	EV/EBITDA 2.8 1.2 0.6
Long-term borrowings	20.2	34.8	24.8	14.8	14.8	Year to 31 Dec	PE 8.3 5.2 4.9
Provisions	1.8	3.3	3.3	3.3	3.3		
Other liabilities	0.8	0.7	0.7	0.7	0.7		
Total liabilities	51.4	79.5	69.5	59.5	59.5		
Share capital	100.3	124.9	124.9	124.9	124.9		
Other reserves	0.0	0.0	0.0	0.0	0.0		
Retained earnings	-59.2	-67.3	-33.9	8.4	63.2		
Total equity	43.2	60.6	94.0	136.3	191.1		
Minority interest	0.0	0.0	0.0	0.0	0.0		
Total shareholders' equity	43.2	60.6	94.0	136.3	191.1		
Total liabilities & SE	94.7	140.2	163.5	195.8	250.6		

Valuation sensitivity to discount rate (A\$/share)



Total revenues and EBIT (A\$m)



Source: Company data, RBS Morgans forecasts

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Absolute performance, long-term (fundamental) recommendation: The recommendation is based on implied upside/downside for the stock from the target price. A Buy/Sell implies upside/downside of 10% or more and a Hold less than 10%. The target price is the level the stock should currently trade at if the market accepted the analyst's view of the stock, provided the necessary catalysts are in place to effect the change in perception. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted value the target price will differ from 'fair' value. Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

For listed property trusts (LPTs) the recommendation is based upon the target price plus the dividend yield, ie total return. A Buy implies a total return of 10% or more; a Hold 5-10%; and a Sell less than 5%.

Absolute performance, short-term (trading) recommendation: The Trading Buy/Sell recommendation implies upside/downside of 3% or more. The trading recommendation time horizon is 0-60 days.

Each stock has been assigned a Volatility Rating to assist in assessing the risk of the security. The rating measures the volatility of the security's daily closing price data over the previous year relative to other stocks included in either the S&P/ASX200 Index (large caps) or the Small Ordinaries Index (small caps) of which it is a member. This rating is a quantitative (objective) measure provided as an additional resource and is independent of the qualitative research process undertaken by our research analysts.

A rating of Low indicates very little movement in price over the previous year (Coefficient of Variation < 4 for small caps or < 5 for large caps). A Moderate rating implies average price movement over the previous year (Coefficient of Variation of 9 - 21 for small caps or 7.25 - 15 for large caps). A High rating implies significant price movement over the past year (Coefficient of Variation greater than 25 for small caps or 35 for large caps).

REGULATORY DISCLOSURES

Subject companies: HZN.AX.

RBS Morgans Limited is a Joint Adviser and Lead Manager to the share placement and share purchase plan for Horizon Oil Limited and may receive fees in this regard: HZN.AX.

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