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Horizon Oil (HZN)

Company makes the right moves - share price will follow

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Recommendation

Buy

Price

\$0.335

Target (12 months)

\$0.50

HZN has recently improved its short term and long term outlook. The dispute over the Elevela/Ketu license in PNG has been resolved and both gas discoveries will be subject to appraisal drilling later this year. An increased equity in the \$300m Beibu Gulf oil project will boost the production growth in 2014. Our valuation has been increased from \$0.47 to \$0.50 and we maintain a Buy on this oily growth stock.

Expected Return

Capital growth **49%**

Dividend yield **0%**

Total expected return **49%**

Company Data & Ratios

Enterprise value **\$435m**

Market cap **\$379m**

Issued capital **1158m**

Free float **100%**

12 month price range
\$0.26-\$0.425

GICS sector
Energy

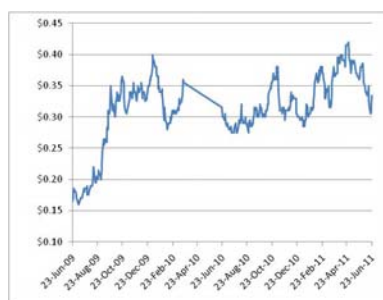
Company initiatives look good

HZN has in our view made some good moves recently. Firstly, they have agreed on a PNG license containing the Elevela and Ketu gas discoveries, which the Government had threatened to revoke. They can now go ahead with appraisal drilling. Secondly, they have bought Petsec (PSA) out of the Beibu Gulf oil development at a cost of \$4-\$12/bbl depending on reserves assumptions. While HZN needs to take on some debt to fund its share of upcoming capex, the balance sheet will be in net cash again by 2014.

Our new valuation of \$0.50 is very achievable

We have increased our valuation for HZN to \$0.50, up from \$0.47. While the Beibu Gulf acquisition added more at face value, we have made some revisions to our forecasts, as the industry continues to struggle with timetables and budgets. We have reduced the Maari oil production profile, delayed start-up at Beibu Gulf by 6 months and now assume \$350m capex plus a similar 6 month delay to Stanley start-up and a capex increase to \$250m. This still leaves us with \$0.50 target for a well-managed, oily growth stock. Buy maintained.

Absolute Price



SOURCE: IRESS

Earnings Forecast

Year end June 30	2010A	2011F	2012F	2013F
Revenue US\$	48.0	62.1	68.7	105.6
EBITDA US\$	37.0	39.4	43.1	60.3
NPAT adjusted US\$	19.8	18.0	18.1	21.8
EPS adjusted A¢	1.9c	1.6c	1.4c	1.8c
EPS growth	N/A	-16%	N/A	29%
PER	17.6x	20.9x	23.9x	18.6x
EV/EBITDA	9.4x	9.2x	9.9x	8.1x
Dividend A¢	0.0c	0.0c	0.0c	0.0c
Yield	0.0%	0.0%	0.0%	0.0%
ROE	23%	14%	11%	12%

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

HZN is doing the right things

The price is again trading in the low \$0.30s which is another good entry point in our view

Investment case is strengthened

HZN has been one of our recommended mid cap oil stocks for some time, particularly for investors with a lower risk tolerance, in a sector that tends to be high risk and volatile. This has been vindicated by the share price trading in a fairly restricted range of \$0.30-\$0.40 since September 2009. The price is again trading in the low \$0.30s which is another good entry point in our view. As the company is expected to make FID on the Stanley liquids project in the 2H 2011, and plans to drill Elevala-2 and Ketu-2 during this period, plus makes progress at Beibu Gulf, we believe there is a very good chance of the shares breaking into the \$0.40s and then the +\$0.50 range.

As an oil/liquids focused growth stock, the valuation is sensitive to the oil price, and a 10% higher oil price than our US\$100 long term assumption would increase the value of HZN by 18% to \$0.59.

Unlike most oil & gas stocks, the upside in HZN is not so much about exploration success, but execution of new developments. CNOOC is the operator for Beibu Gulf, where it has a proven track record while the Stanley liquids stripping project represents HZN's first operatorship at the development level. Its PNG partner is Canada's Talisman Energy, which is looking to commercialise several gas discoveries found in Western PNG, including Stanley, Elevala and Ketu.

The other differentiating factor to most mid cap energy stocks is that HZN has a strong oil/liquids focus and it has stronger, better defined growth prospects.

- Beach Energy has production in the Cooper basin, Egypt and the US, but no real growth identified other than exploration or shale gas potential in the Cooper which is both speculative and expensive.
- AWE is suffering from declining oil production at its existing fields, while gas production is stable, and is also hopeful of shale potential in the WA Perth basin. But no visible growth project.
- Nexus Energy has steady gas production and big upside from the Crux project but how this development will be undertaken remains unclear.
- Roc Oil has a portfolio of oil fields that are all in decline and the only upside asset is Beibu Gulf, which we prefer to get exposure to via HZN.
- Tap Oil has mature oil and gas assets offshore WA and the new Zola gas discovery but the timelines on that project remain hazy.

HZN is a good investment in the mid-cap energy sector in our view, with better growth and lower risk than its peer group. The focus on oil provides it with more upside risk in its commodity exposure compared to more gassy energy stocks.

Beibu Gulf acquisition was at a good price

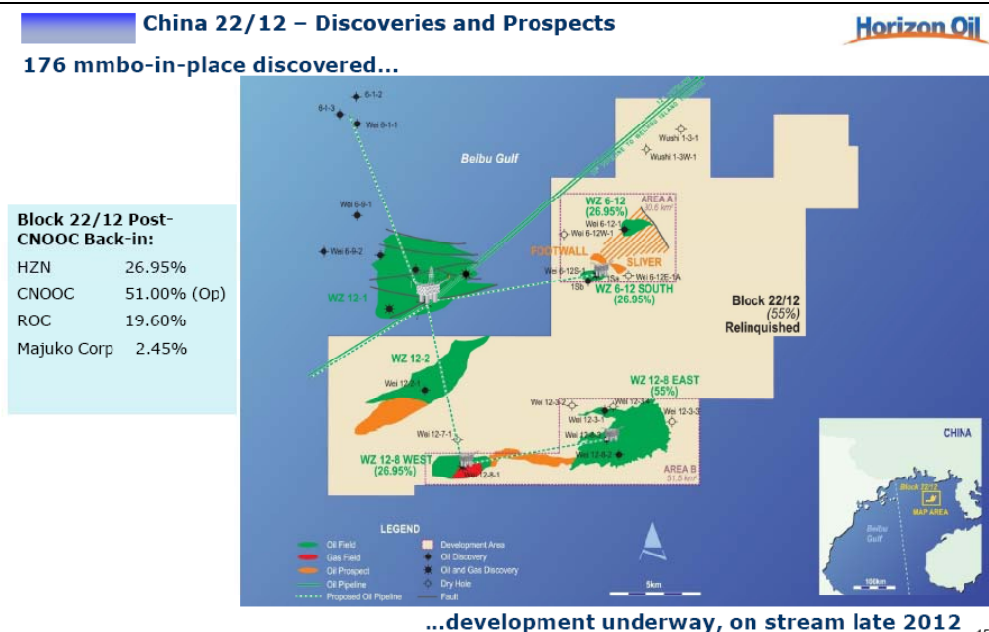
Reserves at Beibu Gulf can be divided into three categories and the US\$38m cost of acquisition represents the following cost/barrel.

Figure 1 - Beibu Gulf acquisition costs

	2P phase 1	2P phase 1 & 2	3P*
Gross	25.0	42.0	75.0
Net 12.25%	3.1	5.1	9.2
Cost per bbl	\$12.41	\$7.39	\$4.14

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES (INCL THE 3P RESERVES ESTIMATE)

Figure 2 - Beibu Gulf oil project (China)



SOURCE: COMPANY DATA

Our NPV is about \$22/bbl for the combined 2P reserves so the acquisition of PSA’s equity in the project was a very attractive deal in our view. The other benefit for the whole JV is that PSA’s weak financial position is no longer a risk that could have retarded the development of this oil project.

Valuation changes

Our valuation of HZN has improved from \$0.47 to \$0.50

Our valuation of HZN has improved from \$0.47 to \$0.50. The key change is from the acquisition of 12.25% equity in the Beibu Gulf project from PSA for US\$38m plus 15m options (ex @ \$0.37) within three years. HZN now owns 26.95% of Beibu Gulf.

Figure 3 - HZN valuation

Reserves	Gross	Net	mmboe	A\$m	\$/share
New Zealand Maari (mb)	45.0	4.5	4.5	188.3	0.17
China Beibu Gulf (mb)	42.0	11.3	11.3	257.9	0.23
PNG Stanley cond/LPG (mb)	12.4	4.9	4.9	110.8	0.10
Sub-total			20.7	556.9	0.49
Other resources					
Maari/Manaia upside (mb)	10	1.0	1.0	10.0	0.01
Beibu Gulf upside (mb)	33	8.9	8.9	44.5	0.04
Stanley liquids upside (mb)	8	3	3.0	14.9	0.01
Elevala/Ketu cond/LPG (mb)	24	8	8.4	41.9	0.04
Stanley gas (PJ)	450	177	29.4	7.4	0.01
Cash (Net debt)				-55.3	-0.05
Corporate overheads				-54.1	-0.05
TOTAL				566.2	0.50

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

We have made revisions to each of the three key assets in HZN’s portfolio, which have offset some of the positive benefits from the Beibu Gulf acquisition:

- The Maari production profile has been reduced by about 8% to reflect

continued disruptions to production, with pump failures and scaling requiring ongoing maintenance at a higher level than previously anticipated.

- The Beibu Gulf project is assumed to come on-stream 6 months later, during the June Half of 2013, and capex is set at \$350m rather than the official budget of \$300m.
- The Stanley liquids stripping project is assumed to come on-stream in the December Half 2013 (6 months later) and at a cost of \$250m rather than \$210m.

We have also added back some value for the Elevala & Ketu potential, which we had stripped out when the license was in dispute. This is a relatively small \$0.04/share but could provide a significant boost to the stock if upcoming drilling is successful.

Finally, we have included the US\$80m of convertible bonds as debt, which the company raised in conjunction with the acquisition. In our modelling, HZN's gearing will peak at 50% in FY13, and return to a net cash position of over \$100m by the end of FY14.

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Earnings changes

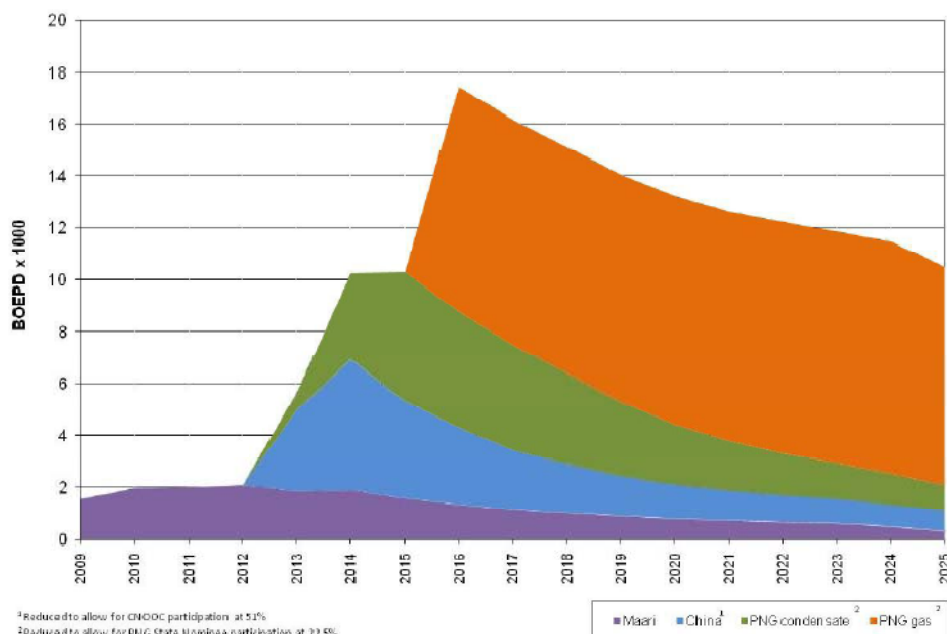
The lower oil production profile at Maari and the assumed delays to Beibu Gulf and Stanley have reduced our EPS estimates for the next three years, but FY14 has a higher estimate reflecting the larger equity in Beibu Gulf and a full year's contribution.

Figure 4 - HZN Earnings changes

	2011F	2012F	2013F	2014F
Old EPS	1.7c	1.7c	3.5c	5.7c
New EPS	1.6c	1.4c	1.8c	6.6c
% change	-6%	-18%	-49%	16%

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Figure 5 - HZN production growth (company projection)



¹ Reduced to allow for CNOC participation at 51%
² Reduced to allow for PNG State Nominee participation at 22.5%

SOURCE: COMPANY DATA

COMPANY DESCRIPTION

HZN is a medium sized oil company with a focus on Australasia. The company has minority interests in three key areas. A 10% stake in a producing oil field at Maari in New Zealand, 26.95% equity in the Beibu Gulf oil project slated to commence production in 2013 and 50% of the Stanley liquids rich gas discovery in Western PNG. Elevala and Ketu are similar discoveries in PNG but require further appraisal drilling, planned for 2H 2011.

The Maari oil field started production in early 2009 and has produced below expectations for various reasons. Cumulative production has reached 15mmbbl from the original oil reserves of 55-60mmbbl and there is substantial upside potential through the nearby Manaia oil well and a shallower oil bearing reservoir called the M2A sandstone above the main Maari reservoir. Cash operating costs are about \$10/bbl and the field could run for +20 years.

INVESTMENT STRATEGY

HZN's cash flow from Maari and the US\$80m convertible bonds recently raised will fund its share of capex for the Beibu Gulf project. The Stanley field will be developed as a liquids stripping projects to start with, while a longer term gas development is championed by partner Talisman Energy which owns several gas discoveries in western PNG. We discount the potential value of the gas heavily, at only \$0.01/share. When all three cornerstone assets are in production, HZN will be generating cash flow in excess of US\$100m pa.

VALUATION

Our DCF valuation for HZN is \$0.50/share. The Maari oil field is valued at \$0.17/share, Beibu Gulf \$0.23 and PNG \$0.10. The Elevala and Ketu License which is now held 45% could have reserves of 200-1,000Bcf and liquids of 10-50mmbbl. We value this at a nominal \$0.04/share. The balance sheet had net cash of US\$24m at March 31 2011, offset by US\$80m of convertible bonds.

RISKS

HZN faces normal oil and gas industry risks and has some specific risks:

- Prices for oil are inherently volatile, and strongly linked to the world economy and market conditions. All of HZN's current cash flow is from the Maari oil field so it has only one operating asset at this stage.
- Political risks exist in all jurisdictions but NZ and China are seen as relatively stable. The Stanley liquids stripping project is not yet sanctioned as a commercial project, so is not guaranteed to go ahead.
- Operational and environmental risks are high in the oil and gas industry, with high safety standards required to avoid explosions, fires, oil spills etc.
- Exploration risks are high, but this is more of a share price risk when the market has high expectations of success from drilling. As HZN is primarily focused on bringing existing discoveries into production there is no exploration work to factor in.

Table 1 - Financial summary

Horizon Oil Ltd (HZN)						Share price:	\$0.335					
As at 23/06/2011						Market cap:	\$379m					
US\$ reporting						Recommendation:	Buy					
Income Statement						Valuation Data						
Year end June 30	2010A	2011F	2012F	2013F	2014F	Year end June 30	2010A	2011F	2012F	2013F	2014F	
Revenue	48.0	62.1	68.7	105.6	271.1	Adjusted NPAT (A\$m)	22.4	18.5	17.0	21.2	78.7	
EBITDA	37.0	39.4	43.1	60.3	164.6	Adjusted EPS (A\$)	1.9c	1.6c	1.4c	1.8c	6.6c	
DD&A	-12.2	-11.8	-12.4	-14.7	-36.8	EPS growth	N/A	-16%	N/A	29%	267%	
Exploration write-off	-0.2	-1.2	-6.4	-7.0	-7.7	P/E ratio	17.6x	20.9x	23.9x	18.6x	5.1x	
EBIT	24.6	26.4	24.2	38.6	120.1	OpCFPS (excl. abnormals)	2.8c	2.8c	3.2c	3.7c	11.4c	
Net interest	-3.0	-0.2	4.3	-4.5	-9.8	Price/OpCFPS	11.9x	11.8x	10.4x	9.1x	2.9x	
Abnormals	32.6	-7.3	0.0	0.0	0.0	DPS (A\$)	0.0c	0.0c	0.0c	0.0c	0.0c	
Pre-tax profit	54.2	18.9	28.5	34.1	110.2	Yield	0.0%	0.0%	0.0%	0.0%	0.0%	
Tax	-1.8	-8.2	-10.5	-12.3	-35.4	EV/EBITDA	9.4x	9.2x	9.9x	8.1x	2.1x	
Minority interests	0.0	0.0	0.0	0.0	0.0	Profitability Ratios						
Reported net profit	52.3	10.7	18.1	21.8	74.8	Year end June 30	2010A	2011F	2012F	2013F	2014F	
Adjusted net profit	19.8	18.0	18.1	21.8	74.8	EBITDA/sales	77%	63%	63%	57%	61%	
(adjusted net profit = pre-tax profit before abnormals minus tax at marginal rate)						EBIT/sales	51%	43%	35%	37%	44%	
Cashflow						Return on assets (avg.)	13%	8%	6%	7%	20%	
Year end June 30	2010A	2011F	2012F	2013F	2014F	Return on equity (avg.)	23%	14%	11%	12%	32%	
Reconciliation						Dividend cover	N/A	N/A	N/A	N/A	N/A	
Net profit US\$	\$52.3m	\$10.7m	\$18.1m	\$21.8m	\$74.8m	Effective tax rate	3%	43%	37%	36%	32%	
Exploration write-off	0.2	1.2	6.4	7.0	7.7	Liquidity & Leverage						
Depreciation	12.2	11.8	12.4	14.7	36.8	Year end June 30	2010A	2011F	2012F	2013F	2014F	
Change in working capital	-1.3	2.5	1.3	0.3	16.4	Net debt	\$14.0m	-\$8.6m	\$21.0m	\$96.7m	-\$14.4m	
Other	-30.2	7.3	0.0	0.0	0.0	Net debt/equity	12%	-6%	13%	51%	-5%	
Net operating cashflow	33.2	33.5	38.2	43.8	135.7	Interest cover	12.1x	203.2x	-10.0x	13.5x	16.7x	
Investing cashflow	0.0	0.0	0.0	0.0	0.0	Assumptions						
Capex on PPE	-8.1	-19.8	-55.1	-105.5	-28.1	Year end June 30	2010A	2011F	2012F	2013F	2014F	
Exploration	-10.6	-11.6	-12.8	-14.0	-15.4	Maari production (bopd)	18,077	18,238	19,398	17,507	15,309	
Other	30.0	30.0	0.0	0.0	0.0	Beibu Gulf production (bopd)	0	0	0	4,110	16,027	
Net investing cash flow	11.3	-1.4	-67.8	-119.5	-43.5	Stanley production (bcopd)	0	0	0	0	4,527	
Financing activities	0.0	0.0	0.0	0.0	0.0	Total Production (Mboe)	0.7	0.7	0.7	1.0	3.1	
Issue of shares	0.2	0.0	0.0	0.0	18.9	Net total production (boepd)	1,813	1,829	1,945	2,866	8,593	
Buy backs	0.0	0.0	0.0	0.0	0.0	Oil price (US\$/barrel)	75.30	90.36	95.00	100.00	100.00	
Dividends paid	0.0	0.0	0.0	0.0	0.0	PNG Gas price (US\$/GJ)	0.00	0.00	0.00	0.00	0.00	
Debt	-28.8	60.0	-10.0	2.2	0.0	Exchange rate (A\$/US\$)	0.883	0.977	1.065	1.025	0.950	
Others	0.0	0.0	0.0	0.0	0.0	Valuation						
Net financing cash flow	-28.5	60.0	-10.0	2.2	18.9	Reserves	Gross	Net	Mboe	A\$m	\$/share	
FX impact	0.5	0.0	0.0	0.0	0.0	New Zealand Maari (mb)	45.0	4.5	4.5	188.3	0.17	
Net change in cash held	16.5	92.1	-39.7	-73.5	111.1	China Beibu Gulf (mb)	42.0	11.3	11.3	257.9	0.23	
Balance Sheet						PNG Stanley cond/LPG (mb)	12.4	4.9	4.9	110.8	0.10	
Year end June 30	2010A	2011F	2012F	2013F	2014F	Sub-total			20.7	556.9	0.49	
Assets						Other resources						
Cash assets US\$	\$26.5m	\$118.6m	\$78.9m	\$5.4m	\$116.5m	Maari/Manaiia upside (mb)	10	1.0	1.0	10.0	0.01	
Receivables	3.5	0.0	0.1	4.8	7.9	Beibu Gulf upside (mb)	33	8.9	8.9	44.5	0.04	
Inventories	3.3	0.0	0.0	0.0	0.0	Stanley liquids upside (mb)	8	3	3.0	14.9	0.01	
Other	0.2	0.0	0.1	0.1	0.1	Elevala/Ketu cond/LPG (mb)	24	8	8.4	41.9	0.04	
Total current assets	33.6	118.7	79.1	10.3	124.6	Stanley gas (PJ)	450	177	29.4	7.4	0.01	
Plant and equipment	89.0	97.1	139.7	230.5	221.8	Cash (Net debt)				-55.3	-0.05	
Investment	0.0	0.0	0.0	0.0	0.0	Corporate overheads				-54.1	-0.05	
Intangible assets	44.7	55.2	61.5	68.6	76.3	TOTAL				566.2	0.50	
Deferred tax assets	4.3	4.3	4.3	4.3	4.3	Sensitivities						
Other	0.0	0.0	0.0	0.0	0.0	Valuation on LT oil price from 2013				A\$m	A\$/sh	
Total non-current assets	138.1	156.5	205.6	303.4	302.4	Base case		US\$100		566	0.50	
Total assets	171.6	275.2	284.6	313.6	427.0	Low case		-10%		489	0.43	
Liabilities						High case		+10%		667	0.59	
Debt	20.6	20.6	10.6	12.7	12.7	Discount rate						
Payables	8.1	0.6	0.6	1.2	2.2	Base case		10%		566	0.50	
Deferred revenue	0.0	6.2	6.9	10.6	27.1	Lower case		12%		517	0.46	
Current tax liabilities	0.0	0.2	0.3	0.4	1.1	Conservative case		14%		471	0.42	
Provisions	0.1	0.0	0.6	1.3	2.6	EPS sensitivity						
Total current liabilities	28.7	27.6	18.9	26.1	45.7	Base case			2011	2012	2013	2014
Debt	19.9	89.4	89.4	89.4	89.4	Base case			1.6¢	1.4¢	1.8¢	6.6¢
Other	0.7	0.7	0.7	0.7	0.7	Oil 10% lower			1.4¢	1.2¢	1.4¢	5.4¢
Provisions	8.0	8.0	8.0	8.0	8.0	Oil 10% higher			1.7¢	1.9¢	2.3¢	8.0¢
Total non-current liabilities	28.5	98.0	98.0	98.0	98.0	Peer group reserves comparison						
Total liabilities	57.3	125.6	116.9	124.2	143.7		EV	2P	3P	EV/2P	EV/3P	
Net assets	114.4	149.6	167.7	189.5	283.2		\$m	Mboe	Mboe	\$/boe	\$/boe	
Equity						AWE	506	65.0	108.9	\$7.79	\$4.65	
Contributed equity	125.3	168.5	168.5	168.5	187.4	BPT	979	66.0	80.0	\$14.84	\$12.24	
Reserves & outside equity	4.0	4.0	4.0	4.0	4.0	CVN	83	24.0	35.0	\$3.46	\$2.37	
Retained earnings	-15.0	-22.9	-4.8	16.9	91.8	ROC	11,023	1044.0	2292.5	\$10.56	\$4.81	
Total equity	114.4	149.6	167.7	189.5	283.2	NXS	42	4.0	5.6	\$10.57	\$7.61	
Diluted shares on issue	1180.0	1188.2	1188.2	1188.2	1242.6	Peer group average				\$9.44	\$6.34	
W'd ave diluted shares	1180.0	1180.0	1188.2	1188.2	1188.2	HZN	435	20.7	71.4	\$21.01	\$6.09	

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 5% and 15% on a 12 month view

Hold: Expect total return between -5% and 5% on a 12 month view

Reduce: Expect total return between -15% and -5% on a 12 month view

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

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Johan Hedstrom owns 100,000 shares in HZN.