StockAnalysis

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By Peter Strachan

This Week

Indices & Prices

All Ordinaries	4,581.30
Energy Index	15,020.90
Brent AU$/bbl	87.87
AUS$/US$	0.8724

As at Close June 22nd

In this Issue

Feedback

StockAnalysis runs a feedback session each Thursday (usually!). Subscribers e-mail questions about stocks and issues to StockAnalysis and if I am able to make a sensible comment in the timeframe, I record the answers for subscribers to download and/or listen online. Send your questions in by 9 am Perth time on Thursday and they will most likely get an airing in Feedback!

Resource 'Super Profits' Tax (RSPT) for Dummies

StockAnalysis has set up two example mining companies/projects, 'A' and 'B' which it examines under current fiscal terms and under the proposed RSPT. Modelling is for life-of-mine analysis with the only modifications being operating costs and tax and royalty regimes.

In all cases a 5% royalty is assumed, equal to that currently levied on base metals. For comparison, gold is subject to a 2.5% royalty while iron ore royalties vary by product type, up to 7.5% of revenue. Example 'A' is a higher cost project while 'B' is a lower cost and, therefore, a more profitable mine.

Under existing tax and royalty conditions, 'A' ends up paying 40% of its pre-tax income to government, while the more profitable company 'B' pays 37% of its pre-tax income as profits. **This dynamic explains why Wayne Swann has no idea about how companies operate.** Company 'B' pays 32% more tax dollars (18.5) than company 'A' (14), but its tax **rate** overall is lower, because it is a lower cost project and thus more profitable. The same dynamic applies as commodity prices rise. I suggest that if the Treasurer only wants to see all Australian companies paying a larger percentage of pre-tax income as tax, then he should make sure that they are all underperforming, high cost operations. He would get a very high percentage of profits then, but in absolute dollar terms, he would get less cash. This is the Cuban solution!

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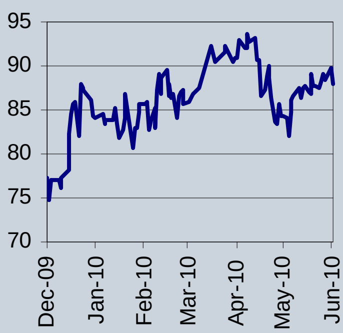
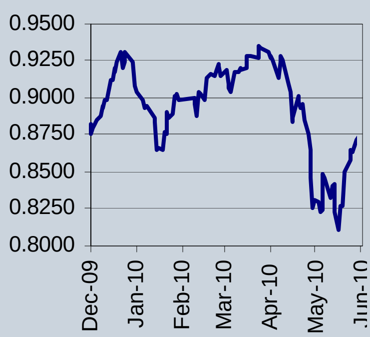
All Ordinaries

S&P ASX 200 Energy Index

Brent Crude Oil $A/barrel



A$/US$



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Life of Project		Current		RSPT	
		A	B	A	B
Revenue		100	100	100	100
Royalty	5%	(5)	(5)	(5)	(5)
Operating costs inc Depreciation		(65)	(50)	(65)	(50)
Net Income				30	45
Capex	10				
Uplift % pa	6%				
RSPT	40%			(7.8)	(13.8)
Royalty credit				5	5
Pre-tax income		30	45	27	36
Corporate Tax	30%	(9.0)	(13.5)	(8.2)	(10.9)
Net profit for owners		21	32	19	25
Profit before taxes & Royalty		35.0	50.0	35.0	50.0
Taxes & Royalties paid		(14.0)	(18.5)	(15.9)	(24.6)
Tax & Rlty as % of pre-tax income		40.0%	37.0%	45.5%	49.3%

Source: Strachan Corporate Pty Ltd

This dynamic explains why Treasurer Swann can complain that while coal miners' profits have risen, the percentage of tax they pay has declined. Sure, coal prices have risen, boosting profits and lowering overall tax rates, but the dollar amount going into Federal coffers has not declined and in fact has risen strongly!

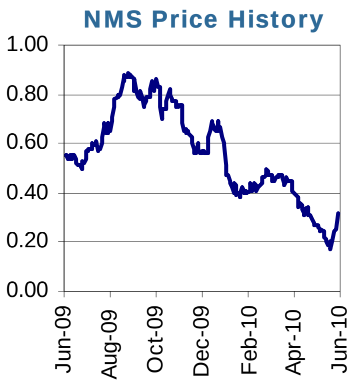
Now stay with me here and follow me closely for these comparisons as I am sure you will enjoy my numbers play!

Looking towards the proposed RSPT and again studying the same two projects or companies (A & B), after allowing for notional repayment of capital costs with uplift at 6% pa over just one year prior to the RSPT kicking in, project 'A' now ends up paying 45.5% (15.9/35) of its pre-tax income while the more profitable and lower cost project 'B', pays a whopping 49.3% (24.6/50) of its pre-tax income to the government. No doubt Dr Henry and Mr Swann would be pleased with this analysis. Not only is 'A' now paying 13.6% more tax overall than it would under the existing tax & royalty system (15.9 vs 14), but this weaker 'A' operation is burdened with a lower rate of tax than its overachieving brother, which has to pay 33% more (24.6 vs 18.5) in tax than under current arrangements.

Analysis of this new RSPT fits with a view of the world which says that the strong should support the weak. Now, no-one is denying that those less fortunate should get a helping hand, but there needs to be incentive for the weak to pick themselves up and improve, otherwise they will stay weak and constantly seek our support. StockAnalysis' modelling illustrates that the end result of an RSPT would be to reduce the incentive for a high cost, inefficient project like 'A' to try to become a star like 'B'.

Why would the owners of 'A' invest time, effort and money to make 'A' as good as 'B' when it means that they will get hit with a total 49.3% tax rate. If 'A' invests funds required to move to the efficient position of 'B', sure its profit increases 31.6% (25 vs 19), but the amount of tax it has to pay rises by 54.7% (24.6 vs 15.9)! Oh sure, Mr Swann, that makes a lot of business sense. You should be teaching that one to Dr Henry's high school class.

Market Moves



Neptune Marine (NMS) has responded to improved operating conditions in its offshore engineering business. Last week, StockAnalysis recommended the stock up to 30 cents per share after it hit lows of around 20 cents per share. In the exuberance which followed, Neptune recovered to around 34 cents, but further evidence of sustained earnings growth and balance sheet security will be required to support additional strength in the company's share price.

In December 2009, StockAnalysis listed a number of companies to watch, but which were then considered to be too expensive to buy. Engineering services company **Transfield Services (TSE)** was then trading at close to $4 per share and had been to over $4.60 per share, but was recommended by StockAnalysis with a price target of $3.20 per share. The stock has now fallen to this target as the market worries about profit downgrades and so, based on consensus earnings estimates, trades with a prospective PER of 10.3 [x], going to 9.4 times expected 2011 earnings and has a modest dividend yield of 3.7%, rising to 4.4%, based on a dividend of 12 cents, rising to 14 cents in FY 2011. Transfield is active globally in the oil and gas industry and has long-term relationships with top level clients.

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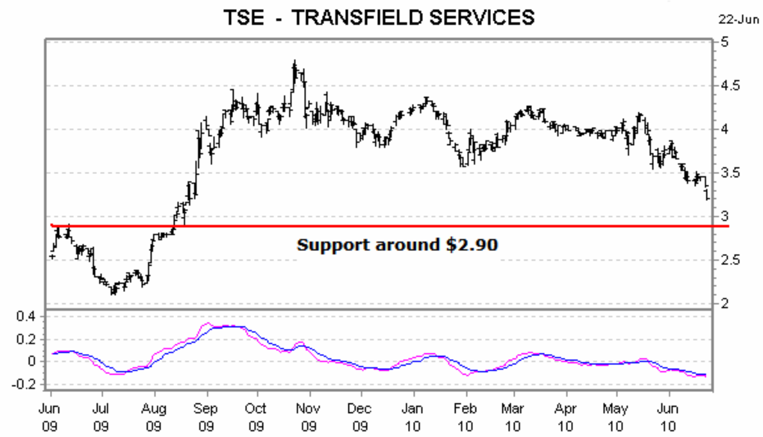

The chart also shows a breach of its 200 day moving average with downtrend confirmed by the 30 day average moving through the 200 day, but both the daily and weekly MACD indicators show that the stock is reaching for a turning point. TSE may yet fall further to $3 per share, most likely as investors look with fear towards the August profit report, but StockAnalysis believes that, despite concerns over the company's gearing, the stock has a healthy interest cover and represents ***a buying opportunity for long-term growth.***

The tax planning season seems to have arrived suddenly this year. Most stocks are trading closer to their 12 month highs than their lows, with the exception of companies such as Roc Oil, Nexus, Coffey International and Transfield, to name a few. No doubt we will see some bargains arrive this week as strange selling, pre-30 June has its impact. Others will see selling in the first week of July, with the prime example here being Adelphi Energy. Since AWE's bid expires in early July, sellers with profits will want to push that sale into FY 2011, so as to stall tax liabilities.

Global economic indicators remain mixed. China's export engine remains intact, with booming sales, but housing stats in the US remain weak. Over in the EU, coincident indicators show some improvement, but the market is looking out at the leading indicators, which remain mixed. China's decision to manage the level of its Yuan has already resulted in a 10% appreciation. You can expect that $75 shirt, made in China, will cost you $85 in the near future and those socks and jocks, along with computers and almost everything we import from China will rise in price as its currency appreciates. On the other side, Chinese will be more able and willing to buy goods and services from us, so expect a few more Chinese tourists to arrive on our shores.

The main focus for global economies remains on **reducing debt** and managing government deficits. This process will involve lifting taxes and reducing government services. Here in Australia we have already seen the beginnings of that process with the putative attempt to put an additional tax layer on resource companies.

The USA's housing sector faces huge challenges as we move into the September quarter. The US has a mountain of mortgages on soft terms, which face reset to market interest rates and repayment terms. Fitch Ratings has forecast that most borrowers who get lower mortgage payments under a US federal government program will default within 12 months. This tsunami of resets will inevitably result in rising defaults and further downward pressure on house prices and wealth generally, leading to lower retail sales and additional job losses. The US unemployment rate has recovered somewhat, but is likely to remain stubbornly around the 9.5% level, with real unemployment closer to 18% in the USA.

In response to this threat, US banks are accelerating their foreclosure programs. Householders will find that they are now renting a house in which they had negative equity. US State economies are in deep fiscal trouble. Collectively, the US States are $200 billion underwater which will lead to many employee layoffs, while raising taxes will further squeeze consumer budgets.

BP's GoM oil disaster is hitting the US oil industry hardest. Forget fishing and tourism. The oil and gas industry is Louisiana's biggest economic engine accounting for about 16% of the state's GDP vs 1% for fishing and 4% for tourism.

Meanwhile, here in Australia the government, which is meant to lead the country on behalf of all its citizens, is doing great damage to the Australian business and mining 'brand' by bad mouthing its leaders and calling legitimate business profits 'rip offs'. Since when was a profit after paying an average of 42% of pre-tax earning to governments, a rip-off? StockAnalysis concludes that Labor is run by un-reconstructed Trotskyites and envy driven class warfare warriors, who have an overriding concern about social equity and wealth distribution, but absolutely no idea about wealth creation.

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Gold appears to have reached a price peak at around A$1,400 to A$1,450 per ounce, at which level it has become overstretched and well removed from its 200 day moving average, which rests at around A$1,250/oz. In the short term, the gold price looks set to retreat to around A$1,300 per ounce, but ongoing concerns surrounding the viability of the Euro and stability of the US dollar should keep the gold price firm.

Adelphi, Adios! ADI/AWE

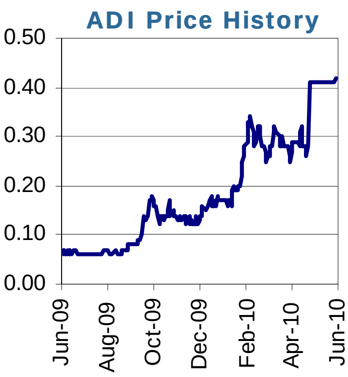
Adelphi's Board had little choice but to capitulate to AWE's improved, 42 cent bid. Hedgers who might have been hoping for 46 cents will face a choice between accepting 42 cents, so as to get their money back, or watching as the stock falls back to 30 cents post the bid, while the company contemplates returning to shareholders during H2 2010, as Aurora has just done, for funds to support ongoing drilling. Given this unpalatable prospect, StockAnalysis believes that AWE will end up with at least 60% of ADI and most likely will end up with 100%. Post 30 June, StockAnalysis expects that ADI shareholders holding at a profit will rush the 42 cent bid in the first week of July.

Company	Current Price cts	Market Cap $m.	Net equity acres	Mkt Cap $/acre of EFS	Look through Value $/share	Discovery Value cps
Adelphi *	42	60	2,350	$ 25,367	$ 0.420	52
Aurora	81	223	10,190	$ 21,881	$ 0.93	146
Eureka	21	32	1,469	$ 21,533	$ 0.24	37
Antares	65	193	23,019	$ 8,378	$ 1.93	139
Texon	39	52	4,504	$ 11,655	$ 0.74	80

* Market cap is value for EFS holding after subtracting cash & Yemen

Source: Strachan Corporate Pty Ltd

After subtracting value for ADI's net cash and other assets, AWE's bid effectively values ADI's Eagle Ford Shale (EFS) area at around A$25,300 per acre. Recent transactions in the EFS have seen participants willing to pay up to US$10K (A$11.4K) per acre for mineral rights, so effectively, ADI shareholders will be achieving twice the market price for their assets. ADI's ability to extract higher value for shareholders from the EFS acres depends on its ability to fund ongoing development. This added area of risk for ADI provides AWE with leverage in this transaction, since it has cash available to divert into the Sugarloaf project.



The table above compares look-through values for other ASX listed EFS players, based on the value ascribed to ADI's EFS by the AWE bid, after allowing for the value of its cash and other assets. On this basis, Aurora Energy is seen to be worth 93 cents and Antares has a value of $1.93 on its expanded capital.

Looking at target Resources in each case and applying either the AWE/ADI value for Sugarloaf assets or the transaction value which flows from the XTO purchase, to Antares and Texon, delivers discovery values per share for each company's EFS assets only. Hence, AZZ is seen to have a value of $1.39 while Texon has a target value of 80 cps for its EFS assets, based on this transaction multiple of 70 cents per Mcfe. StockAnalysis reasons that ultimately, these EFS assets will find a value level much higher than those calculated by these recent corporate deals.

Recommendation: ***Despite difficult markets for gas in the USA, StockAnalysis continues to recommend Antares and Texon, both of whom are much more exposed to the oil price from their shale projects.***

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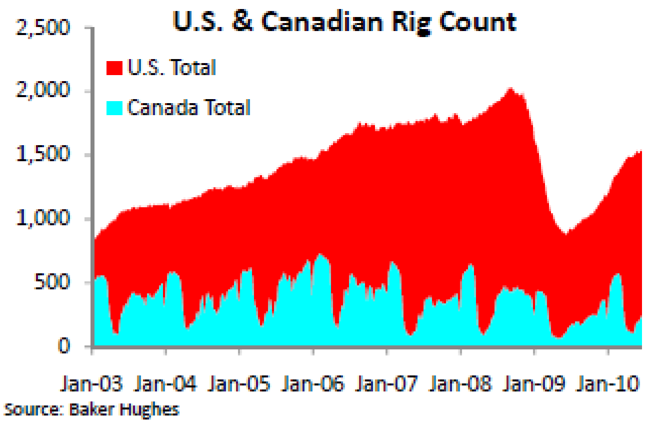
Unconventional Hydrocarbons

MARKET & TAX ISSUES

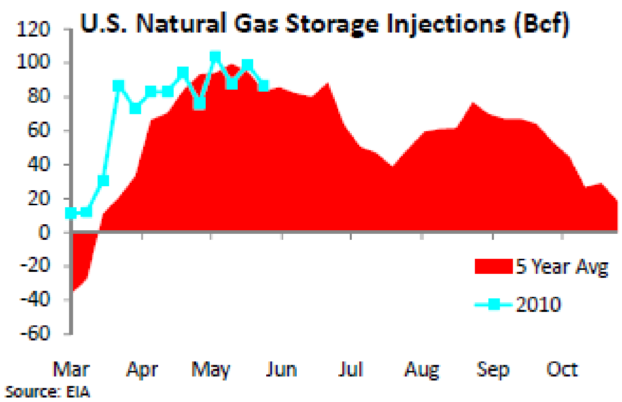
There have recently been major developments in both the **coal seam gas and shale gas/oil** sectors globally, which impact on short-term project viability.

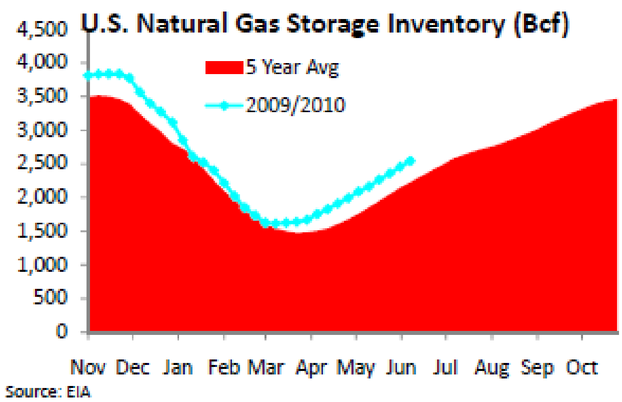
While shale and coal seam gas (CSG) projects may hold commercial appeal in North America and Europe, where relatively strong local energy markets, ready access to skills, capital cost control and rapid link-up to sales lines for payback provide an attractive financial environment, Australian conditions are not as strong. Low gas prices are likely to persist for at least a decade on Australia's east coast while higher capital costs, combined with a lack of gas sales infrastructure, is likely to inhibit commercial development for at least a decade.

Companies such as Beach Petroleum are taking a long-term approach to this opportunity. Subscribers should not expect rapid value accretion from unconventional hydrocarbon developments of the sort seen by Queensland's CSG players over the past 5 years, though some speculative bubbles are likely to occur.



Firstly, a **glut of natural gas** in North America has pulled gas prices down below US$5/mmBtu. Despite the poor economics represented by this **low gas price**, US drill rigs continue to operate, with drilling economics boosted in some jurisdictions such as the Eagle Ford Shale, by high oil contents. In other areas, operators are continuing to spin their drill bits, just to ensure that they can hold leases by production. In many parts of the country, gas wells are completed and tested to demonstrate production and then production is suspended. There is no doubt that if the gas price was to lift back towards US$6/mmBtu, many of these higher cost wells would come straight back on-line, boosting US domestic supply even further. Meanwhile, summer injection of gas into underground storage is running at a high rate with storage build-up indicating another record peak in the run up to winter.





Locally, CSG projects are being hit from all sides. The proposed **RSPT**, combined with **weak LNG markets** in Asia and rising concerns surrounding **environmental impacts of drilling CSG** grids in the fertile crop and pasture lands of the Bowen Basin, is raising the level of risk associated with these massive projects. Undoubtedly, it now appears that **Arrow Energy** has shown great timing in its sale to Shell while others in the sector, including **Eastern Star**, **Blue**, **Bow**, **Vicpet** and **Exoma**, look to be resource bound with limited options for a commercial outcome within a decade or more.

Asian LNG prices are under pressure, with cargoes of Qatari LNG, previously earmarked for sale in the USA, now seeking spot sales in Asia and even travelling all the way to Europe. The long run demand growth profile for LNG looks secure.

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However, short-term influences like the RSPT, more shale gas in China and pipeline gas from Russia into China, along with an LNG glut which will take 5 years to clear, mean that development of CSG-LNG projects is less likely over the coming 4 years.

In the Cooper, Perth and Canning Basins, there is much talk about shale oil and gas. **StockAnalysis does not believe that subscribers should buy into this shale gas hype, since commercialisation of any deposit is likely to be at least a decade away in all regions except the Perth Basin.**

Let's look at what is involved in commercial production of petroleum from shale. Firstly, the **capital cost** of development is high, considering that about 75% of all production from each well is delivered within the first 18 months of production. Wells drilled to around 3,000 metres with 1,500 metre horizontal sections that are fracture stimulated with multiple stages, typically cost upward of A$6 million per well in the USA. StockAnalysis estimates that assembling that sort of gear and know-how in Australia is going to cost at least 20% more to undertake locally. Typically, production of gas and/or associated liquids from shale formations declines by about 80% in the first year of production.

The key to commercial production in this business is an ability to rapidly achieve high returns on sales. In the USA, wells can be drilled, fracced and put on sales within 3-4 months, providing rapid payback of high up-front costs and reducing financial risks, but at current low US gas prices, equal to about A$5.60/Mcf, many of the gassier shales struggle to make a profit, so in Australia's $3-$5/Mcf gas environment, the chances of shale gas making a positive cash flow would rely heavily on production of high levels of associated condensate. Only in the Perth Basin, where the gas price is closer to A$7/Mcf, do the economics stack up from a product price point of view. The Canning Basin is so remote that it is going to take several years, post discovery for the Great Northern Pipeline to be constructed. A market might emerge for gas as LNG, compressed natural gas or pipeline gas, but the returns are uncertain given the timeline to first discover, then develop and finally to market.

Next, a key aspect of the US shale gas industry is its **abundant pipeline network**. Shale gas fields are typically located under or near conventional oil and gas assets, so linking new production into the market can be achieved in a matter of months, if not days. Here in Australia, shale target areas in the Cooper and Canning Basins are remote and lacking in access to a comprehensive grid of gas pipeline infrastructure. Hooking up new gas wells might be expected to initially take many months if not years to achieve, so that sunk costs will decay in the ground. Only in the Perth Basin do gas sales lines look more promising and even there, a network of spur lines would be needed to access new gas wells and funnel the product into that State's main arterial gas line.

Conclusion: ***Don't get too excited about shale gas in Australia.***

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SEAAOC – South East Asia Offshore Conference 2010

I will be speaking at the upcoming SEAAOC—South East Asia Australia Offshore Conference 2010— in Darwin on 22-24 September 2010. My presentation will focus on peak oil and gas (Where are we at?) and petroleum investment (How attractive is Australia, who are the upcoming players, and why?).

For more information, click **here**.

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The author has small holdings in shares of BRU, SRI. Modest holdings in ABC, ADX, ROC, NMS, OEL, OSH, CWP, NXS, UXC, MGR, COF, PAG, SUN, COE, HZN, RCR, TAP, AWE, TLS, PTM, WPL, & GLH and larger holdings in ACE, HAV.

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