

ALTONA RESOURCES

15 October 2007

Good Things Come to Those who Wait

Altona's effective resource base of 700m barrels of oil equivalent is valued at only US\$0.04 per barrel. It is however in the form of coal, and converting to liquids will be slow and capital-intensive, but should ultimately be rewarding and profitable. The upside could be substantial – as much as 20x over the next five years.

- Altona is not a miner, but aims to become an integrated energy company – coal miner, oil producer, oil refiner and power station operator.
- It plans a large-scale development to use the Arckaringa coal fields in South Australia as feedstock for an integrated coal to liquids (CTL) plant to supply 16m bbl p.a. of diesel and 900MW of electrical generating capacity into the domestic market over a +75 year life.
- The project is scheduled to commence production in 2013, and at full capacity should by our estimates be capable of producing EBITDA of over £500m p.a. Our middle-case NPV calculation suggests an un-risked project valuation of £1.2bn (44p at our assumed share base), increasing to over £2.7bn (100p per share) at the time of production in 2013 once all investments have been made and risks overcome. The project therefore offers the potential of a 20x share price uplift from current levels over the next five years as risk hurdles are overcome. We argue that 15% of the total project risk will have been overcome by end-2007 and set a risked-NPV valuation of 7p on the basis of our product price projections.
- Altona's current market capitalisation equates to US\$0.04 per in-situ barrel equivalent. In addition, the projected capex requirement equates to \$5.60/bbl, with base case production costs projected to be \$20/bbl. This operating cost could be reduced further with additional electricity credits arising from recent increases in South Australian electricity prices, pushing the total cost down toward levels on par with traditional oil scenarios.
- Project fundamentals are supported by a looming energy deficit facing the state of South Australia. The Altona project is scheduled to commence production at the same time as the expansion of BHP Billiton's giant Olympic Dam operation nearby. This mining operation currently accounts for 10% of South Australia's total electricity demand, with plans being drafted to increase the size of the operation by up to five times.
- We believe the most likely endgame for Altona is that it is acquired by an energy major.

Rating	Corporate
Target price (p)	7
Price (9/10/07) (p)	4.75
Market cap. (£m)	13
Sector	Mining and Metals
Reuters/Bloomberg	ANR.L / ANR LN
AIM	1128

ANR £'000s			
Year	2006	2007E	2008E
Oil Price \$/bbl	70	70	70
Power Price \$/MWhr	30	50	50
Sales	0	0	0
EBITDA	(394)	(445)	(650)
EBIT	(359)	(422)	(589)
Tax	0	0	0
Net Earnings	(359)	(422)	(589)
EPS	-0.18	-0.16	-0.18
NAV	2,709	4,451	8,862
NAV/share	1.33	1.71	2.73

52 week range	4.63-10
Free float (%)	80
Number of shares (m)	283
Daily volume (m)	50000



Performance over	1mth	3mths	12mths
Absolute (%)	-23	-24	-58

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Executive Summary

Over \$1bn p.a. gross revenue over a 50-year life

Altona Resources is the classic option-play example: a small company, in the early stages of developing a large energy project, with a long life, in a safe jurisdiction. The upside potential of Altona is considerable as the company moves toward construction of an integrated CTL plant that could generate gross cash flows in excess of \$1bn p.a. over a +75 year life. It faces little exploration risk, as the resource is already defined (albeit to an historical standard), little sovereign risk as it is located in Australia, and controllable technical risk as the development – while capital intensive – comprises largely proven technology.

Timed to match Olympic Dam

South Australia is facing fuel and electricity shortages. Low levels of growth in recent decades has resulted in little investment in new production or generating capacity. Reduced production from local gas and oil fields, near exhaustion of the main coal supply, loss of reliable electricity from the neighbouring state of Victoria, all piled against a looming and dramatic increase in demand from several major mining developments, leaves the state facing a large energy deficit in the next five years. The Altona development is geared to fill this gap and is especially well suited to match the expansion of BHP Billiton's Olympic Dam mining operation nearby. Olympic Dam currently consumes 10% of the total electricity supply of South Australia and is scheduled to be at least trebled in size by 2013, with recent speculation suggesting that this upgrade could increase the annual production by five times, at a total capital cost of \$15bn. This and other new mining developments underpin the significant increase in power and fuel demand that the state of South Australia is facing in coming years.

Staged capex

Altona's work over the past few years has been targeted at proof of concept and pre-feasibility studies, with the last of these bricks now being put in place. The next major phase is to progress to a full bankable feasibility study, which should be completed by end-2008. We anticipate a significant equity-raising in 2008 to take the project to this milestone, with an ultimate goal of production in 2013.

20x uplift potential

The project is to be developed in stages, with stage one forecast by the company to cost \$3.2bn, and stage two requiring an additional \$1.5bn. On the basis of our projected prices for the three output products, we forecast the development as having the potential to generate net earnings of £163m (6p EPS) in its first year of production in 2013, increasing to almost £400m (15p EPS) once expanded production is bedded down. Our preliminary DCF calculations suggest an NPV10 value of £1.2bn (44p per share), taking into account the significant cash outflows ahead. This NPV increases to over £2.6bn at the commencement of production in 2013 as previous capex falls out of the future cash flow calculation. We estimate this as equivalent to 100p per share, based on our assumed level of additional equity, which would represent potential upside of more than 20x from current price levels. We argue that by end-2007, 15% of the total project risk should have been overcome and that on a risked NPV basis, a price of 7p could be justified on the basis of our commodity price projections.

We favour Altona as all of the hurdles required to underpin a Bankable Feasibility Study have been overcome or are about to be overcome, and the project economics remain robust. The risks ahead are not insignificant but we see the management of Altona approaching the development in a methodical and meticulous fashion that gives us comfort that successive hurdles should be cleared as they approach.

Project would be undertaken with external resources, regardless of who owns it.

We believe that the market has to date ignored the stock due to disbelief that such a large project could be undertaken by such a small company. We argue, however, that the market may not fully appreciate how such projects are undertaken in this day and age – major companies no longer have vast internal teams of engineers, the large consulting groups now do most of the work. This project will likely be progressed in precisely the same fashion, regardless of it being pursued by Altona or a major; the same hurdles must be overcome, the same processes employed, the same work must be done and the same external expert consultants will likely do it. Altona is managed by a coal expert in Chris Schrape, the CTL process is being put together by industry leader Jacobs Consulting, mining work is being undertaken by Hatch and other leading groups and financial modelling is being coordinated by Royal Bank of Scotland (RBS). The expertise and money are in place; all that is needed is time.

Having said this, we believe that the most likely outcome for Altona will be that it is taken over by an energy major as the prospect of such a large resource base in a safe jurisdiction should be too compelling to resist. But in the meantime, they are more than capable of adding value.

Business Case

7.5bn tonnes of coal

Altona proposes to construct an integrated CTL plant on the back of the previously defined Arckaringa coal resources in northern South Australia. The project includes development of a coal mining operation to provide feedstock to the CTL plant.

The Arckaringa coal field contains approximately 7.5bn tonnes of sub-bituminous coal, spread across three closely spaced deposits: Westfield, Wintinna and Murloocoppie. Westfield is by far the largest of the three and will provide feedstock to the CTL plant.

Figure 1: Resource Figures

	Measured (million t)	Indicated (million t)	Inferred (million t)	Total (million t)
Wintinna	1,150	750	2,000	3,900
Murloocoppie	250	300	2,600	3,150
Westfield	100	200	500	800
Total	1,500	1,250	5,100	7,850

Source: Altona Resources – SADME Resource standard (non JORC)

The resource was discovered and drilled in the mid 1980s but not developed, as the high moisture content (38%) made it uneconomic, due to the cost of transportation to the main markets in Adelaide. The resources are currently defined to the now-defunct South Australian Dept of Minerals and Energy (SADME) standard. However this is not JORC-compliant, and a drilling programme is currently underway to convert a +50 year portion of the Wintinna resource to the JORC standard.

The conversion is roughly 1:1 – one tonne of coal is converted into one barrel of FT petroleum products, and co-generated electricity.

The production of liquid fuel is a two-step process: coal feedstock from the Wintinna deposit is to be converted to synthetic natural gas (Syngas) via the Conoco Phillips gasification process. Waste tail gases from this process would then be diverted to a standard gas turbine to generate electricity, with the bulk of the syngas then run through a Rentec Fisher-Tropsch (FT) plant to be converted to FT liquid products (81% ultra-low sulphur diesel and 19% Naphtha). Both processes are proven and exist in large-scale operation around the world, with SASOL in South Africa being the largest proponent, producing 160,000 bbl per day with plans to expand to 200,000 bbl per day.

Altona plans to develop the CTL operation in two stages. Stage one has been projected in the company's pre-feasibility to cost \$3.2bn and to produce 30,000 bbl per day (10m bbl per year) of liquids and 560MW of electricity generation. Stage two would then expand this to 45,000 bbl per day (16m bbl per year) and 900MW for an additional investment of \$1.5bn. We anticipate full feasibility to be completed in late-2008, and construction to commence early-2009 when the final corporate structure and financing is put in place. Subject to these hurdles being cleared, commissioning and production should be seen in 2013.

The Wintinna deposit contains sufficient resources for over 100 years of production at scheduled rates; however a 30-year life is being used in our financial analysis.

Figure 2. Staged Capex

	Stage 1	Stage 2
Capex	\$3.2bn	\$1.5bn
bbl per day	30,000	45,000
Electricity MW	560	900

Source: Jacobs Consulting

Commodity Price Assumptions

The Altona CTL plant design is geared to produce gas-fired electricity and FT liquid products comprised of 81% ultra-low sulphur diesel and 19% Naphtha. All three would make a contribution to revenue but being separate products, respond to different market forces.

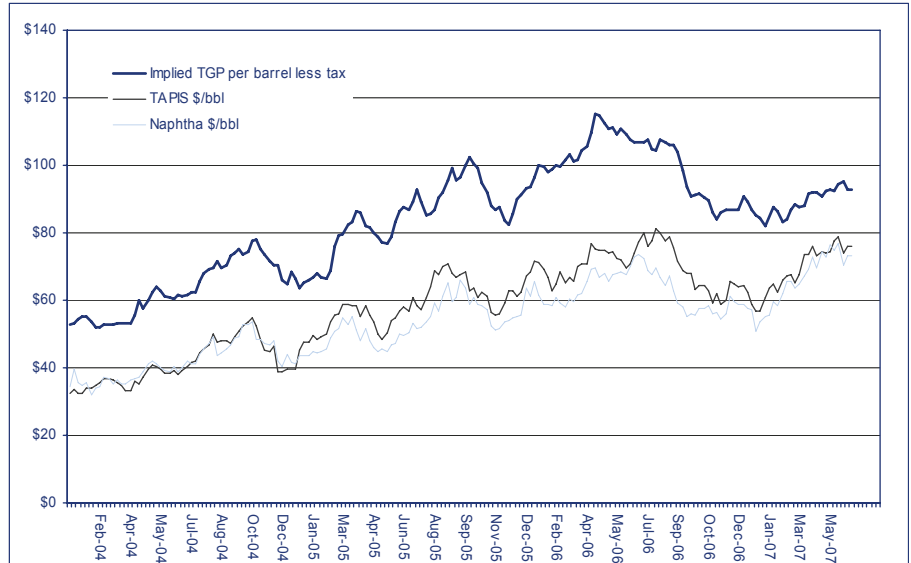
Liquids Price

Low-sulphur diesel fetches a substantial premium to crude

Diesel is a mid-level distillate, similar to jet fuel and heating oil and competes with these products in the refining stream. The diesel margin above spot crude varies according to seasonal demands for the three competing products, with the mix in SE Asia being driven by the Singapore market. Wholesale diesel prices in Australia (Terminal Gate Price – TGP), when corrected for local taxes and exchange rates, show an historical \$20/bbl premium to the TAPIS crude benchmark, as shown in Figure 3.

Naphtha, however, is a lower-level distillate used in petroleum refining and the petrochemical industry. It is traded in Europe and the price has historically been closely tied to the oil price, rarely moving outside the range of 0.9x to 1.1x the oil price.

Figure 3. Adelaide TGP and Naphtha versus TAPIS benchmark



Source Bloomberg

\$15/bbl premium

When TGP and Naphtha prices are combined in the 81:19 output ratio produced by the CTL plant, we are left with a product premium of roughly \$15/bbl above the crude benchmark. However, we must also take into account the fact that Altona will probably not sell its primary fuel product in Adelaide, but to remote towns and mining sites that currently buy their supplies from Adelaide at a significant freight premium. Altona will therefore likely achieve an additional 20% premium to the gate price because of its remote location.

Received product prices are therefore based on long-term oil price projections; we have used those from the US Energy Information Administration (EIA) as a reasonably objective base, plus a premium for the product and the location. Our model prices are well below current spot prices.

Electricity Price

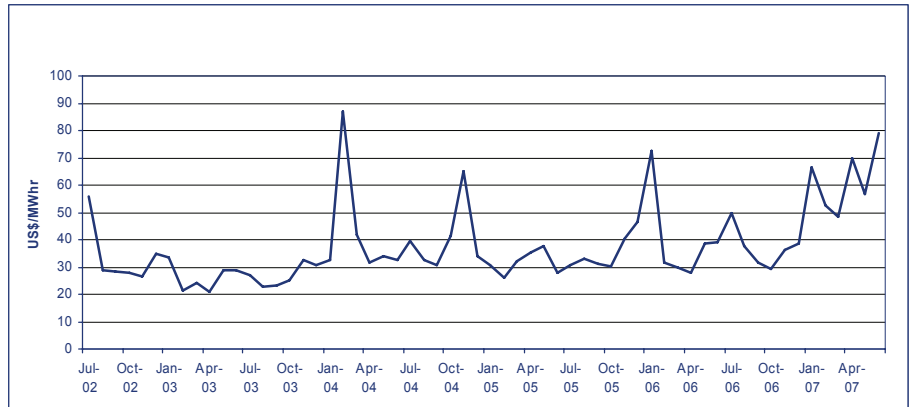
South Australian electricity prices have doubled in recent months

Internal project modelling carried out by Altona and its consultants was undertaken on the basis of a base electricity price of US\$30/MWhr, however the average daily spot price for electricity in South Australia by mid-2007 was US\$90/MWhr (source NEMMCO).

No new power stations planned in South Australia

South Australia is a net importer of electricity, with roughly 10% of total requirement being sourced from interstate. South Australian electricity prices have been reasonably stable for the last five years at around US\$30/MWhr with occasional summer peaks. However expansion of the South Australian economy and reduction of electricity available from the neighbouring state of Victoria pushed SA into supply deficit in late-2006. As a result, prices have therefore more than doubled in the last six months despite a move into winter. No capacity expansion is currently under construction and this supply tightness shows no sign of easing.

Figure 4. Historical South Australian electricity price – Five-year monthly average

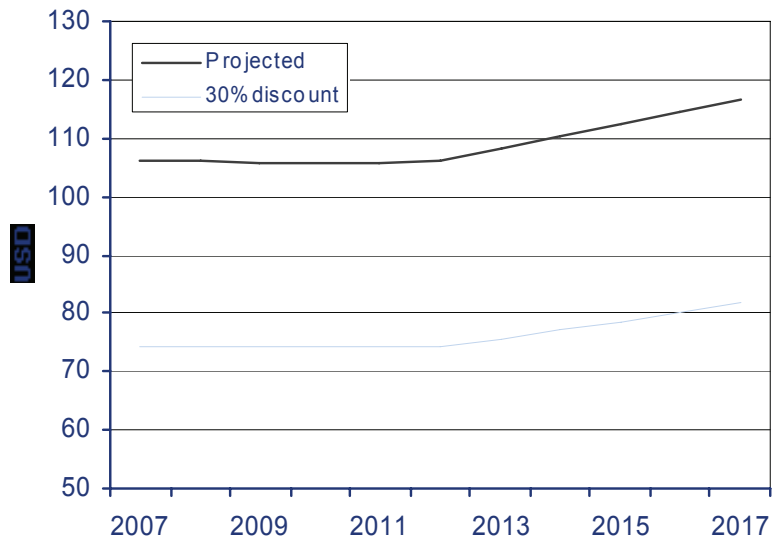


Source - NEMMCO

Lack of supply from Victoria and Commonwealth Government requirements to increase local supply mean that the South Australian deficit is projected by the South Australian Government to increase to 500MW by 2015, without taking into account a likely additional demand requirement of 500-1000MW from the Olympic Dam and Prominent Hill mining operations.

Altona will likely sell electricity on long-term contracts to local industrial consumers and so should not obtain these retail prices, however we forecast that achieved power prices will be well in excess of US\$30/MWhr. As an inflated case therefore, we have used these government projections with a 30% discount to take into account bulk sales to major industrial users.

Figure 5. Projected average retail electricity prices for South Australia



Source – South Australia Electricity Supply Industry Planning Council, Draft Annual Planning Report, June 2007

Operating Costs

Operating cost below \$20 bbl

Pre-feasibility studies published by Altona, have indicated that cash costs of the CTL plant should be in line with CTL industry averages of \$35/bbl. However when the base case \$30/MWhr electricity revenue is credited back to the CTL project, the effective cost of liquid production falls to \$20/bbl, which is in the lowest quartile of equivalent producers. Higher electricity prices increase this revenue credit in a linear fashion, such that at a \$60/MWhr electricity price, the implied cost of fuel production reduces to \$5/bbl, which is in line with normal oil and gas production numbers.

Future Funding Requirements

We view it as unlikely that Altona will develop the integrated CTL plant alone, or even manage the process. As a small company, Altona's stated strategy is to overcome the technical planning hurdles, take the project to the point of feasibility and to then bring in one or more major partners to fund and manage the development and construction.

£2m was raised in April 2007 to convert a portion of the Wintinna deposit to a JORC compliant resource and to complete technical coal testing, both of which are required to underpin the subsequent Bankable Feasibility Study.

Valuation of the company will depend on the ultimate share structure and equity involvement with JV partners. Negotiations with major partners are ongoing and several non-binding MOUs are in place; however the ultimate form of any JV is unknown. Therefore we will, for the time being, presume that Altona will fund the project entirely on its own via equity and debt in order to demonstrate the increase in project value over the next five years.

Capital-raising required in 2008 to fund BFS

Given that RBS is intimately involved in the development process, and the project is long-lived in a safe jurisdiction, project finance should in our view be readily available and we have used a roughly 80:20 debt equity split. For our calculations, therefore, we have assumed that £5m is raised in 2008 to fund ongoing CTL feasibility work. We have then forecast an additional £230m in equity-raising from 2009 to 2012, plus £1.2bn in debt funding over the course of the development. We have assumed that the second phase development follows immediately after completion of the first, and that all free cash from the operation of phase one is reinvested in the expansion.

Valuation

Although development plans are far from finalised, we have constructed a rudimentary model on the basis of Altona developing the project alone and using the price assumptions discussed. We have also assumed that the second stage development is undertaken almost immediately after completion of phase one, so that fully ramped-up production is reached in 2016.

Upside case

Although our price assumptions are higher than the conservative figures used by Altona in its preliminary studies, they are still below current spot prices for both power and fuel and are put forward as a demonstration of potential returns from the project in a reasonable case.

On this basis, as outlined in Figure 6, we forecast Altona becoming cash-positive in 2013 with net earnings of £168m (6.2p per share), increasing to over £400m (15p) after the phase 2 expansion

Figure 6: Forecast Income Statement

Income Statement £'000s	2012E	2013E	2014E	2015E	2016E	2017E
FT liquids price \$/bbl		80	82	82	85	85
Power price \$/MWhr		75	75	77	78	79
Sales		576,400	591,104	593,456	962,240	969,296
Less operating expenses		(175,000)	(175,000)	(175,000)	(280,000)	(280,000)
Net Operating Expenses	(350)	401,400	416,104	418,456	682,240	689,296
Operating Profit	(350)	401,400	416,104	418,456	682,240	689,296
Interest Charge		(83,287)	(82,250)	(75,250)	(50,750)	(16,625)
Loss on ordinary activities before taxation	(350)	318,113	333,854	343,206	631,490	672,671
Depreciation		(84,186)	(100,978)	(100,978)	(100,978)	(101,478)
Earnings after Depreciation	(350)	233,927	232,876	242,228	530,512	571,193
Tax charge		(65,297)	(69,863)	(72,668)	(159,154)	(171,358)
Net Earnings	(350)	168,630	163,013	169,560	371,358	399,835
Per Share	(0.01)	6.19	5.99	6.23	13.63	14.68

Source: Matrix Corporate Capital estimates

Under this scenario, our NPV10 valuation taken over the next 30 years is £1.2bn with an IRR of 18.8%. If additional equity is raised along the lines of our assumptions, this equates to 44p per share. Although the IRR figure is not high, it must be remembered that this is a project IRR, taking into account all subsequent capital investments. This IRR is well within the acceptable ranges for major resources companies and therefore leaves open the takeover scenario. Given the option status of Altona, the potential share price uplift to current shareholders is more significant.

In our view, Altona has been undervalued by the market because of disbelief in the project being completed by a small company and by difficulties associated with valuation during the long and costly development and construction phase.

Risked NPV

At the point of reliable production, we would anticipate the market valuing Altona on the basis of its revenue stream, however in the meantime it is a value-curve play and a long one at that. Because of this time and complexity, we argue that the most appropriate valuation methodology at this time is that of Risked NPV.

15% of risk overcome by 2007

We believe that by the completion of this current drilling programme, associated coal testing and establishment of a JORC-compliant resource, Altona will have overcome 15% of the total project risk. This is a subjective judgement, however, by this point, Altona would have a proven resource and would have compiled all of the necessary technical inputs to complete the Bankable Feasibility Study. The remaining risks then will be associated with execution.

On this simple basis, we place a price target of 7p on Altona by the completion of the resource calculation by the end-2007. However as we see the resource-drilling process as largely an administrative conversion from an old resource standard, we rate the risks associated with the process as low and would argue that this valuation is justified in advance of the new resource figure.

Work in 2008 will concentrate on developing the full feasibility plan for the development. This will be a complex task, however it should to a large extent draw on much of the pre-feasibility work completed to date. It must however be understood that final feasibility is not designed to determine whether a project is viable – this would have already been determined in earlier studies, and an expensive final study would not be undertaken unless all major financial hurdles had been overcome. Final feasibility is instead a detailed plan of how the development will proceed, most importantly providing a detailed analysis of project costs and timeframes. As a result, whilst this work does represent an additional risk reduction, the risk impact is not large, as the complexity of the development weights the bulk of risk in the execution phase.

To take longer view of the value of the project at the point of production, in the currency of the day, we have recalculated the NPV as it would stand in 2013 after all capital has been raised and invested. This NPV value in (2013 currency) is £2.7bn, or 100p per share, suggesting the potential of a 20x uplift from current levels over the course of the development.

We hold the view that at least one major resources company will take a stake in the project, probably prior to the commencement of construction, once the final feasibility studies are nearing completion. An obvious candidate would be BHP Billiton, as the development would be a valuable adjunct to its Olympic Dam expansion plans. The ultimate form of a JV would either be via an equity stake in Altona or a stake in the project, and while negotiations with several majors are ongoing, with MOUs signed, the short-term impact is negligible and we will thus revisit this issue if circumstances change.

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