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Nexus Energy (NXS)

Analyst

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Authorisation

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Quality assets will prevail

Recommendation

Buy

Price

\$0.335

Target (12 months)

\$0.49

New MD Richard Cottee is on his first roadshow with the company since joining in early May. Having strengthened the financial position of the company his priorities are now on re-starting the Longtom gas field and negotiating a commercially sensible agreement with Shell for the Crux project development. We expect significantly improved visibility for the company's future before Christmas. Buy.

Expected Return

Capital growth **46%**

Dividend yield **0%**

Total expected return **46%**

Company Data & Ratios

Enterprise value **\$603m**

Market cap **\$325m**

Issued capital **958m**

Free float **100%**

12 month price range
\$0.21-\$0.42

GICS sector
Energy

Financial initiatives completed

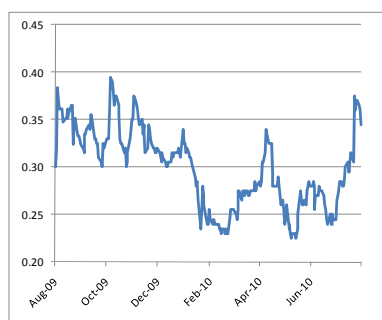
Since he joined in early May MD Richard Cottee has focused on strengthening the financial position of NXS. By establishing an Equity Line of Credit (ELOC) for \$50m, he has (1) been able to get work underway on the Longtom alterations needed to handle the mercury, (2) exchange the majority of subordinated notes for later repayment, and (3) engage Shell in more serious discussions about Crux development options.

Crux is the key attraction

Mr Cottee's key reasons to join NXS are the quality of the assets and the Board. He also admits to liking a challenge and while the mercury contamination in Longtom's gas is an unwanted problem it is solvable. He sees Crux as a particularly valuable asset, impaired by the complex commercial arrangement with Shell. With his track record as a commercial lawyer and MD of QGC as well as CS Energy, we believe there is a very high probability for a successful outcome for shareholders in NXS. Buy.

Disclosure: Southern Cross Equities assisted NXS with its placement and equity issue in September 2009 and received shares and fees as payment.

Absolute Price



SOURCE: IRESS

Earnings Forecast

Year end June 30	09A	10F	11F	12F
NPAT (reported) (A\$m)	-50.4	4.7	-17.5	4.1
NPAT (adjusted) (A\$m)	1.8	-23.5	-12.2	4.1
EPS (adjusted) (cps)	0.3	-2.7	-1.3	0.4
EPS growth (%)	N/A	N/A	-52%	-131%
PER (x)	115.0x	N/A	N/A	N/A
P/CFPS (x)	-16.0	16.4	113.8	7.1
EV/EBITDA (x)	10.2	-37.6	22.1	8.1
Dividend (¢ps)	0.0c	0.0c	0.0c	0.0c
Yield (%)	0.0%	0.0%	0.0%	0.0%
ROE (%)	0%	-5%	-2%	1%

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

House in order, now bring clarity to growth

Financial position enhanced

The challenge of building a successful oil & gas company at NXS became bigger the same week that Mr Cottee joined the company, as the Longtom gas field had to be shut down after mercury was found in the gas stream. Instead of starting with an asset providing a reliable steady cash flow of about \$70m pa, the company was faced with capital expenditures to fix the problem, as well as looming interest payments on both the project debt facility and the subordinated notes.

Mr Cottee executed an Equity Line of Credit (ELOC) for \$50m, which he doesn't intend to use but it provides back-up funds to the company if needed. This was crucial to get work started at the Santos operated gas plant which handles the gas from Longtom. It also enabled an agreement with 86% of the subordinated note holders, who agreed to exchange their notes to a 2017 maturity as opposed to a 2013 repayment. Interest payments have been delayed from July 2010 until 2012. The ELOC has also been pledged as security to Longtom's debt provider (BOSI) so they are covered while we await the return of cash flows.

All in all, the ELOC has been extremely useful in getting the company on a more secure financial footing, and without actually being used.

Mr Cottee makes the point that the ELOC will hopefully not be used as it can be quite dilutive and lead to downward pressure on the share price. If the company really needs funds, an equity issue is probably the preferred option.

Re-start Longtom in September

Santos is working to install the Mercury Removal Unit (MRU) and expected the gas plant to be operational in late September. The associated condensate requires a separate MRU which will not be installed until February 2011, but because of the relatively small volumes, the condensate can be sold at a discount until then.

The costs to install the MRU's are expected to be higher than the \$2m previously advised but below \$10m. Santos as operator of the plant invoices NXS as the work is completed. We have assumed capex of \$10m in our model.

Negotiate a win-win Crux deal with Shell

With the financial position of NXS strengthened and the Longtom work underway, NXS can now focus on the Crux project's future.

There are very good reasons to believe that a new commercial agreement between NXS, Shell and Osaka Gas can be reached for the development of Crux:

- The liquids stripping project is demonstrably commercial, and a Production License (PL) has been awarded to NXS. (The company calculates the value of tax payments to the Government at around \$1B on an oil price assumption of US\$70)
- The PL requires construction for the liquids stripping project to commence no later than March 2014.
- If not, the Government could potentially take the license back as no precedence exists to convert a PL into a Retention License (RL). Only Exploration Licences have been converted into RL's if they contain

discoveries which are commercially uncertain and as long as the Operator makes efforts to commercialise such discoveries.

- NXS has requested a 3 year extension of the December 2020 ownership rights to the liquids from Shell in order to finance the development.
- The alternative of NXS not proceeding with a liquids stripping project and handing over operatorship to Shell does not remove the risk of losing the licence. Shell may not be ready to proceed with a gas project by 2014 and has no incentive to do a liquids stripping project for the benefit of NXS and Osaka Gas.

To ensure the partners retain long term ownership of the Crux hydrocarbons, a new agreement needs to be made. We believe that the potential loss of the PL will focus the minds of all three parties.

NXS will need to give something up to get the desired 3 year extension, or to extract a firm commitment from Shell to develop the field as a FLNG project in conjunction with Prelude or in its own right. Shell will need to accommodate NXS's and Osaka Gas's rights to the liquids or risk Government intervention and upsetting a client, as Osaka Gas recently signed an LNG contract with Prelude.

It is very difficult to predict how a new arrangement may pan out, but it seems clear to us that a win-win agreement is available to the parties. With NXS having sorted out its short term financial issues and greater engagement from Shell, we expect a resolution before the end of this year.

Our valuation has adjusted up to \$0.49

We have made a few adjustments to our valuation of NXS, taking it from \$0.45 to \$0.49/share.

The key change in our assumption is that NXS only sells down 20% of its 85% equity in the Crux project, thereby retaining a greater 65% stake in this development. As our DCF values the project at \$9/bbl, it is better for the NXS valuation to retain equity, rather than selling down at \$5/bbl. A small reduction in our Longtom valuation was due to increased capex for the MRU installation. We have also reduced cash flow and earnings in FY11 due to Longtom costs and delayed revenues.

Figure 1 - NXS valuation

				DCF	DCF
Gas Reserves/Resources	Bcf	net	Mboe	\$m	/share
Longtom (100%)	350	350	62.5	322	\$0.34
Crux Gas (0%)	2,000	0	0.0	0	\$0.00
Echuca Sh (100%)	900	900	150.0	0	\$0.00
Total PJ	3,250	1,250	212.5	322	\$0.34
Liquids Reserves/Resources	Mb	net			
Longtom (100%)	5.0	5.0	5.0	40	\$0.04
Crux (assumed 65%)	70.4	45.8	45.8	412	\$0.43
Echuca Sh (100%)	60.0	60.0	60.0	0	\$0.00
Liquids Reserves Mboe	135.4	110.8	110.8	452	\$0.47
Exploration (No value recognised)				0	\$0.00
60% of franking credits (no value recognised)				0	\$0.00
Assumed payable for 20% Crux @ \$5/bbl				70	\$0.07
Cash (Net debt)				-135	-\$0.14
Unsecured notes				-143	-\$0.15
DCF of Corporate Costs \$15m pa				-99	-\$0.10
Total @ 10% discount rate Longtom / 12.5% Crux				467	\$0.49

SOURCE: SOUTHERN CROSS EQUITIES ESTIMATES

Nexus Energy Ltd

Company Description

NXS is an oil & gas explorer and developer, with two key assets. The Longtom gas field in Bass Strait is 100% owned, and is temporarily shut-down to install mercury screens. Annual cash flow will be about \$70m, and the field should have a field life up to 15 years. The Crux gas/condensate field in the Browse basin, WA has discovered about 2Tcf of gas and 75mmbbl of liquids. The dry gas remains the property of Shell, and NXS owns 85% of the liquids until the end of December 2020. However, if NXS decides not to develop an early liquids-stripping project and advises Shell accordingly, it retains the rights to the liquids forever.

Investment Strategy

NXS is essentially an explorer, which takes up 100% equity positions in new licenses and seeks funding of exploration drilling through farm-in partners. Both the Longtom and the Crux discoveries were made by prior owners of the areas, but deemed uneconomic at the time of discovery. NXS uses its technical skills to re-assess these types of discoveries, and undertakes the lower risk appraisal drilling to evaluate the commercial merits of the fields.

Valuation

Our valuation of NXS is \$0.49. This assumes a 10% discount rate for the producing Longtom gas field, and 12.5% discount rate for the Crux project. In addition, we have assumed that NXS sells a 20% stake in Crux for \$70m, representing a low \$5/bbl. Our actual NPV for Crux is \$9/bbl but our reasoning is that they need a partner to help them fund the development, and the partner will not pay full value to enter the project. We provide zero value for the exploration acreage held by NXS, although the upside from some prospects is high, notably the Echuca Shoals prospect in the Browse.

Net debt of the company stands at \$278m and is made up of \$135m net debt and \$143m of convertible notes.

Risks

NXS faces normal industry risks as well as some specific issues:

- Prices for oil and hydrocarbon liquids are inherently volatile, and strongly linked to the world economy and market conditions. Most of NXS's current cash flow is from contracted gas at Longtom, but Crux is leveraged to oil prices.
- Project execution at Crux is the key risk for NXS, and it needs to find a partner with financial strength, and potentially the operating capability to develop the project;
- 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, but this is not evident in the current price of NXS shares;
- Financing risks exist as NXS does not have the balance sheet or cash flow to fund the US\$700m Crux development at the current high 85% ownership.

Nexus Energy

as at 12 August 2010

Recommendation Buy
Price \$0.335
Target (12 months) \$0.49

Table 1 - Financial summary

Nexus Energy Ltd (NXS)						Share price: \$0.34					
As at 12/08/2010						Market cap (\$m): \$325m					
Recommendation: Buy											
Income Statement						Valuation Data					
Year end June 30	2009A	2010F	2011F	2012F	2013F	Year end June 30	2009A	2010F	2011F	2012F	2013F
Revenue	\$82.9m	\$22.4m	\$60.9m	\$107.7m	\$110.4m	Adjusted net profit	\$1.8m	-\$23.5m	-\$12.2m	\$4.1m	\$3.9m
EBITDA	51.6	-14.1	24.0	65.5	72.9	Adjusted EPS	0.3c	-2.7c	-1.3c	0.4c	0.4c
DD&A	-1.0	-14.3	-29.8	-45.3	-45.5	EPS growth	N/A	N/A	-52%	-131%	N/A
Exploration write-off	-16.8	-2.5	-5.0	-5.0	-5.0	P/E ratio	111.7x	N/A	N/A	N/A	N/A
EBIT	33.9	-30.8	-10.8	15.3	22.4	OpCFPS (exl. abnormals)	-2.2c	2.1c	0.3c	4.9c	4.4c
Interest	-31.3	-2.8	-6.6	-9.5	-16.8	Price/OpCFPS	-15.5x	15.9x	110.5x	6.9x	7.6x
Other	0.0	0.0	0.0	0.0	0.0	DPS	0.0c	0.0c	0.0c	0.0c	0.0c
Abnormals	-89.8	0.0	0.0	0.0	0.0	Yield	0.0%	0.0%	0.0%	0.0%	0.0%
Pre-tax profit	-87.2	-33.6	-17.5	5.8	5.6	EV/EBITDA	10.1x	-36.9x	21.7x	7.9x	7.1x
Tax	36.8	38.3	0.0	-1.7	-1.7	Profitability Ratios					
Reported net profit	-50.4	4.7	-17.5	4.1	3.9	Year end June 30	2009A	2010F	2011F	2012F	2013F
Adjusted net profit	1.8	-23.5	-12.2	4.1	3.9	EBITDA/sales	62%	-63%	39%	61%	66%
(adjusted net profit = pre-tax profit before abnormals minus tax at 30%)						ROA (average)	0%	-3%	-1%	0%	0%
Cashflow						ROE (average)	0%	-5%	-2%	1%	1%
Year end June 30	2009A	2010F	2011F	2012F	2013F	Dividend cover	N/A	N/A	N/A	N/A	N/A
Reconciliation						Effective tax rate	42.2%	113.9%	0.0%	30.0%	30.0%
Net profit	-\$50.4m	\$4.7m	-\$17.5m	\$4.1m	\$3.9m	Liquidity & Leverage					
Exploration write-off	16.8	2.5	5.0	5.0	5.0	Year end June 30	2009A	2010F	2011F	2012F	2013F
Depreciation	1.0	14.3	29.8	45.3	45.5	Net debt	\$169.6m	\$194.5m	\$314.7m	\$395.6m	\$576.9m
Change in working capital	0.0	-2.8	-14.4	-7.3	-11.9	Net debt/equity	37.6%	37.1%	62.1%	77.5%	112.1%
Other	18.6	0.0	0.0	0.0	0.0	Interest cover	1.1x	-11.1x	-1.6x	1.6x	1.3x
Net operating cashflow	-14.1	18.6	2.9	47.0	42.6	Assumptions					
Investing cashflow						2009A	2010F	2011F	2012F	2013F	
Capex PPE & Development	-314.7	-135.2	-106.5	-108.5	-197.0	Liquids production (Mboe)	0.0	0.1	0.2	0.3	4.0
Exploration	-19.6	-5.0	-10.0	-10.0	-10.0	Gas production (PJ)	0.0	5.8	15.5	25.0	25.0
Acquisitions / Divestments	131.7	70.0	0.0	0.0	0.0	Production (Mboe)	0.0	1.0	2.8	4.5	8.2
Net investing cash flow	-202.5	-70.2	-116.5	-118.5	-207.0	Oil price (US\$/bbl)	70.11	73.59	75.00	80.00	81.51
Financing activities						Eastern Aust Gas price (\$/GJ)	2.16	2.99	3.08	3.16	3.25
Issue of shares	8.2	74.5	0.0	0.0	0.0	Exchange rate (A\$/US\$)	0.748	0.857	0.818	0.790	0.767
Buy backs	0.0	0.0	0.0	0.0	0.0	DCF Valuation					
Dividends paid	0.0	0.0	0.0	0.0	0.0	DCF	DCF	DCF	DCF	DCF	
Borrowings	4.6	-10.0	100.0	100.0	150.0	Gas Reserves/Resources	Bcf	net	Mboe	\$m	DCF /share
AED deposit (returned)	35.0	-35.0	0.0	0.0	0.0	Longtom (100%)	350	350	62.5	322	\$0.34
Others	0.3	-2.8	-6.6	-9.5	-16.8	Crux Gas (0%)	2,000	0	0.0	0	\$0.00
Net financing cash flow	48.1	26.7	93.4	90.5	133.2	Echuca Sh (100%)	900	900	150.0	0	\$0.00
Net change in cash held	-168.5	-24.9	-20.2	19.0	-31.2	Total PJ	3,250	1,250	212.5	322	\$0.34
Balance Sheet						Liquids Reserves/Resources	Mb	net			
Year end June 30	2009A	2010F	2011F	2012F	2013F	Longtom (100%)	5.0	5.0	5.0	40	\$0.04
Assets						Crux (assumed 65%)	70.4	45.8	45.8	412	\$0.43
Cash assets	\$55.4m	\$30.5m	\$10.3m	\$29.4m	-\$1.9m	Echuca Sh (100%)	60.0	60.0	60.0	0	\$0.00
Receivables	9.3	3.4	9.1	10.8	4.4	Liquids Reserves Mboe	135.4	110.8	110.8	452	\$0.47
Other financial assets	7.2	7.2	7.2	7.2	7.2	Exploration (No value recognised)				0	\$0.00
Prepayments	3.5	0.4	0.4	0.4	0.4	60% of franking credits (no value recognised)				0	\$0.00
Total current assets	75.5	41.5	27.1	47.8	10.2	Assumed payable for 20% Crux @ \$5/bbl				70	\$0.07
PPE & Development	656.1	748.3	831.6	904.3	1072.6	Cash (Net debt)				-135	-\$0.14
Exploration & Evaluation	31.1	33.6	38.6	43.6	48.6	Unsecured notes				-143	-\$0.15
Other financial assets	0.0	0.0	0.0	0.0	0.0	DCF of Corporate Costs \$15m pa				-99	-\$0.10
Intangible assets	0.6	0.6	0.6	0.6	0.6	Total @ 10% discount rate Longtom / 12.5% Crux				467	\$0.49
Deferred tax assets	61.5	61.5	61.5	61.5	61.5	Valuation sensitivities					
Total non-current assets	749.3	843.9	932.3	1010.0	1183.3	Oil price assumption at Crux start mid 2013				\$m	\$/sh
Total assets	824.7	885.4	959.3	1057.8	1193.4	Base case		US\$80		467	\$0.49
Liabilities						Low case		US\$50		158	\$0.16
Short-term debt	0.0	0.0	0.0	0.0	0.0	High case		US\$100		703	\$0.73
Payables	55.7	36.4	27.7	21.1	5.6	Crux Capex (NXS' base case is US\$900m)					
Current tax liabilities	0.0	0.0	0.0	0.0	0.0	Base case		65% of US\$900m		467	\$0.49
Provisions	0.0	7.3	7.4	8.4	5.6	Higher capex		65% of US\$1000m		419	\$0.44
Other liabilities	0.2	0.2	0.2	0.2	0.2	Lower capex		65% of US\$800m		504	\$0.53
Total current liabilities	55.9	43.9	35.3	29.7	11.4	Crux equity sell-down (assuming 70mmbbl)					
Long-term debt	225.0	225.0	325.0	425.0	575.0	Base case		20% for \$70m (\$5/bbl)		467	\$0.49
Deferred tax liabilities	39.0	39.0	39.0	39.0	39.0	Reasonable case		20% for \$105m (\$7.50/bbl)		502	\$0.52
LT provisions	53.3	53.3	53.3	53.3	53.3	Upside case		20% for \$140m (\$10/bbl)		537	\$0.56
Total non-current liabilities	317.3	317.3	417.3	517.3	667.3	Mitsui equivalent case		20% for US\$250m (\$14/bbl)		593	\$0.62
Total liabilities	373.1	361.2	452.6	547.0	678.7	Crux FLNG option (assuming 112mmbbl)					
Net assets	451.6	524.2	506.7	510.8	514.7	Retain 45% of Liquids		Sale of 40% for \$134m (\$3/bbl)		448	\$0.47
Equity						Retain 35% of Liquids		Sale of 50% for \$168m (\$3/bbl)		406	\$0.42
Contributed equity	469.8	525.5	525.5	525.5	525.5	Retain 25% of Liquids		Sale of 60% for \$202m (\$3/bbl)		379	\$0.40
Retained earnings	-18.2	-1.3	-18.8	-14.7	-10.8	Discount rate					
Total equity	451.6	524.2	506.7	510.8	514.7	Base case		12.5%		467	\$0.49
Diluted shares on issue	653.8	966.5	966.5	966.5	966.5	Low case		10.0%		523	\$0.55
W/Avg diluted shares on issue	651.7	883.3	966.5	966.5	966.5	Conservative case		15.0%		401	\$0.42
Peer group comparison											
						EV	2P	3P	EV/2P	EV/3P	
						\$m	Mboe	Mboe	\$/boe	\$/boe	
						AWE	581	69	113	\$8.42	\$5.15
						CVN	230	17	46	\$13.87	\$4.99
						HZN	333	21	57	\$15.51	\$5.83
						ROC	377	19	89	\$19.94	\$4.23
						Peer group average				\$14.44	\$5.05
						NXS	603	113	323	\$5.32	\$1.86

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 0% and +15% on a 12 month view

Reduce: Expect -15% and 0% total return on a 12 month view

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

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Disclosure: Southern Cross Equities assisted NXS with its placement and equity issue in September 2009 and received shares and fees as payment