

Tuesday, 22 November 2011

MEO Australia Limited (MEO)

Stronger and more diversified

- After a year of quietly rebuilding and diversifying its exploration portfolio, oil and gas explorer MEO Australia is about to embark on an extraordinarily active year that should help crystallise value for shareholders.
- In Australia, MEO will participate in at least one and possibly two Timor Sea wells funded by Italian energy giant ENI that should, with some degree of finality, prove or disprove the commerciality of the Heron and Blackwood gas discoveries. Assuming success in at least one of the wells, the ground will be set for discussions between ENI and MEO about gas reserve pooling and building a case for a joint LNG/methanol plant development. In the Bonaparte Basin, offshore Western Australia, newly acquired acreage is close to gas pipelines and offers further upside at relatively low risk.
- In Indonesia, MEO has identified a number of high-impact exploration plays and will likely farm out some of its Seruway production sharing contract (PSC) to a major industry player during 2012. Due to earlier successful wells in this permit, the chances of confirming commercial hydrocarbons is much better than average.
- We have upgraded our MEO valuation range to reflect the recent additions of Bonaparte Basin (WA) and Indonesian acreage. Despite applying severe risk factors to new projects, our valuation has increased from 30 cents per share to 38 cents per share.
- **Recommendation:** MEO Australia offers investors exposure to high-impact oil and gas exploration and development projects in Australia and, in the near future, selected international locations. The stock trades below our central valuation of 38 cents per share. MEO shares are high risk and unsuited to investors with low risk tolerance. We rate MEO as a Buy.

In Brief

Recommendations

Rating: Buy
Risk: High
Share Price: **\$0.19**
Price Target: \$0.36

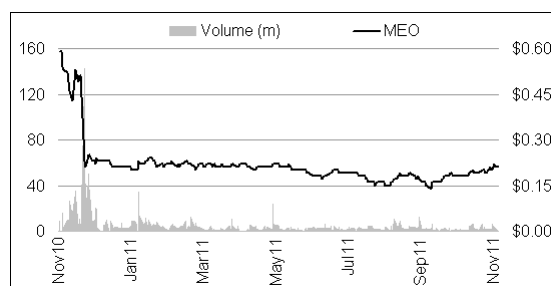
Snapshot

Monthly Turnover \$12.7m
Market Cap \$105m
Shares Issued 539.9m
52-Week High \$0.56
52-Week Low \$0.14
Sector Energy

Business Description

MEO Australia Limited (MEO) is an oil and gas exploration company, aiming to develop gas discoveries in the Timor Sea as well the Tassie Shoal methanol project. The company intends to build a portfolio of international projects.

12-Month Price and Volume



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Disclosure: The author owns no shares in MEO.

Recommendations

Buy: The stock's total return is expected to increase by at least 10-15 percent from the current share price over the next 12 months.

Hold: The stock's total return is expected to trade within a range of $\pm 10-15$ percent from the current share price over the next 12 months.

Sell: The stock's total return is expected to decrease by at least 10-15 percent from the current share price over the next 12 months.

MEO Australia: Investment Summary

Year to 30 Jun		2010	2011	2012	2013	2014
Revenue	\$m	1	33	3	3	3
EBITDA	\$m	-4.1	14.9	-3.9	-4.5	-5.1
EBIT	\$m	-4.3	14.8	-4.1	-4.7	-5.3
Reported Profit	\$m	-4.8	13.7	-4.1	-3.3	-3.7
Adjusted Profit	\$m	-4.8	13.7	-4.1	-3.3	-3.7
EPS (reported)	¢	-1.1	2.7	0.0	0.0	0.0
EPS (adjusted)	¢	-1.1	2.7	0.0	0.0	0.0
EPS Growth	(%)	N/A	N/A	N/A	N/A	N/A
PER (reported)	(x)	N/A	6.9	N/A	N/A	N/A
PER (adjusted)	(x)	N/A	6.9	N/A	N/A	N/A

2012 – year of delivery

- After a year of quietly rebuilding and diversifying its exploration portfolio, oil and gas explorer MEO Australia is about to embark on an extraordinarily active year that should help crystallise value for shareholders.
- In Australia, MEO will participate in at least one and possibly two Timor Sea wells funded by ENI that should, with some degree of finality, prove or disprove the commerciality of the Heron and Blackwood gas discoveries. Assuming success in at least one of the wells, the ground will be set for discussions between ENI and MEO about gas reserve pooling and building a case for a joint LNG/methanol plant development.
- It is widely believed that ENI was the party that recently purchased 40 percent of the Evans Shoal gas field in the Timor Sea for US\$350 million from Santos, with \$250 million paid upfront and the remainder paid upon a final investment decision. As ENI is now funding up to \$250 million in exploration and appraisal work in the Heron and Blackwood fields, it appears obvious to the casual observer that the Italian energy giant is working on a regional consolidation and development play.
- The following table highlights current equity holdings in the Evans Shoal and Heron/Blackwood projects, on the assumption that ENI is confirmed as the new owner of 40 percent of Evans Shoal and other parties do not exercise pre-emptive rights. We also assume that ENI takes up its options to move to 75 percent ownership of Heron and Blackwood.

Timor Sea LNG/Methanol Consolidation

Pro-forma share of merged gas fields

		Evans Shoal	Heron **	Blackwood **	Total
<i>Resources</i>					
Recoverable Gas	bcf	6600	4960	1500	13060
CO ₂ content	%	28%	15%	25%	23%
<i>Equity Interests</i>					
ENI Group*	%	40%	75%	75%	57%
MEO	%		25%	25%	12%
Shell	%	25%			13%
Petronas	%	25%			13%
Osaka Gas	%	10%			5%

* Assumes Shell does not exercise pre-emption

** Blackwood and Heron resources are estimates

- ENI has committed up to \$350 million to Evans Shoal and up to \$280 million to Heron/Blackwood. These sums – and the speed with which they have been committed – can only be justified if ENI's strategy is to build an LNG/methanol project that is aiming to get off the ground this side of 2020.
- **Heron/Blackwood program.** ENI farmed into NT/P68 – the lease holding the Heron and Blackwood gas discoveries – on the basis of a staged buy-in. ENI has the right to withdraw from the project after the first well, Heron 3, which will be drilled early in 2012.
- If Heron 3 is not a success and fails to find commercial hydrocarbons, ENI can walk from the permit with no further obligation or it can keep funding the program in the hope that the Blackwood field will become a producer. As the Heron field is the larger of the two, we think it safe to assume that ENI will walk if Heron 3 fails to meet its technical expectations, with production wells capable of producing around 20 million cubic feet of gas per day.

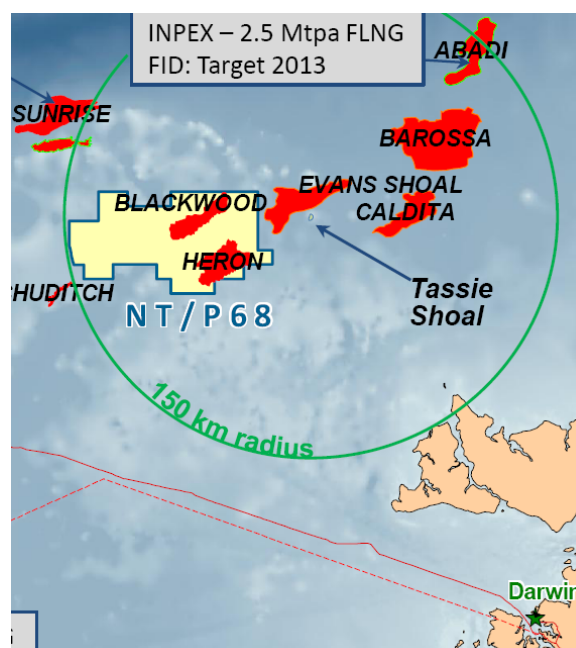
- **Value implications.** The success of Heron 3 would have dramatic value implications for MEO, as a good outcome would give a clear look-through valuation for the 25 percent balance of the project for MEO.
- Using a mid-point recoverable gas resource of 6.1 trillion cubic feet and a post-drill value of 30 cents per gigajoule (combined for Heron and Blackwood), we see the value upside to MEO at around \$541 million, or approximately 70 cents per diluted share, in the ENI joint venture. The following table shows our estimate of the value created if the Heron and Blackwood exploration programs are a success and ENI exercises its options to move to 75 percent ownership of the permit.

MEO Australia

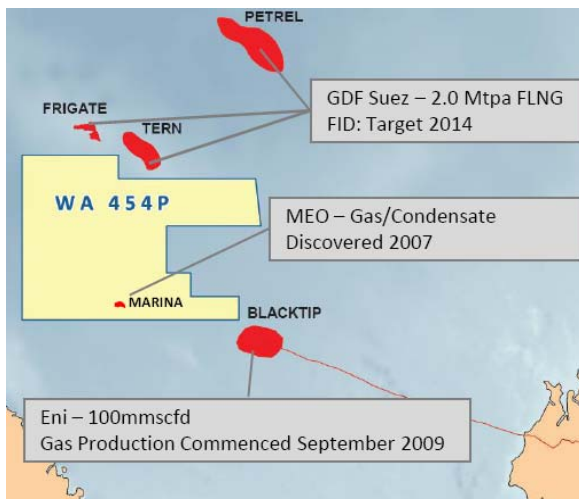
ENI farm-in value metrics

	\$m
Cost of First Heron Well	60
Cost of Second Heron Well	60
Blackwood 3D seismic cost	15
Cost of Blackwood well	35
Free Carry MEO to FID	45
FID Bonus Payment	75
Total permit cost upon success	290
ENI maximum acquired interest	75%
Implied value to MEO	
Cash component	75
Success resource component	466
Total value upside to MEO	541
Per diluted MEO share	\$/shr 0.70

- **The case for consolidation.** The Blackwood, Heron, Evans Shoal, Caldita, Barossa and Abadi gas fields all lie close to each other and collectively are thought to have between 13.3 Tcf and \$19.5 Tcf of gas. The economic case for merging all or most of the projects – which have varying ownership structures – is overwhelming. All of the fields have relatively high CO₂ levels, so a common mitigation strategy (conversion to methanol, re-injection) would save billions. What has been missing has been recognition from all parties that only a unified project stands a chance of reaching commercial sanction. The emergence of ENI may be the beginning of a change.



- The second leg of MEO's Australian value realisation campaign in 2012 will be based on the recently acquired Bonaparte Basin exploration permit WA-454P. The permit contains the Marina gas/condensate discovery drilled by Drillsearch and ExxonMobil in 2007. The Drillsearch team was looking for oil and consequently, when wireline logs and drill stem tests showed that the formations were tight, plugged and abandoned the well. MEO believes that the well was not configured properly for examining gas productivity and that a properly executed gas exploration/appraisal well would produce better flow results.
- Also in this permit are two big structures – Lighthouse and Breakwater – which offer promise of gas and gas/condensate reservoirs. On its own WA-454P might be marginal, but the proximity to the under-utilised Blacktip gas pipeline to Darwin would justify the development of even relatively small gas/condensate discoveries due to the low infrastructure costs.
- An alternative commercialisation route for gas and condensate discovered in the WA-454P permit would be to sell gas to the nearby GDF Suez Bonaparte floating LNG project. The GDF Suez Bonaparte project is based on the Petrel, Frigate and Tern gas fields, the latter two of which are just a few kilometres from the northern border of the WA-454P permit.
- **Next steps.** The next move for MEO will be to acquire a 3D seismic survey across the most prospective zones of WA-454P and, following analysis, will seek out a joint venture partner to fund most of the cost of drilling 1-2 wells.
- **Value upside.** Currently the MEO share price values WA-454P at nil. Modest exploration success would, in our view, add 5-10 cents per share to valuations.



- **Indonesia – Seruway PSC.** The Seruway production sharing contract (PSC) is composed of leases that were originally part of the ExxonMobil acreage located on the north coast of Sumatra. Several years ago ExxonMobil made a strategic decision to stop investing in the Sumatra region as the local market – the ARUN LNG facility – was running short of gas and Exxon wanted to focus on greenfields developments such as Gorgon and PNG.

- Exxon relinquished the Seruway PSC acreage and this was picked up by privately owned Transworld Group, which subsequently passed control to MEO in return for a small upfront cash payment and a modest production royalty. The ARUN LNG facility, which operates at about one-third of its capacity, is now up for sale. Irrespective of the new owner of ARUN, any new gas found will find a ready market at the LNG plant.
- **Regional gas market setting.** MEO was attracted to Indonesia because of the attractive gas market dynamics – many old fields which had been major LNG producers were in steep decline and yet domestic gas demand (for fertiliser, power generation and petrochemicals) is growing strongly. Indonesia's gas demand is predicted to grow so strongly that there are some suggestions that Indonesia – once one of the world's four largest LNG exporters – will become an importer by 2020.
- The Seruway PSC contains two gas discoveries – Gurame and Kuala Langsa – and a number of prospects that made modestly successful drill results in the past but were never fully explored.
- **Gurame.** The Gurame field was discovered with several exploration wells in the 1960s, with mixed flow rates of gas and oil from at least two potential production zones. MEO plans to secure an independent resource estimate for the Gurame field next year and work up a new development plan for the field, thereby meeting the main pre-condition for retention of the PSC. MEO may drill a sole-risk exploration well or alternatively farm out. The following table shows preliminary resource estimates. The presence of oil in the lower Belumai Formation makes the field an obvious first candidate for development, although the project would be economic on gas production alone due to shallow water depths and proximity to gas gathering pipelines.

Resource Estimates	Lower Belumai Hydrocarbon Estimates		
	P90	P50	P10
Recoverable Gas (Bscf)	322	490	737
Recoverable Oil (MMstb)	15	25	41

- The Gurame field was thought well advanced enough that ExxonMobil in 2001 worked up a field development concept that would have been based on 10 gas/condensate wells delivering up to 125 million cubic feet per day to the ARUN LNG plant. However, this project was never sanctioned, most likely because of the low oil prices at the time of that study (in 2001, oil prices were below \$30 per barrel) and the onerous fiscal regime at that time. Now with oil prices above \$90/bbl, and the fiscal terms significantly relaxed since ExxonMobil owned the permit, the project looks economically attractive.
- Very high depreciation rates on gas development costs – the developers are allowed to write off the project development cost in the first five years – would give the project a very low tax rate and high levels of free cash flows over the first five year, which is the period of anticipated stabilised production

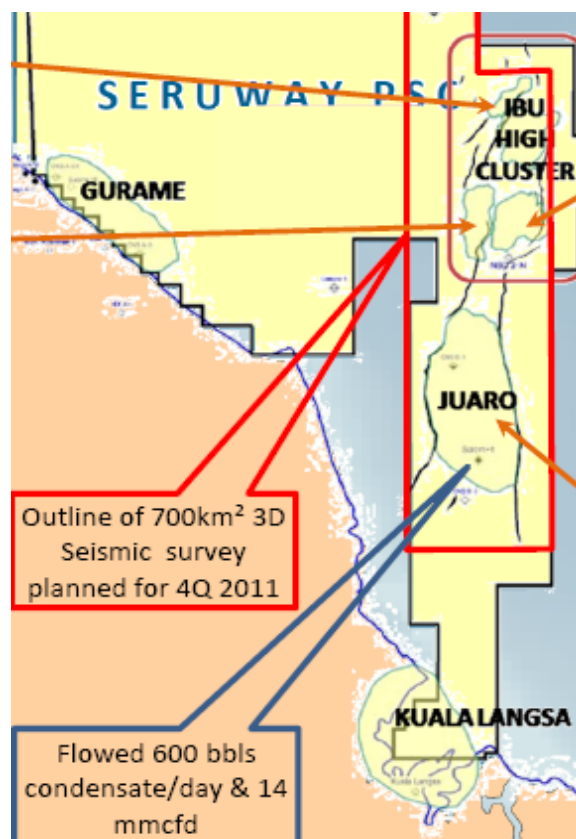
before natural decline sets in. Given the attractive nature of the fiscal terms applying to the Seruway PSC, we would be surprised if potential farminees would not offer to cover the cost of the first two to three wells to secure a stake in the project.

- **Kuala Langsa.** The main body of the Kuala Langsa gas field sits into the onshore Bock A PSC, owned by PT Medco and Premier Oil. The field has extremely high CO₂ levels (80 percent) and therefore net recoverable sale gas is much lower than the field's size would indicate. The north eastern edge of the field overhangs into the Seruway PSC, with perhaps 10-15 percent of the gas in place attributable to MEO. The following table shows a preliminary resource estimate (net to MEO).

Resource Estimate	MEO Share		
	P90	P50	P10
GIIP (Bscf)	1,795	2,315	3,066
Hydrocarbon GIIP (Bscf)	533	762	1,097
Recoverable H.C Gas (Bscf)	369	532	772

- **Ibu Horst Structural High.** The Ibu Horst at the eastern end of the PSC contains a series of structural targets which have a high probability of containing large gas/condensate accumulations.
- During exploration drilling in the 1980s the Japex B1 well flowed 14 million cubic per feet of gas and 600 barrels per day of condensate, a very high liquids to condensate ratio. Another well in the area, Salem -1, flowed 19 million cubic feet of gas and 38 barrels of condensate per day.
- The early explorers were looking for much bigger targets (given low oil prices at the time) and never explored further. Also, low quality seismic data at the time limited data on drilling locations and wells were often drilled slightly off structure.
- MEO plans to rectify the knowledge gap by acquiring 700 square kilometres of 3D seismic over the Ibu Horst structure to gain a better understanding of the leads and prospects in the area and de-risk future exploration drilling. The seismic survey is currently being run.
- There are no current estimates of the size of the Ibu Horst gas/condensate but the field's original operator, Caltex, estimated that the reservoir had the potential to contain 300 million barrels of oil equivalent in gas/condensate fields. At least three to four exploration wells would be required to prove this thesis.
- MEO plans to drill one well on the Ibu High in the fourth quarter of 2012. Regardless of whether the company drills the well on a sole-rise basis, or farms out to another oil company, the planned Ibu High well will have a big impact on perceptions of the upside in Seruway. Another well with similar flow rates to Japex B1's would lead to a dramatic re-rating.
- The following map shows the locals of the Ibu High structure. The Japex B1 well was drilled in the lower margin of the Juaro structure.

- **Partnerships.** MEO's principal skill base lies in identifying and de-risking high-impact exploration plays within very tight time frames. These skills have significant appeal to large oil companies which need to replace reserves at an affordable cost without the need to run a 300-man new project unit. MEO has developed close relationships with Petrobras of Brazil and ENI by being able to identify and secure interesting projects. MEO's ability to develop strong relationships with the likes of Petrobras and ENI is a key strength.



- **Balance sheet and funding.** MEO has done better than most in the small cap E&P sector in managing exploration risk by farming out the bulk of its exploration costs to farm-in partners, and has retained further upside upon success. For example, in the NT/P68 (Heron & Blackwood) farm-out to ENI, MEO negotiated a free carry on exploration costs to a final investment decision, plus a \$75 million bullet payment at FID. While MEO will only retain 25 percent of the Heron and Blackwood fields upon success, the company will not put itself at risk and would end up with an asset worth at least \$250 million in a fire sale and more than \$700 million post development. Assuming that MEO continues to use such cleverly-structured farm-out deals, the company should be able to keep future equity capital needs to a minimum.
- As of 30 September the company had \$90 million in cash, and a forward work commitment of less than \$30 million.
- **Valuation.** We value each MEO permit by estimating the amount of recoverable hydrocarbons and then applying a probability factor (chance of success) to each potential resource. Our probability factors range from 5 percent to 30 percent. Due to gaining a better understanding of the Indonesian assets, we have upgraded our valuation from 30 cents per share to 38 cents per share. A breakdown of our valuations is shown on the following page.

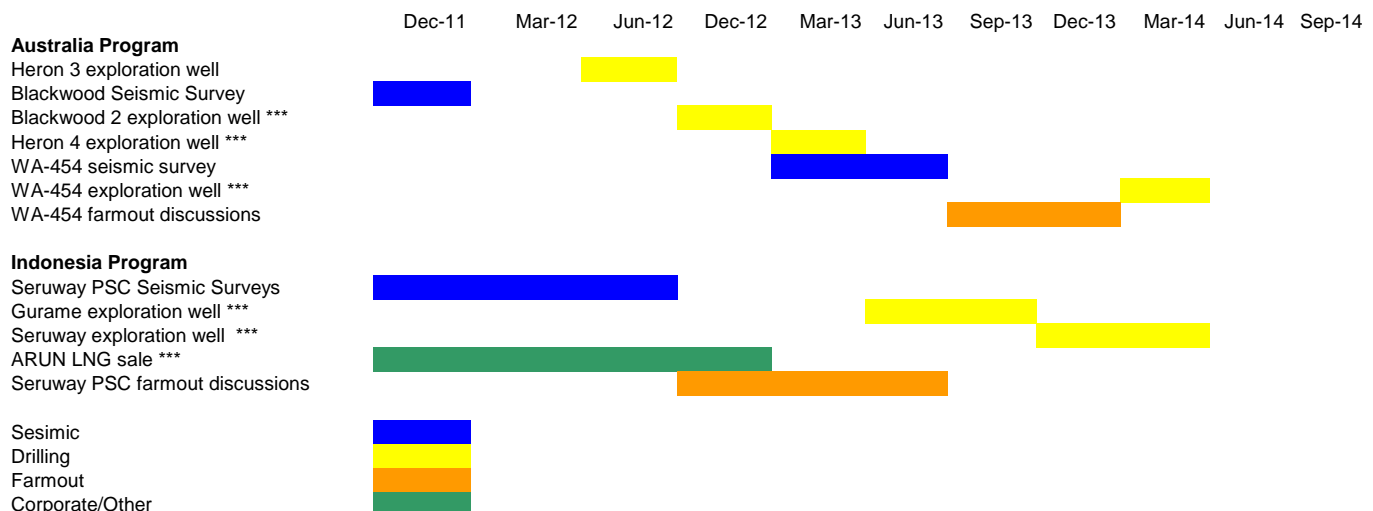
- High risk. MEO Australia has not yet established sustainable cash flows from operations and therefore performance of its share price is dependent on the outcome of exploration activities. Due to these characteristics MEO shares will be highly volatile and the stock is therefore unsuited to investors with a low level of risk tolerance.

MEO Australia - Permits and Indicative Valuation Metrics

						Nov-11					
						Riskd P50 Resource	Riskd P50 Resource	MEO P50 Share	MEO P50 Share	MEO P50 Value	MEO P50 Value
						Low	High	Low	High	Low	High
						mmboe	mmboe	mmboe	mmboe	US\$m	US\$m
		GIP	P90	P50	P10						
		Bcf	Bcf	Bcf	Bcf						
			**	**	**						
WA-360-P	US\$m									1	2
WA-361-P	US\$m									10	15
Tassie Shoals Methanol	US\$m									38	91
NT/P68 - Heron Gas	US\$m	11240	3660	4960	6640					60	90
NT/P68 - Blackwood Gas	US\$m	1500	1000	1250	1500					30	45
ACP50, ACP51	US\$m	1000	600	900	1200					9	18
Indonesia	US\$m	11000	2000	4000	6000					39	57
Cash	US\$m									92	92
Commitments/Corporate	US\$m									-65	-65
Gross Enterprise Value	US\$m									214	346
Reserves/Resources	Bcf	24740	7260	11110	15340						
Forex										1.02	1.02
Gross Enterprise Value	A\$m									210	339
Fully Diluted Capital	Mill shares									550	550
Future Dilution	Mill shares									220	220
Valuation Capital Base	Mill shares									770	770
Value Per Share	A¢	Mid-Point:		Mid-Point:		36				27	44

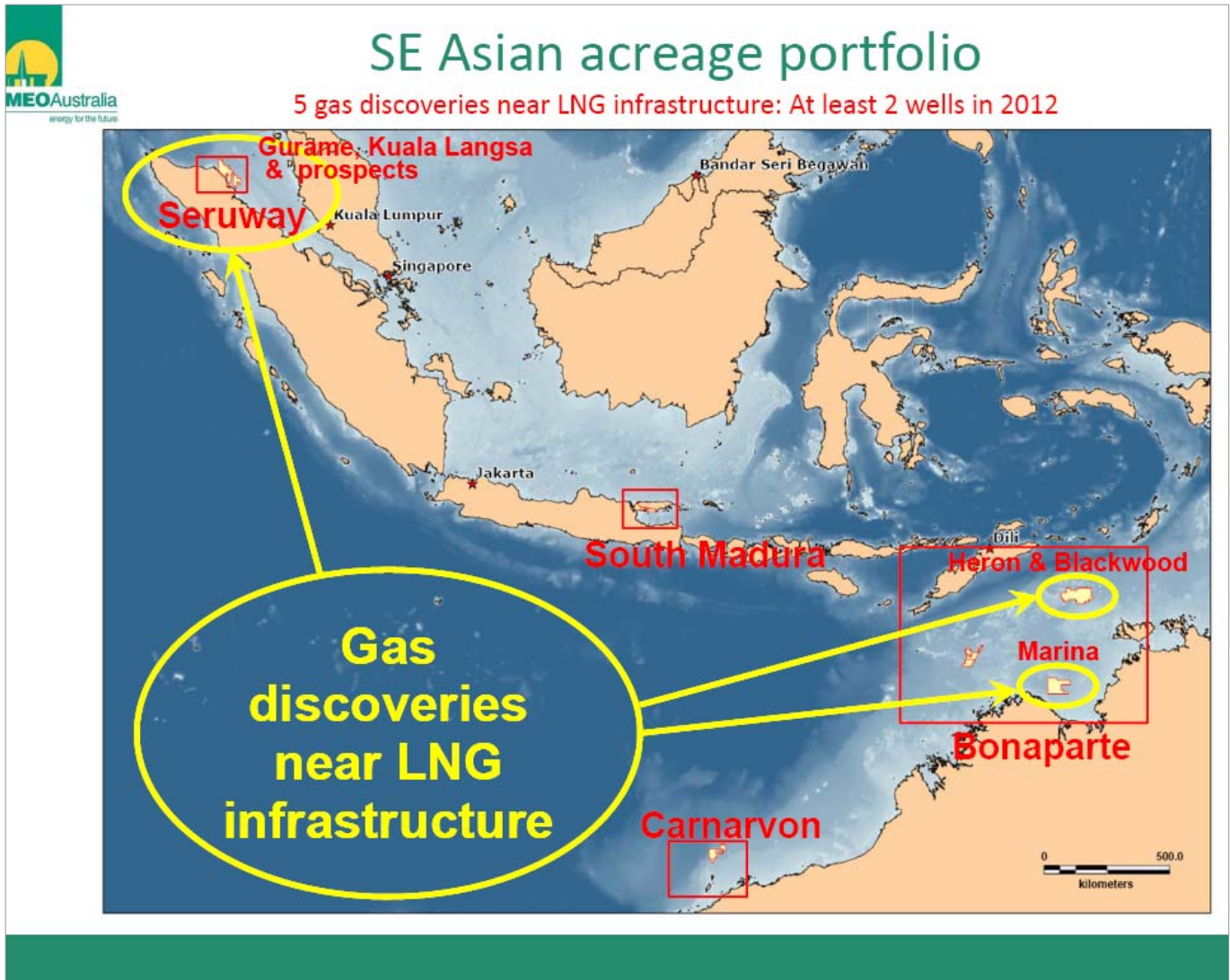
- MEO has a very active 12-18 months ahead with a number of key share price catalysts identified in the outcome of farm-in negotiations and exploration drilling. Baillieu's estimates of what MEO's forward work program might look like is shown in the following diagram. Investors should note that many of the wells indicated are predicated upon success in earlier wells and successful farm-in negotiations.

MEO: Indicative Forward Work Program



*** The above timetables are Baillieu estimates and are not MEO commitments. Most the exploration wells identified are conditional on success in earlier wells, the outcome of farm-in talks, and are subject to the availability of drilling rigs.

- **Location of MEO exploration projects.** The following map summarises the location of MEO exploration permits in Australia and south-east Asia. Proximity to fast-growing Asian energy markets is a key feature of the portfolio.



E.L. & C. Baillieu Stockbroking Ltd

MEO Australia Limited (MEO)

Analyst:	Ivor Ries	Recommendations:	
Date:	22 Nov 11	Rating:	Buy
Share Price: (\$A)	\$0.19	Risk:	High
Issued Shares:	539.9m	Valuation:	\$0.38
Market Cap:	\$105m	Price Target:	\$0.36

Financial Performance (\$m)				
Year End: June 30	2011 (A)	2012 (E)	2013 (E)	2014 (E)
Sales Revenue	32.9	3.1	2.9	2.7
EBITDA	14.9	-3.9	-4.5	-5.1
Depreciation	0.0	0.0	0.0	0.0
EBITA	14.9	-3.9	-4.5	-5.1
Amortisation	0.0	0.0	0.0	0.0
EBIT	14.8	-4.1	-4.7	-5.3
Net Interest	0.0	0.0	0.0	0.0
Other Non-Oper. Inc./(Exp.)				
Pre-tax Profit	14.2	-4.1	-4.7	-5.3
Tax	-0.5	0.0	1.4	1.6
Associates				
Outside Equity Int.				
Reported NPAT	13.7	-4.1	-3.3	-3.7
Significant Items				
Discontinued Items				
Adjusted Profit	13.7	-4.1	-3.3	-3.7

Balance Sheet (\$m)				
Year End: June 30	2011 (A)	2012 (E)	2013 (E)	2014 (E)
Cash	90.2	72.4	69.2	65.6
Receivables	1.5	0.1	0.1	0.1
Inventories				
Other	0.0	0.0	0.0	0.0
Current Assets	91.7	72.5	69.3	65.7
Investments				
Prop., Plant & Equip.	0.2	0.3	0.3	0.3
Intangibles (net)	0.3	0.1	0.1	0.1
Other	119.5	134.9	134.3	133.6
Non-Current Assets	120.0	135.3	134.7	134.0
Total Assets	211.7	207.8	204.0	199.7
Payables	1.6	1.3	1.3	1.3
Borrowings				
Provisions & Other	0.1	0.1	0.1	0.1
Current Liabilities	1.7	1.4	1.4	1.4
Payables				
Borrowings				
Provisions & Other	0.1	0.5	0.5	0.5
Non-Current Liabilities	0.1	0.5	0.5	0.5
Total Liabilities	1.8	1.9	1.9	1.9
Share Capital	240.7	240.7	240.7	240.7
Reserves	1.6	1.1	1.1	1.1
Retained Profits	-32.3	-37.6	-40.8	-44.5
Shareholders Equity	209.9	204.2	200.9	197.2
Outside Equity Int.				
Total Equity	209.9	204.2	200.9	197.2
Total Funds Employed	209.9	204.2	200.9	197.2

Recommendations

Buy: The stock's total return is expected to increase by at least 10-15 percent from the current share price over the next 12 months.
Hold: The stock's total return is expected to trade within a range of ±10-15 percent from the current share price over the next 12 months.
Sell: The stock's total return is expected to decrease by at least 10-15 percent from the current share price over the next 12 months.

Cash Flow (\$m)				
Year End: June 30	2011 (A)	2012 (E)	2013 (E)	2014 (E)
Receipts from Customers				
Payments to Suppliers	-5.9	-7.0	-7.4	-7.8
Other	3.5	1.7	1.7	1.7
Operating Cash Flow	-2.4	-5.3	-5.7	-6.1
Capital Expenditure	-0.2	-0.7	-0.7	-0.7
Other	25.1	-15.0	0.0	0.0
Investing Cash Flow	25.0	-15.7	-0.7	-0.7
Proceeds from Issues	32.6	0.0	0.0	0.0
Net Borrowings	0.0	0.0	0.0	0.0
Dividends				
Other	1.7	0.0	0.0	0.0
Financing Cash Flow	34.3	0.0	0.0	0.0
Net Change in Cash	56.8	-21.0	-6.4	-6.8
Cash at Begin. of Year	36.0	90.2	72.4	69.2
Exchange Rate Adj.	-2.5	3.2	3.2	3.2
Cash at End of Year	90.2	72.4	69.2	65.6

Ratios				
Year End: June 30	2011 (A)	2012 (E)	2013 (E)	2014 (E)
EBITDA Margin (%)				
EBIT Margin (%)				
NPAT Margin (%)				
Return on Assets (%)				
Return on Equity (%)				
Net Debt to Equity (%)				
Net Interest Cover (x)				
Fixed Charges Cover (x)				

Valuation				
Year End: June 30	2011 (A)	2012 (E)	2013 (E)	2014 (E)
Basic EPS ¢	2.7	0.0	0.0	0.0
Adjusted EPS ¢	2.7	0.0	0.0	0.0
EPS Growth	N/A	N/A	N/A	N/A
P/E Ratio (x)	6.9	N/A	N/A	N/A
EV/EBITDA	1.0	-8.4	-8.0	-7.7

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Buy: The stock's total return is expected to increase by at least 10-15 percent from the current share price over the next 12 months.

Hold: The stock's total return is expected to trade within a range of \pm 10-15 percent from the current share price over the next 12 months.

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