

7 May 2010

Spec. Buy

Important: The above recommendation has been made on a 12 month view and may not suit your investment needs or timeframe. The basis it is prepared on is summarised on the last page of this report. **PLEASE CONTACT YOUR ADVISER TO DISCUSS THIS GENERAL RECOMMENDATION BEFORE ACTING ON IT.**

Current Price

A\$1.19

Market Cap

A\$333.5m

Net Cash

A\$81.8m

Shares on issue

280.3m

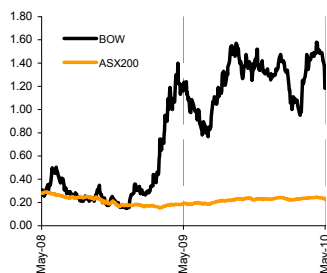
Management

Ron Prefontaine – Managing Director

John de Stefani – CEO

Steven Bizzell – Non-exec Director

Nick Mather – Non-exec Director

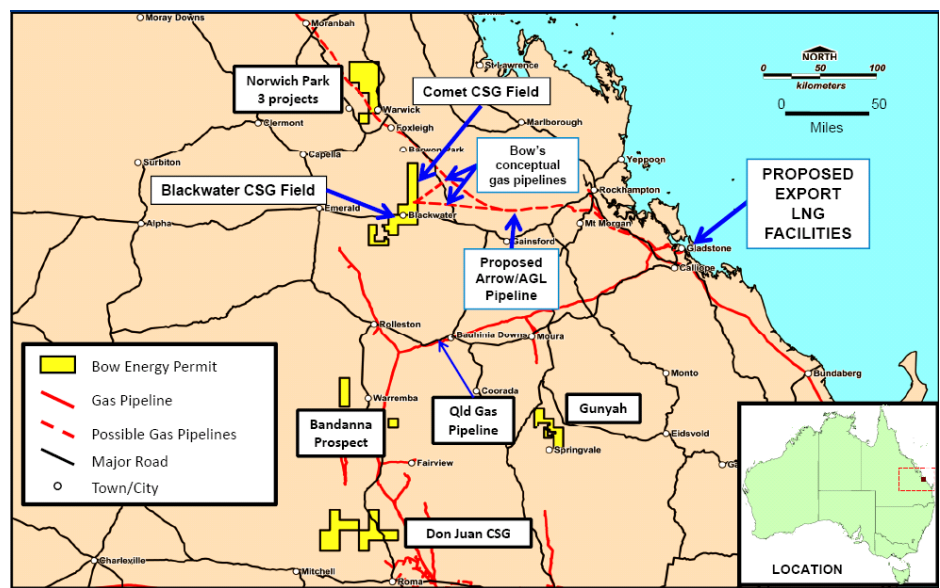


Bow Energy (BOW)

Pilot Production Testing the Key

BOW has recently increased its gas reserves at the Blackwater and Comet CSG projects. Successful testing of pilot production wells will lead to booking of 1P reserves and ultimately a re-rating of the company. The proposed RSPT is a concern but its close proximity to Gladstone and upcoming FID of LNG projects makes BOW a logical supplier/acquisition to the LNG players. Speculative BUY.

Figure 1: Map of BOW's exploration tenements and proximity to market



Source: BOW presentation, 29/4/10

BOW upgrades gas reserves: YE target of 2750 PJ 3P reserves will be exceeded

BOW's recent reserves upgrade has delivered them a 60% growth in 3P reserves to 2,360 PJ. BOW has the largest 3P reserves amongst the remaining pure CSG players, assuming Shell/PetroChina complete their proposed acquisition of Arrow Energy. Further reserves upside exists, with BOW expected to exceed 450 PJ of 2P reserve by YE 2010.

30MW of power generation – cash flow and commerciality of reserves

The construction of a 30MW power station will see the company generating cash flow in early 2011. Importantly, it provides BOW with a market for its gas during the pilot production phase. We expect this demonstration will ultimately lead to the construction of a pipeline connection to the domestic gas market, and possible 3rd party offtake with LNG projects.

We expect the proposed Resource Super Profits Tax (RSPT) to be watered down

The Government's proposed 40% RSPT would have a huge impact on the LNG projects at Gladstone. Delays or cancellations of any LNG developments could have an adverse impact on the smaller CSG players such as BOW, as they seek to prove up gas for potential LNG supply. We anticipated the RSPT will be watered down or be cancelled altogether once the impact on future resource investments is fully appreciated. Reasons to buy include: A steady stream of reserves upgrades coming through, pilot production results and progress on power generation construction. We rate BOW as a speculative BUY.

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BOW100507

Investment Summary

Bow Energy (BOW) is a coal seam gas (CSG) explorer with a number of exploration tenements in the Bowen Basin in Queensland. The company will become the largest independent holder of 3P CSG gas reserves if Shell and PetroChina and successful in its efforts to acquire Arrow. BOW is seeking to rapidly expand its reserves base and source high margin gas markets for its gas reserves. BOW's CSG 3P reserves are currently 2,360 PJ and, with a YE 2010 target of > 2,750 PJ.

Commercialisation of its reserve base requires the successful demonstration of economic gas production, which should occur during 2010. BOW will also construct and operate a 30 MW gas fired power station at its Blackwater CSG project, using gas produced from the production pilot being developed to certify 1P and 2P reserves.

Reasons to Buy

We have identified the following reasons to buy BOW.

- **Largest 3P reserves base amongst remaining independent CSG players.** The following table shows how BOW ranks amongst the remaining independent CSG players in Australia.

Table 1: Reserves amongst remaining independent CSG Players

Company	1P Reserves	2P reserves	3P reserves
	PJ	PJ	PJ
Bow Energy	0	114	2,360
Eastern Star Gas	77	988	1,818
Metgasco	3	397	2,239
Molopo	24	176	348
Westside Corporation	30	95	382
Victoria Petroleum	0	45	88

Source: RBS Morgans, company data

- **Large uncontracted gas volumes close to Gladstone.** BOW has expressed its willingness to supply gas into LNG. Having a large uncontracted volume of gas on the doorstep of Gladstone would improve BOW's chances of achieving this outcome. It would however depend on the LNG project participants' desire to purchase 3rd party gas over its own gas resource. With the recent moves by BG to utilise 3rd party gas during ramp-up, and the positive economics of a 3rd LNG production train, we believe the odds of this occurring are improving.
- **Potential for further reserves upgrades.** BOW has reached 2,360 PJ of 3P reserves and 114 PJ of 2P reserves. The company is targeting 2,750 PJ of 3P reserves by YE 2010.
- **Pilot project commencing Q3 this year** should lead to demonstration of commercial gas flow rates and certification of 1P reserves.
- **Potential corporate target.** If BOW can demonstrate commercial flow rates are possible from its acreage and one or more of the LNG participants at Gladstone are keen to aggregate more CSG resources for additional LNG trains, BOW may be on the radar.
- **YE 2010 valuation metrics look to be attractive relative to some of its peers.** BOW looks inexpensive compared to some of its peers, in particular when its YE 2010 reserves target of 2,750 PJ is taken into account.

Impact of proposed Resource Super Profits Tax (RSPT)

The Federal Government has proposed a 40% 'super profits' tax on onshore resource projects (including oil and gas developments). The RSPT is essentially a 40% tax on an asset's EBIT, where carried forward losses can be escalated at the Government's Long Term Bond Rate. With this rate currently at approximately 6%, the 'super profits' tax is charged on any earnings that generate more than a 6% rate of return.

We believe this is far too aggressive, given most small companies in particular have a weighted average cost of capital (WACC) at more than 10%, so as it stands, companies would be charged

this super profits tax when the project is generating a negative NPV. In addition to this, key terms of the RSPT have yet to be defined, and the RSPT is not due to be introduced until 2H 2011, meaning the entire resource and oil and gas industry has entered a period of uncertainty surrounding the economics of their existing operations and proposed projects.

In particular, the CSG to LNG projects are at a critical stage, with three projects due to reach final investment decision by the end of 2010. Both Origin and Santos have indicated that the new tax proposal will cause them to delay a decision on FID, and with Santos looking to sell down a stake in the GLNG project to a 3rd party, there is a small risk that the buyer may want to renegotiate key terms of any purchase.

These uncertainties have a flow-on effect to the other CSG players, and BOW is no exception. One of BOW's paths to gas commercialisation is to supply gas to LNG at Gladstone. However with a cloud over these projects due to the proposed RSPT, this commercialisation path is also in some doubt. This has weighed heavily on CSG stocks over the past few days.

We therefore believe that the Government will soon realise the negative impact the proposed tax is having on these projects and will have to either water down the terms of the tax (e.g. increasing the hurdle rate to something north of 10%, increasing the capex depreciation rate, adding a RSPT holiday period for new projects or reducing the tax rate) or abandoning it altogether.

However investors do need to be aware that the proposed RSPT has added an unwanted layer of uncertainty over stocks such as BOW, which will have an impact on share price performance until the uncertainty is cleared up.

Relative Valuation Metrics

Table 1: CSG Company Enterprise Valuation Calculations (as at 6th May 2010)

Company	Code	Share Price	Estimated EV A\$ million	Current Reserves		Valuation Metric		YE 2010 Reserves		Valuation Metric	
				2P PJ	3P PJ	EV/2P A\$/GJ	EV/3P A\$/GJ	2P PJ	3P PJ	EV/2P A\$/GJ	EV/3P A\$/GJ
Arrow Energy	AOE	\$4.740	3240	3,690	5,781	0.88	0.56	4,400	7,500	0.74	0.43
Blue Energy	BUL	\$0.190	91	0	0	0.00	0.00	0	0	0.00	0.00
Bow Energy	BOW	\$1.190	252	114	2,360	2.21	0.11	450	2,750	0.56	0.09
Comet Ridge	COI	\$0.245	59	0	0	0.00	0.00	0	0	0.00	0.00
Eastern Corp	ECU	\$0.290	18	0	0	0.00	0.00	0	0	0.00	0.00
Eastern Star Gas	ESG	\$0.765	649	988	1,818	0.66	0.36	1,300	2,392	0.50	0.27
Exoma Energy	EXE	\$0.230	48	0	0	0.00	0.00	0	0	0.00	0.00
Icon Energy	ICN	\$0.245	89	0	0	0.00	0.00	0	150	0.00	0.59
Metgasco	MEL	\$0.405	77	397	2,239	0.19	0.03	400	2,258	0.19	0.03
Molopo	MPO	\$1.200	199	176	348	1.13	0.57	250	400	0.80	0.50
Westside	WCL	\$0.490	47	95	382	0.49	0.12	206	1,880	0.23	0.02

Source: RLMS, Company data, IRESS, RBS Morgans

Note: EV = Enterprise Value

Using YE 2010 reserves targets as a valuation metric guideline, BOW looks cheaper than AOE, ESG, MPO and ICN. However it should be noted that each company has their own unique issues, so it is not a case of comparing apples with apples.

Recent transaction have averaged A\$0.56/GJ on a 3P reserves level, and with BOW trading at A\$0.11/GJ on current 3P reserves and A\$0.09/GJ on the YE 2010 3P reserves target, BOW looks inexpensive. However we do caution on using these metrics as a basis for investment, as the price paid for reserves in recent transactions are in fact a combination of a number of factors, such as the quality of CSG acreage, the potential size of the resource (beyond the certified reserves), the end market for the gas and the competitive intensity of the sale process.

Upcoming Catalysts / Milestones

BOW's upcoming catalysts include the following:

- Progress on gas sales;
- Further increases in reserves certification;
- Results from the 2P pilot production wells; and,
- Commercial gas flows and electricity production leading to 1P reserves (1Q CY11).

2010 Work Programme

BOW has announced an aggressive 2010 exploration and appraisal programme:

Figure 2 : Bow Energy 2010 drilling and reserves certification targets

Drilling Program	2010				2011	BOW ENERGY'S END OF 2010 TARGET
	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	1st Qtr	
1P Program •12 production pilot in Blackwater CSG Field	Drilling/Completions		Pumping/Testing		Connection	To supply up to 2PJ/annum to Blackwater Power Station
2P Program •17 additional test wells in the Blackwater CSG Field •10 additional test wells subject to 3P drilling	Drilling/ Completions			Pumping/ Testing		450 PJ of 2P Reser ves
3P Program •Total of 13 core holes across entire CSG portfolio	Gas Contents and Saturations					2750 PJ of 3P Reser ves
Blackwater 30MW Power Station	Approvals		Construction			Expected completion early 2011
END 2010 TOTAL RESERVES (net to Bow)					450PJ 2P / 2750PJ 3P	

Source: BOW quarterly activities report, 29/01/2010

In addition to this, BOW is planning on spending approximately A\$35m on the construction of a 30 MW gas fired power generator.

Key Risks

The following key risks have been identified for BOW.

- **Market access.** Blackwater acreage is not connected to a market – it will require a pipeline to be constructed to sell gas to domestic customers or LNG. Located 230 km west of Gladstone.
- **Poor results from pilot project.** Commercial gas flow rates have yet to be established from Blackwater. Pilot wells will be drilled in 2010 to ascertain the optimal drilling and completion techniques, as well as how much gas can flow from each well (peak gas production rate and total recovery). A poor flow rate result will mean that the cost of extraction will be high on a \$/GJ basis, meaning a higher margin market (such as LNG) may be required to make an economic rate of return from full field development.
- **Valuation metrics are only one component of corporate valuation** and should not be look at in isolation. Other factors to consider include market access, resource size and coal seam quality.
- **Impact of proposed RSPT.** As outlined earlier, the uncertainty on the proposed RSPT will be a risk to companies like BOW. Our early economic analysis of the RSPT on companies such as BOW, where most investment is in the future, is a 25-35% reduction in NPV. We do expect the Government to eventually relent and water down or cancel the RSPT after the implications of the new tax on future investment is fully appreciated.

Company Description

BOW's key tenement, which includes the Blackwater and Comet CSG fields, are strategically located to Gladstone – home of 5 proposed LNG projects. BOW's will initially feed its gas into a 30 MW gas fired power generator, which it will construct during 2010 and be online 1H 2011. Beyond this first stage of commercialisation, BOW will seek to market its gas volumes into one of the proposed LNG projects, or seek an alternate high margin gas customer (such as larger scale power generation).

BOW recently completed a successful equity raising, increasing BOW's total cash position to A\$95m (now at A\$81m after some expenditure). BOW plans to apply these funds to the following:

- Expansion of 3P reserves delineation;
- 2P reserves certification through successful pilot projects at Blackwater, Comet and Norwich Park, and;
- Construction of a 30 MW gas fired power generation capacity at Blackwater, utilising gas produced during the pilot stage.

Key Assets

Bow Energy's key assets are as follows:

- 100% interest in ATP 1025P, containing the Blackwater and Comet CSG fields
- 100% interest in ATP 1031P, containing the Norwich Park CSG field.
- 55% interest in ATP 593 and 771P, containing the Don Juan CSG field
- 100% interest in ATP 1053P, containing the Gunyah CSG field

BOW is operator of all of these assets. The Don Juan field is located in the Surat basin, whereas all other permits are targeting coals in the Bowen Basin.

Reserves / Resources

BOW has certified reserves in the Don Juan and Blackwater CSG fields. Current and target 2P and 3P reserves are outlined in the table below.

Table 2 : Current Reserves and YE 2010 Targets

Project	Proven Reserves		2010 Reserve Targets	
	3P Reserves (PJ net to Bow)	2P Reserves (PJ net to Bow)	3P	2P
Blackwater CSG Field (Comet Block)*	1,382	59	> 1500	>200
Comet CSG Field (Comet Block)**	871	-	> 500	>100
Norwich Park Projects (3 prospects)	-	-	> 500	>100
Don Juan Project (55%)	107	55	150	50
Gunyah Project	-	-	> 100	n/a
Total Reserves (net PJ to Bow)	2,360	114	>2,750	>450

Source: BOW, 25/3/2010

Key to certifying additional 2P (and maiden 1P) reserves in 2010 will be the completion of a successful pilot project in Blackwater CSG field. 2P reserves certification requires BOW to prove permeability of coal seams between adjacent wells over the field. 1P reserves certification requires BOW to demonstrate that commercial gas quantities can be produced.

BOW seems to be on track to easily exceed their stated 3P reserves target by YE 2010.

RESEARCH TEAM

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NIK BURNS	-	Senior Analyst	SCOTT POWER	-	Director - Research
ALEX CLARKE	-	Analyst	TOM SARTOR	-	Associate Director - Research
FIONA BUCHANAN	-	Director - Research	TAMARA STRETCH	-	Associate Director - Research
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JAMES LAWRENCE	-	Analyst	MARCEL VON PFYFFER	-	Director - Strategy
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For listed property trusts (LPTs) the recommendation is based upon the target price plus the dividend yield, ie total return. A Buy implies a total return of 10% or more; a Hold 5-10%; and a Sell less than 5%.

Absolute performance, short-term (trading) recommendation: The Trading Buy/Sell recommendation implies upside/downside of 3% or more. The trading recommendation time horizon is 0-60 days.

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