

## Sales Commitment Mitigates Uncertainty

### Investment Highlights

- Commitment to sales process mitigates risk.** AZZ has reiterated its 100% commitment to the sale of its cornerstone Eagle Ford assets. AZZ is funded to complete the drilling of FD-7H and drill FD-8H and if a transaction has not been sufficiently progressed at this point, intends to cease operations rather than raise any additional equity at the current share price. We believe that the drilling of additional wells adds value to the asset but we do not foresee any further fracking and testing operations will be completed on the Yellow Rose or Blue Bonnet projects.
- Sale of interests likely to yield a competitive price.** The assets present a high value and unique investment opportunity with a significant acreage position, a thick Eagle Ford reservoir, single land owner and provide a 100% interest in the Yellow Rose and Blue Bonnet projects. Recent transactions have ranged in the range of US\$10,000-12,000 acre and we do not believe that interested parties would have progressed without discussing the realms of pricing. A sale in this range would value AZZ's net 23,019 acres across all 3 projects at \$0.85/sh to \$1.03/sh, respectively. A sale of Blue Bonnet and Yellow Rose only would yield \$0.67/sh to \$0.83/sh whilst maintaining its interest in the Hawkville area – today's announced IP from the first well highlights the upside of this fully carried asset, which we value at \$0.16/sh, risked if 25%. In addition, tax impacts need to be considered.
- We are upgrading our recommendation to a SPECULATIVE BUY with a price target of \$0.68/sh.** We believe that there is potential for significant upside in the share price via the sale of the company's Yellow Rose, Blue Bonnet and potentially the Hawkville acreage, but highlight that this is speculative due to the uncertainty surrounding the timing and outcome of the sales process. AZZ's progress over the past weeks and the information contained in the recent presentation has confirmed commitment to the sales process and given us further confidence as to a successful outcome - mitigating some key risks.

9 September 2010

**12mth Rating**

**SPECULATIVE BUY**

Price	A\$	0.45
Target Price	A\$	0.68
12m Total Return	%	52.2

RIC: **AZZ.AX**

BBG: **AZZ AU**

Shares o/s	m	299.3
Free Float	%	94.4
Market Cap.	A\$m	134.7
Net Debt (Cash)	A\$m	11.0
Net Debt/Equity	%	437.2
3m Av. D. T'over	A\$m	1.08
52wk High/Low	A\$	0.88/0.23
2yr adj. beta		1.10

**Valuation:**

Methodology		DCF
Value per share	A\$	0.68

**Analyst:**

**Scott Simpson**

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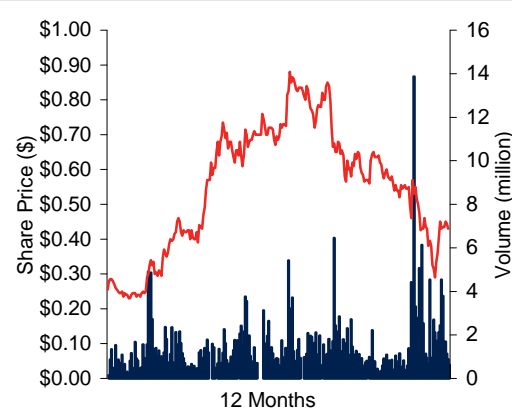
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*Disclosure: Patersons Securities was the Lead Manager to the \$10m Institutional Placement and \$4.2m SPP in August 2009 and the \$19.2m placement completed in February 2010. It was paid a fee for these services.*

Year End Dec 31	2009A	2010F	2011F	2012F	2013F
Reported NPAT (\$m)	(3.2)	13.6	55.3	77.3	127.8
Recurrent NPAT (\$m)	(3.2)	13.6	55.3	77.3	127.8
Recurrent EPS (cents)	(1.8)	5.2	18.6	26.0	43.0
EPS Growth (%)	na	na	258.0	39.9	65.2
PER (x)	(25.0)	8.7	2.4	1.7	1.0
EBITDA (\$m)	0.2	15.3	57.9	107.5	193.2
EV/EBITDA (x)	532.0	8.6	2.5	1.3	0.6
Free Cashflow	(14.5)	(41.3)	0.5	7.6	11.8
FCFPS (cents)	(8.2)	(15.7)	0.2	2.6	4.0
PFCF (x)	(5.5)	(2.9)	255.6	17.5	11.3
DPS (cents)	0.0	0.0	0.0	0.0	0.0
Yield (%)	0.0	0.0	0.0	0.0	0.0
Franking (%)	0.0	0.0	0.0	0.0	0.0

### 12 Month Share Price Performance



Performance %	1mth	3mth	12mth
Absolute	1.8	18.9	989.7
Rel. S&P/ASX 300	5.1	12.9	874.9

# Sale of its Eagle Ford Assets

## Sales Process

### Receipt of Written Expression of Interest

On the 2<sup>nd</sup> of August, AZZ announced it had received an unsolicited expression of interest to acquire its interests in the Eagle Ford shale, which included the Yellow Rose and Blue Bonnet project areas as well as the Petrohawk term assignment area. Following receipt of the expression of interest, the company met with its JV partner SIDC which resulted in the parties agreeing to proceed to negotiate a sale. The JV then engaged Tudor Pickering Holt & Co – Energy Investment and Merchant Banking (TPH) to assist with the process.

### Progress to Date

Since this initial announcement the company has reportedly met with a number of interested parties to present the opportunity. The meetings are reported to have consisted of a detailed presentation of the company's assets with discussions focussed on the land tenure (a key highlight of the deal with 100% interest of 2 of the 3 projects and a single land owner), the attributes of the shale and progress achieved to date.

On the 18<sup>th</sup> to the 20<sup>th</sup> of August the JV attended the NAPE expo held in Houston, where it exhibited the opportunity to a larger audience. The expo undoubtedly attracted a wide range of interest and further publicised the sale of the assets, which increases the potential likelihood of a high-value sale.

### Forward Program

Feedback from the initial meetings was reportedly very positive and as a result, a number of interested parties are progressing to further assess the assets with the opening of a data room. There is still potential that a party could make a bid in the short term, however AZZ has provided the likely schedule for a full sales process. This would see opening the data room opening on the 13<sup>th</sup> of September through to the 20<sup>th</sup> of October, with bids due on the 21<sup>st</sup> of October and execution of the Purchase Sale Agreement (PSA) on the 28<sup>th</sup> of October.

## Key Issues

### Tudor, Pickering, Holt & Co.

The engagement of TPH will assist in yielding the best result for the company, with strong technical skills, a history of execution and specific experience in the Eagle Ford shale. TPH is regarded as the leader in this type of transaction achieving 33 deals between 2008 and 2010 valued at ~US\$35billion. TPH advised Pioneer Natural Resources on its \$1.3b JV deal with Reliance, which equated to a value of US\$12,000/acre.

### Value of the Transaction

Recent deals in the shale have ranged in the order of \$9,700 acre to \$12,000 acre with a number of private undisclosed deals rumoured to be further pushing this pricing window. Some of the key deals are summarised below. The Talisman/Common Resources deal is the most relevant deal as it was a full acquisition, rather than a farm-in and achieved a price of US\$9,700/acre. However we believe that prices are moving higher. In our opinion, an optimum outcome for shareholders would be a farmout deal to provide validation of the acreage, while maintaining upside – yet this is not the likely outcome.

**Figure 1: Recent Transactions**

Date	Acquiring Party	Selling Party	Transaction Type	Net Acreage	Window	Transaction Value (US\$)		Price US\$/acre
24-Jun-10	Reliance Industries	Pioneer Energy	Joint Venture	118,000	Oil Window	\$	1,315,000,000	\$ 11,144
21-Jun-10	AWE Limited	Adelphi Energy	ASX on-market Take-over	2,349	Oil Window	\$	54,810,000	\$ 23,300
14-Jun-10	Kohlberg Kravis Roberts & Co	Hilcorp Energy Co	Farm-in	40,000	Oil Window	\$	400,000,000	\$ 10,000
5-May-10	Talisman Energy	Common Resources	Acquisition	37,000	Oil Window	\$	360,000,000	\$ 9,730

Source: Various

This range of US\$10,000-12,000/acre would value AZZ's net acreage as follows:

**Figure 2: Valuation Range**

Asset	Acreage	US\$10,000/acre		US\$12,000/acre	
		US\$m	A\$/sh	US\$m	A\$/sh
Yellow Rose	13706	137	0.51	164	0.61
Blue Bonnet	5035	50	0.19	60	0.22
Hawkville	4279	43	0.16	51	0.19
<b>Total</b>	<b>23019</b>	<b>230</b>	<b>0.85</b>	<b>276</b>	<b>1.03</b>

Source: Patersons Estimates

### Taxation Implications

The tax implications of the transaction are not clear at this stage and we anticipate further clarification from the company regarding this issue in the short term. We understand that ~US\$60m of USA tax losses could be offset but this has not been confirmed. It is also unclear whether a sale would be considered part of normal operations and attract a 30% tax rate or be taxed at the 15% capital gains rate. On this basis we reduced our assumed proceeds for Yellow Rose and Blue Bonnet at 20% to arrive at our valuation. Below is a very basic look at some tax implications:

**Figure 3: Quick Look at Tax Implications**

Sale of Blue Bonnet, Yellow Rose and Hawkville			
<b>Sales Proceeds at US\$10,000/acre</b>	230 US\$m	<b>Sales Proceeds at US\$10,000/acre</b>	230 US\$m
less accumulated tax losses	60 US\$m	less accumulated tax losses	30 US\$m
taxable amount	170 US\$m	taxable amount	200 US\$m
tax at 30%	51 US\$m	tax at 30%	60 US\$m
net proceeds	179 US\$m	net proceeds	170 US\$m
Value per share	<b>0.60 A\$/sh</b>	Value per share	<b>0.57 A\$/sh</b>
<b>Sales Proceeds at US\$10,000/acre</b>	230 US\$m	<b>Sales Proceeds at US\$10,000/acre</b>	230 US\$m
less accumulated tax losses	60 US\$m	less accumulated tax losses	30 US\$m
taxable amount	170 US\$m	taxable amount	200 US\$m
tax at 15%	26 US\$m	tax at 15%	30 US\$m
net proceeds	205 US\$m	net proceeds	200 US\$m
Value per share	<b>0.68 A\$/sh</b>	Value per share	<b>0.67 A\$/sh</b>

Source: Patersons Estimates

## How it Could Play-Out

With multiple interested parties the most likely scenario is that the sale would be for the Yellow Rose and Blue Projects alone as these assets are 100% held and for sale. Sale of a part interest in the Hawkville project area is complicated by the agreement with Petrohawk, so at this stage this is our base case assumption. However, it is very likely that Petrohawk could bid for Yellow Rose and Blue Bonnet, plus AZZ's interest in the Hawkville term assignment area or for the entire company. In fact, given the wording of the original Written Expression of Interest (as it included the Hawkville area), we believe it is likely that Petrohawk was this original interested party and this has been further enhanced by today's announced progress in the Hawkville area. However, as stated, at this stage our assumption and valuation is based on a sale of Blue Bonnet and Yellow Rose project areas only. The value of the Hawkville area has been further substantiated by today's announcement of the completion of the first well and commencement of development drilling, which is discussed further below.

## Key Asset Attributes

With a number of deals within the US\$10,000-12,000/acre range flagged by the company we believe that there are a number of reasons that AZZ should attract this price range for its assets:

- Yellow Rose and Blue Bonnet are held at 100% with JV partner SIDC.
- The acreage has one landowner. This is advantageous as land tenure is one of the key risks in such a play and together with the item above, makes this a very unique asset sale.
- The acreage has been de-risked by the drilling of 7 wells with 4 wells on production. Whilst production has been below expectations, predicted EUR's are inline with other players in the oil window, but more importantly the fracking process is in a constant state of evolution and any potential bidder will likely hold its own view as to the potential productivity of the shale. Key to this is that the well data highlights a very thick shale (150ft+) with a high net to gross (+95%), a high carbonate and silica content (+75%) and high total organic content (+5%). Hence we believe that potential buyers will place much less emphasis than production results from the first few wells than the market has, given its expertise and appreciation for the learning curve.

## Well Performance to Date

- The early performance of the initial wells in AZZ's acreage were below expectations, based on an annualised Haynesville assumed curve and below our modelled mid-case curve (provided by AZZ in its June Q report). The lower outcome than anticipated and the inability to predict how future wells would perform resulted in a significant sell-off in the share price due to the implications for future funding. Two of the key risks that we have highlighted in early stage shale plays are the funding requirements and need to be able to absorb an average of well results. Our modelling based on the mid-case curve suggested further capital requirements of ~A\$10m before the asset was self-funding, however the production results to date have fallen below this curve. While it is difficult to predict how much capital would be required to get to a self-funding level (whether it is \$10m or \$30m) the decrease in share price was severe and created a circular issue that de-railed AZZ's prospect of extracting value from the acreage.
- It is also worth noting that there is a steep learning curve in any early play and AZZ would have likely significantly improved its drilling and in particular fracking outcomes due to industry wide developments and improvements in company expertise.
- AZZ has today announced that the Donnell-457 No. 1H in the Hawkville Term Assignment area has been brought into production, achieving an IP of 563boepd and 3,628mscf/d (1168boepd), which is well above the mid-case assumed IP of 484boepd. We eagerly await further production and decline data from this latest well, which will likely be a dramatic improvement on results to date, given the learning curve and Petrohawk's expertise. AZZ also announced Petrohawk has commenced drilling of the second well in the area, the FD-1H with a planned horizontal length of ~8,000ft. While the details of the agreement over this area are confidential, it is believed that Petrohawk has a right to earn a 50% WI interest in the area on a well by well basis, after fully

recovering its drilling costs. The area of 8,558 acres (4,279 net) requires 14 wells to hold it by production and borders the oil and gas/condensate window.

- As highlighted above, we do not believe that the production results achieved to date will have a dramatic impact on the sale of the Eagle Ford assets. The sales process will certainly focus on the quality of the acreage, but potential buyers will have different expectations as to what can be achieved via application of experienced fracking and production techniques.

## Valuation / Recommendation

Based on the recent presentation material and progress achieved on the sales process, AZZ appears fully committed to a sales outcome and stated that it does need and nor does it intend to raise any additional equity at these levels. On this basis we are upgrading our recommendation to a **SPECULATIVE BUY** with a price target of \$0.68/sh. Our valuation is summarised below:

**Figure 4: Base Case Valuation**

Valuation	A\$m	A\$/sh
Producing Assets	9	0.03
Yellow Rose - Eagle Ford	122	0.38
Bluebonnet - Eagle Ford	45	0.14
Hawkville - Eagle Ford	51	0.16
Exploration and Appraisal	3	0.01
Cash - est	4	0.01
Debt	(15)	(0.05)
<b>Total @ 10% Discount Rate</b>	<b>219</b>	<b>0.68</b>
<b>Price Target</b>		<b>0.68</b>

Source: Patersons Estimates

Our valuation is based on a sale of the company's net Yellow Rose and Blue Bonnet acreage at US\$10,000/acre, risked at 80% to allow for any tax implications and our modelled value for the Hawkville Term Assignment Area, risked at 25%. Note that our valuation for the Hawkville area ties in very closely to its net acreage value at \$10,000/acre but will be further de-risked as Petrohawk progress through the drilling program.

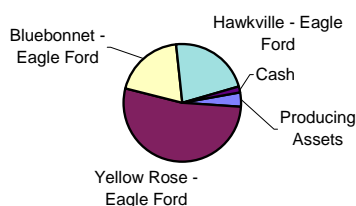
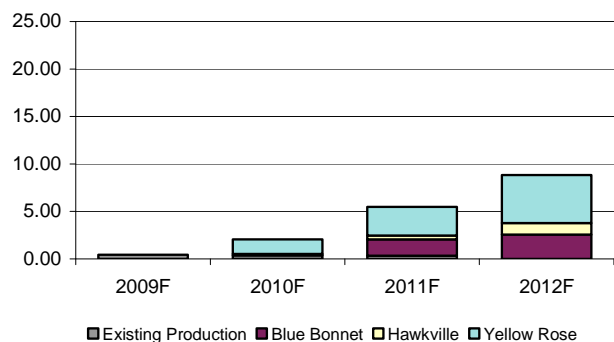
A key risk to our valuation is that a sale does not proceed. We believe that this risk is minor based on the location and quality of the assets and interest reported to date. This risk was further mitigated today with the announced progress in the Hawkville assignment area. This area will be drilled out at Petrohawk's cost (subject to cost recovery) and in the longer term AZZ would benefit from its share of revenue (post cost recover) to fund development of its assets.

**Antares Energy Ltd****\$0.45**

Valuation	A\$m	A\$/sh
Producing Assets	9	0.03
Yellow Rose - Eagle Ford	122	0.38
Bluebonnet - Eagle Ford	45	0.14
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<b>Total @ 10% Discount Rate</b>	<b>219</b>	<b>0.68</b>
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Valuation Sensitivity	-10%	0%	+10%
Gas Price Sensitivity (A\$/sh)	0.68	0.68	0.69
Oil Price Sensitivity (A\$/sh)	0.67	0.68	0.70
Exchange Rate Sensitivity (A\$/sh)	0.71	0.68	0.67

**Valuation Summary of Operating Assets****Production Summary****Reserves & Resources**

Reserves as at Dec 2009	Oil/Cond (mmbbl)	Gas (bcf)	Total (mboe)
1P Reserves		1.49	
2P Reserves		8.15	
3P Reserves		22.8	

**Directors**

Name	Position
James Cruickshank	Chairman & Chief Executive Officer
Matthew Gentry	Director & Chief Operating Officer
Gregory Shoemaker	Director & Chief Scientist
Vicky McAppion	Director & Company Secretary
Mark Clohessy	Non-Executive Director

**Substantial Shareholders**

	Shares (m)	%
HEP Oil GP, L.L.C	15.4	5.6

Commodity Assumptions	Year End December 31			
	2009A	2010F	2011F	2012F
A\$:US\$	0.79	0.91	0.89	0.86
Crude Oil - WTI (USD/bbl)	61.69	80.72	81.88	85.63
Gas Price - Base Case (US\$/GJ)	9.04	5.01	5.09	5.19

Production Summary	2009A	2010F	2011F	2012F
<b>Gas (bcf)</b>				
Yellow Rose	0.00	0.46	0.99	1.67
Blue Bonnet	0.00	0.06	0.57	0.84
Hawkvilleville	0.00	0.00	0.14	0.40
Producing Assets	0.75	0.74	1.07	1.02
<b>Total Gas (bcf)</b>	<b>0.75</b>	<b>1.26</b>	<b>2.77</b>	<b>3.94</b>
<b>Liquids (mmbbl)</b>				
Yellow Rose	0.00	0.16	0.34	0.57
Blue Bonnet	0.00	0.02	0.19	0.29
Hawkvilleville	0.00	0.00	0.05	0.14
Producing Assets	0.05	0.05	0.04	0.03
Total Liquids (mmbbl)	0.05	0.22	0.62	1.02
<b>Total (bcfe)</b>	<b>0.43</b>	<b>2.05</b>	<b>5.47</b>	<b>9.13</b>
<b>Total (mmboe)</b>	<b>0.07</b>	<b>0.32</b>	<b>0.91</b>	<b>1.52</b>

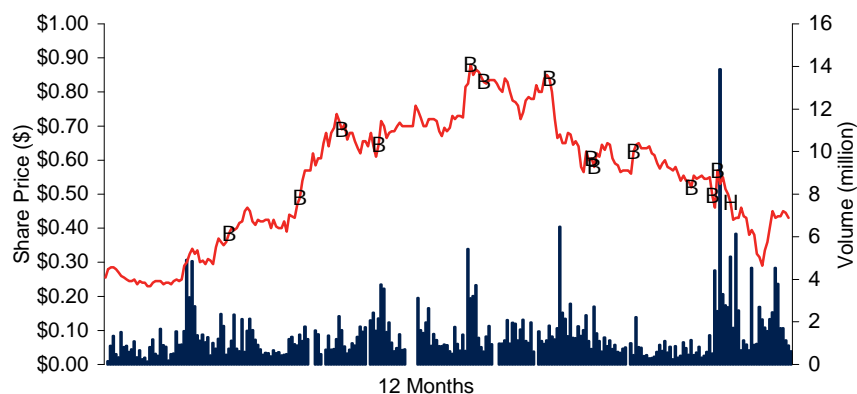
Profit & Loss (A\$m)	2009A	2010F	2011F	2012F
<b>Sales Revenue</b>	<b>3.4</b>	<b>16.9</b>	<b>62.6</b>	<b>113.9</b>
Other Income	0.6	0.3	(0.1)	0.4
Operating Costs	0.7	0.7	2.9	5.2
Exploration Exp.	1.6	0.0	0.0	0.0
Royalties	0.0	0.0	0.0	0.0
Corporate/Admin	1.5	1.2	1.6	1.6
<b>EBITDA</b>	<b>0.2</b>	<b>15.3</b>	<b>57.9</b>	<b>107.5</b>
Depn & Amort	1.2	0.2	1.2	3.4
<b>EBIT</b>	<b>(1.0)</b>	<b>15.1</b>	<b>56.7</b>	<b>104.1</b>
Interest	2.2	1.5	1.4	1.4
<b>Operating Profit</b>	<b>(3.2)</b>	<b>13.6</b>	<b>55.3</b>	<b>102.7</b>
Tax expense	0.0	0.0	0.0	25.4
Minorities	0.0	0.0	0.0	0.0
FX Adjustments	(4.9)	0.0	0.0	0.0
<b>NPAT</b>	<b>(8.1)</b>	<b>13.6</b>	<b>55.3</b>	<b>77.3</b>
<b>Normalised NPAT</b>	<b>(3.2)</b>	<b>13.6</b>	<b>55.3</b>	<b>77.3</b>

Cash Flow (A\$m)	2009A	2010F	2011F	2012F
Adjusted Net Profit	(3.2)	13.6	55.3	77.3
+ Interest/Tax/Expl Exp	3.7	1.5	1.4	26.8
- Interest/Tax/Expl Inc	9.2	26.4	1.4	26.8
+ Depn/Amort	1.2	0.2	1.2	3.4
+/- Other	0.7	0.6	0.0	0.0
<b>Operating Cashflow</b>	<b>(6.8)</b>	<b>(10.5)</b>	<b>56.5</b>	<b>80.7</b>
- Capex (+asset sales)	7.8	30.8	55.9	73.1
- Working Capital Increase	0.0	0.0	0.0	0.0
<b>Free Cashflow</b>	<b>(14.5)</b>	<b>(41.3)</b>	<b>0.5</b>	<b>7.6</b>
- Dividends (ords & pref)	0.0	0.0	0.0	0.0
+ Equity raised	15.3	40.1	0.0	0.0
+ Debt drawdown (repaid)	(3.8)	0.0	0.0	0.0
+ Other	(0.0)	1.1	0.0	0.0
<b>Net Change in Cash</b>	<b>(3.1)</b>	<b>(0.1)</b>	<b>0.5</b>	<b>7.6</b>
Exchange rate effects	(0.9)	0.1	0.0	0.0
Cash at End Period	1.7	1.7	2.2	9.8
Net Cash/(Debt)	(13.2)	(13.3)	(12.8)	(5.2)

Balance Sheet (A\$m)	2009A	2010F	2011F	2012F
Cash	1.7	1.7	2.2	9.8
Total Assets	26.0	81.2	136.5	213.8
Total Debt	14.9	15.0	15.0	15.0
Total Liabilities	15.9	17.3	17.3	17.3
Shareholders Funds	10.2	63.9	119.2	196.6

Ratios	2009A	2010F	2011F	2012F
Net Debt/Equity (%)	130.0	20.9	10.7	2.6
Interest Cover (x)	na	na	na	na
Return on Equity (%)	na	21.3	46.4	39.3

## Recommendation History



Date	Type	Target Price	Share Price	Recommendation	Return
13 Nov 09	Research Note	0.62	0.37	B	
22 Dec 09	Research Note	0.90	0.47	B	27.0%
13 Jan 10	Event Impact Email	0.90	0.69	B	46.8%
02 Feb 10	Research Note	1.03	0.65	B	-5.8%
23 Mar 10	Event Impact Email	1.03	0.79	B	21.5%
30 Mar 10	Research Note	1.27	0.83	B	5.1%
04 May 10	Research Note	1.21	0.83	B	
26 May 10	Event Impact Email	1.21	0.60	B	-27.7%
27 May 10	Event Impact Email	1.21	0.59	B	-1.7%
17 Jun 10	Research Note	1.22	0.56	B	-5.1%
19 Jul 10	Research Note	1.16	0.53	B	-5.4%
29 Jul 10	Research Note	0.95	0.50	B	-5.7%
02 Aug 10	Event Impact Email	0.95	0.52	B	4.0%
09 Aug 10	Research Note	0.50	0.50	H	-3.8%
	Current Share Price		0.43		

**Stock recommendations:** Investment ratings are a function of Patersons expectation of total return (forecast price appreciation plus dividend yield) within the next 12 months. The investment ratings are Buy (expected total return of 10% or more), Hold (-10% to +10% total return) and Sell (> 10% negative total return). In addition we have a Speculative Buy rating covering higher risk stocks that may not be of investment grade due to low market capitalisation, high debt levels, or significant risks in the business model. Investment ratings are determined at the time of initiation of coverage, or a change in target price. At other times the expected total return may fall outside of these ranges because of price movements and/or volatility. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. This Document is not to be passed on to any third party without our prior written consent.

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