Hartleys

PCL.asx
Buy

Conventional Oil & Gas: Explorer

PANCONTINENTAL OIL AND GAS NL

First Up Gas Discovery – Upgrade to Buy

Pancontinental Oil and Gas Limited ("Pancontinental", "PCL", "Company") has announced first up drilling success at its 15% owned L8 block offshore Kenya. The Company has encountered 50m of net pay in gas charged sands at the primary target in the Mbawa prospect, operated by Apache.

The result is very significant as it opens up a new hydrocarbon province offshore Kenya and additional success is now highly likely. The secondary target in this well has been de-risked by this result and should be encountered any day. The possibility of oil in this zone has not been ruled out; however, the gas case now seems more likely.

Whilst many of the parameters required to make an estimate on recoverable volume have not been disclosed, we can infer and make assumptions based around pre-drill estimates and also the nature of the discoveries to the south. These are detailed on page 3. The upshot is a range of 2-5 trillion cubic feet of recoverable gas, with a mid case of 3.5 trillion cubic feet of gas (Hartleys estimates). We assume PCL's interest will reduce to 10% (Tullow will free carry PCL in a second well), which results in value of 23cps for this horizon alone.

We have upgraded PCL from a Speculative Buy to a Buy and increased our valuation from 30cps to 85cps. Our price target is 51cps.

First of Many – Kenya Re-Rated

We now assume that 25 trillion cubic feet of gas will ultimately be discovered across PCL's 4 permits offshore Kenya (L6, L8, L10A, L10B). Our estimated chance of success has increased from an average of <10% to ~40% (50% for L8 – 30% for L6, L10A, L10B). Using these estimates results in a risked valuation for the Kenyan acreage of 73.5cps, with upside potential of 275cps.

Remember Cove? Time for Smart Money to Move In

It took considerable time for the market to digest the significance of the discoveries made by Cove offshore Mozambique; however, the initial success was followed by many more and ultimately the company was acquired for over A$2b by PTTEP after a bidding war with Shell.

Onwards and Upwards – More Drilling Success Inevitable

Results from the secondary target in the Jurassic should be encountered any day. Pre drill estimates of potential closure at this horizon are in excess of 300km^2 (as compared with 179km^2 at the primary target level) and, as with the primary target, followup potential is very large.

It now seems likely that Tullow will exercise its option to drill a second well as part of its farm-in with PCL. This will reduce PCL's interest to 10% in L8 and should see drilling of an additional well within 6 months, subject to rig availability.

BG has been fast tracking its exploration program at L10A and L10B (PCL 15%) and it is likely that at least one well will be drilled on this acreage in H1 2013.

PCL also has a 40% interest in L6, which is adjacent to L8 and the source kitchen from which the Mbawa hydrocarbons have been generated. 3D seismic was recently acquired over two large prospects on this permit.

We have upgraded to PCL to a Buy with a price target of 51cps.

	10 Sep 2012
Share Price:	$0.175
6mth Price Target:	$0.51

Brief Business Description:
Large acreage position across 4 permits offshore Kenya - recent gas discovery upgrades. Also huge oil potential offshore Namibia.

Hartleys Brief Investment Conclusion
Play opening discovery offshore Kenya upgrades to a Buy. Additional discoveries highly likely.

Key Personnel
Mr Henry David Kennedy (Chairman)
Mr Roy Barry Rushworth (CEO, Director)
Mr Ernest Myers (Finance Director)

Top Shareholders:
SUNDOWNER INTERNATIONAL LIMITED (11.8%)
HSBC CUSTODY NOMINEES (13.5%)

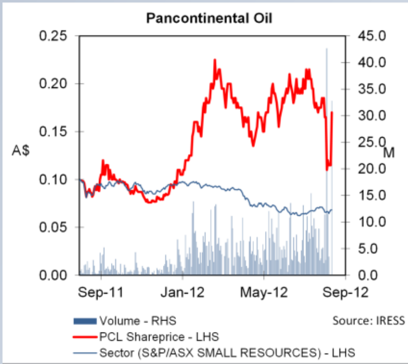
Company Address:
Ground Floor, 288 Stirling St
Perth, WA, 6000

Valuation:	$0.85
Issued Capital:	1122.7m
- fully diluted	1136.4m
Market Cap:	$196.5m
- fully diluted	$198.9m
Cash Equiv (Jun '12):	$47.0m
Debt (Jun '12):	$0.0m

Valuation Summary

Asset	**Value ($m)**	**Value ($ps)**	**Unrisked Value ($ps)**
L8 - Mbawa	183.75	0.162	0.23
L8 - Other	262.50	0.231	0.46
EL0037	78.00	0.069	3.43
10A	112.50	0.099	0.33
10B	112.50	0.099	0.33
L6	173.63	0.153	0.51
Australia	3.60	0.003	0.06
Cash	47.00	0.041	0.041
Debt	0.00	0.000	0.000
Corp Admin	-11.33	-0.010	-0.010
Options	1.00	0.001	0.001
Total	**963.15**	**0.848**	**5.39**

Source: Hartleys Research



Authors:
Dave Wall
Oil and Gas Analyst
Ph: +61 8 9268 2826
E: david_wall@hartleys.com.au

Hartleys has provided corporate advice within the past 12 months and continues to provide corporate advice to Pancontinental Oil and Gas. See disclosure on back page for details. The analyst has a beneficial interest in the shares of Pancontinental Oil and Gas Ltd.

Mbawa discovery opens up new hydrocarbon province.

HIGHLIGHTS

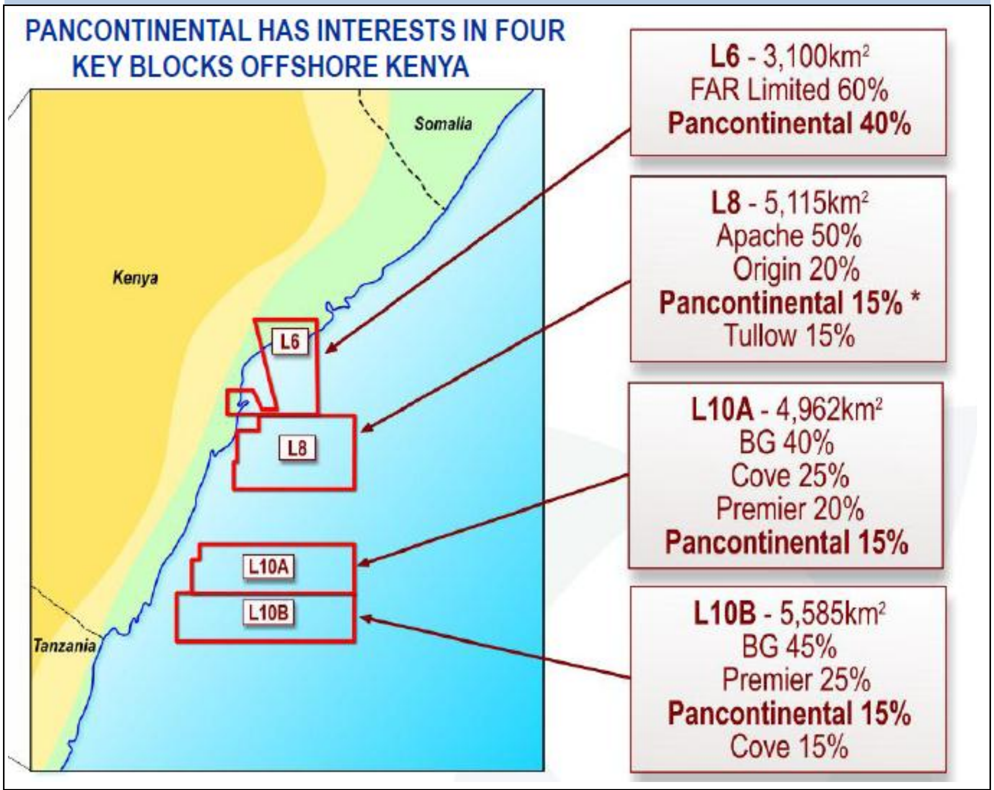
It is hard to overstate the significance of first-up drilling success in what is effectively a virgin area. The success at Mbawa, whilst not fully quantified, is likely the beginning of a new wave of discoveries offshore Kenya. If even a portion of the potential of the existing leads and prospects is converted to discovery then there will be a repeat of what has already transpired in Tanzania and Mozambique. Success rates, based on prospects that have Direct Hydrocarbon Indicators (like Mbawa), have been over 80% - which is staggering.

Many more discoveries likely.

We cannot help but think of the success of Cove, recently acquired for A$2.2 billion (240p) by PTTEP. Its story started with the Windjammer discovery in March 2010, when its share price was 24p. It doubled to 40p and then had an inexorable rise before the bidding war between PTTEP and Shell started, almost 2 years to the day later than the initial discovery.

Secondary target imminent.

Fig. 1: PCL – Large Exposure over 4 Blocks



Source: Pancontinental

Upgrade to Buy on possible volume of 3.5tcf at Mbawa and the likelihood of 20tcf of followup potential on PCL's 4 permits offshore Kenya.

Given the success rates in East Africa using modern seismic techniques, additional success is highly likely, representing an opportunity for those that can weather some near term volatility (eureka effect and secondary target results) to make multiple returns over the next 12-18 months. PCL is now firmly in the sights of Super Majors and National Oil Companies looking to secure energy in what is now a new hydrocarbon province. As with Cove, bids may not come until more gas is discovered; however, given Shell's recent bridesmaid status and the "hot" nature of the region, a pre-emptive attempt would not surprise.

Upgrade to Buy with 51cps price target.

We have upgraded PCL to a Buy with a price target of 51cps (there is room for upwards movement in this as further details are revealed).

MBAWA / KENYA VALUATION ASSUMPTIONS

As there was not much information released, we have had to make some assumptions to come up with a volumetric estimate. These are detailed below with justifications for our reasoning.

It is early days for Mbawa and not much information is available but our assumptions indicate 2-5tcf potential recoverable gas.

Fig. 2: Assumptions

Metric	Comment
Net Pay	50m (provided)
Aerial Closure	70-90km2 (~50% of the pre-drill estimate)
Porosity	20-25% (in line with pre-drill estimate and consistent with results to the south)
Gas Saturation	70% (industry average)
Gas Formation Volume Factor	0.004-0.005 (based on similar depth gas fields)
Recovery Factor	70-80% (industry average)

Source: Hartleys

Using the upper end of our estimates results in recoverable gas of 5 trillion cubic feet of gas. Using the lower end results in 2.2 trillion cubic feet of gas. Our base case is 3.5 trillion cubic feet of gas.

In our valuation we have assumed value of $0.75 per thousand cubic feet of gas of in ground resource for L8 and $0.50 for L6, L10A, L10B. The difference is because L8 was one of the early PSCs, where the fiscal terms are more attractive.

We have assumed that there is 10 trillion cubic feet of gas potential on L8 and an additional 10 trillion cubic feet of gas at L10A and L10B combined. The L6 estimate of 5.7 trillion cubic feet of gas has been independently estimated. This results in a total of ~25 trillion cubic feet of gas. Our assumptions are tabled in Fig. 3 below.

Fig. 3: Exploration Valuation

Permit / Prospect / Interest*	Net Recoverable Potential*	NPV per Unit (A$)	POS	Risked Value (A$m)	Risked Value (cps)	Un-risked Value (cps)
L8-Mbawa (10%)	350bcf	A$0.75 per mcf	70%	A$184m	16cps	23cps
L8 – Other 10%)	700bcf	A$0.75 per mcf	50%	A$263m	23cps	46cps
L6 (20%)	1.1tcf	A$0.5 per mcf	30%	A$174m	15cps	51cps
EL0037 (30%)	390 million barrels	A$10 per bbl	2%	A$78m	6.9cps	343cps
10A (15%)	750bcf	A$0.5 per mcf	30%	A$113m	10cps	33cps
10B (15%)	750bcf	A$0.5 per mcf	30%	A$113m	10cps	33cps
Aus-Baniyas (20%)	5 million barrels	A$15 per bbl	5%	$4.8m	0.3cps	6cps
Total	**3.7tcf 390 million barrels**			**A$926m**	**82cps**	**535cps**

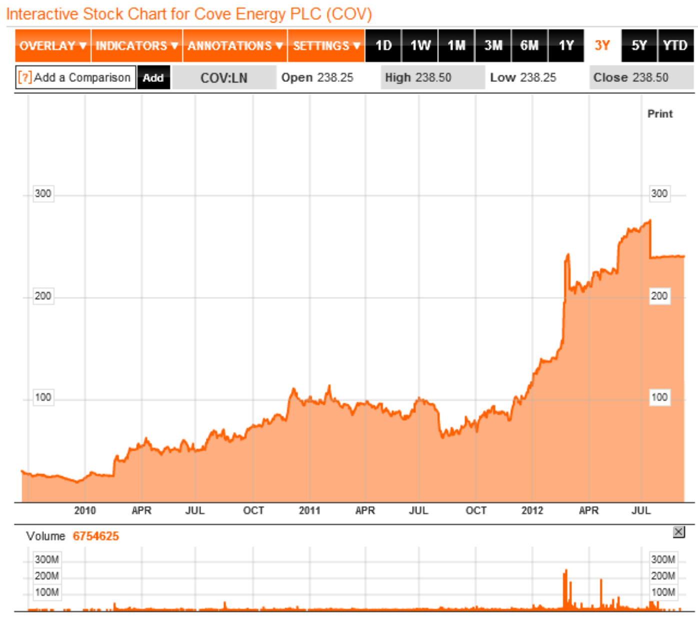
Source: Hartleys, *post farm-out

Chance of success increased significantly for the rest of the Kenyan acreage.

The Cove chart below shows the potential path forward for PCL. Of course, more gas discovered in East Africa will start questions about which asset is best, which regime is best etc but ultimately, we believe that acquisition by a Super Major or National Oil Company is the most likely outcome.

Is PCL the next Cove?

Fig. 4: Cove – PCL Next?

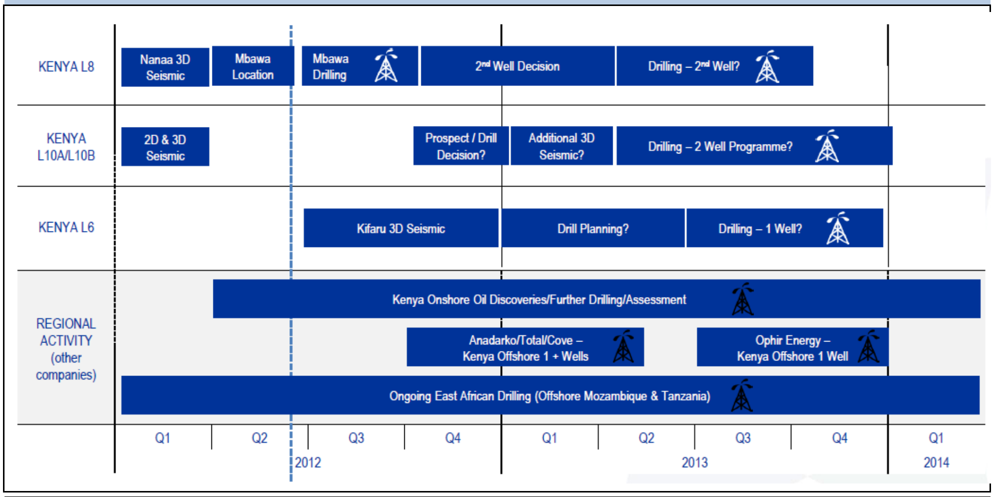


Source: Bloomberg

Multiple follow up wells likely over the next 12 months.

The possible forward program below now seems a likely path forward, given the success at Mbawa.

Fig. 5: Possible Forward Program



Source: Pancontinental

Significant potential in the same play type as the discovery as well as additional play types. More discoveries are inevitable.

Fig. 6: Huge Follow Up Potential

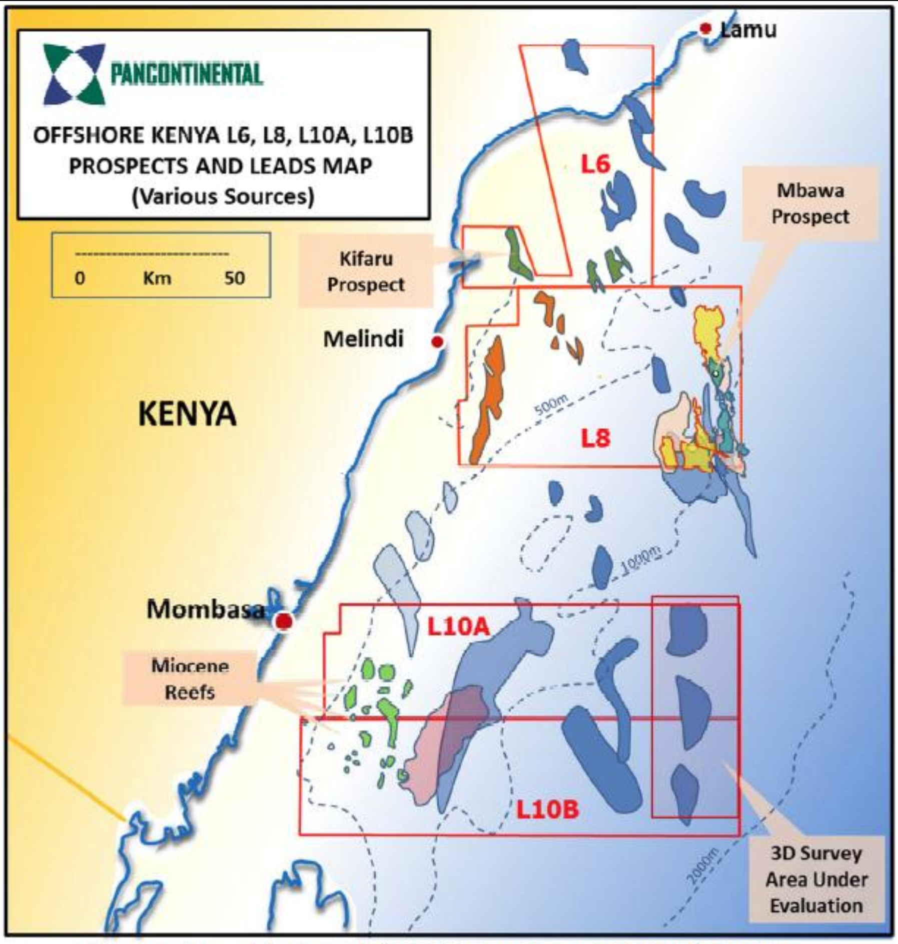


Figure 1: Pancontinental's Projects Offshore Kenya (L6, L8, L10A, L10B)

Source: Pancontinental

The multiple blobs on the figure above highlight the substantial follow up potential in the Mbawa play type as well as others. This follow up is the key to the investment thesis at this early stage. The initial discovery by Cove opened up a complex, with multiple horizons and prospects, all of which have proven to be saturated with gas. The Mbawa Complex on the map above could replicate this and the imminent results from the secondary target will be significant for the greater resource potential offshore Kenya as this is a different play type than Mbawa.

We have not mentioned PCL's large EL0037 block offshore Namibia; however, this also has huge potential and a re-rating is possible in the near term based on drilling results by others.

We rate Pancontinental Oil and Gas Ltd as a Buy with a price target of 51cps.

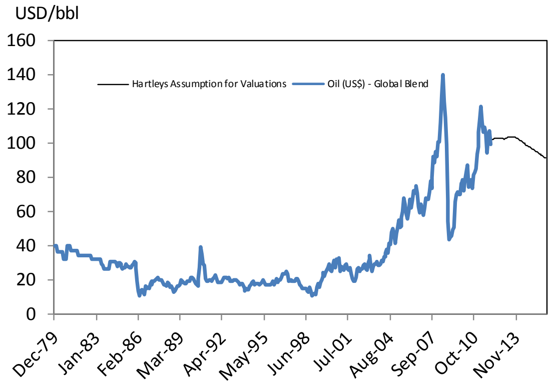
KEY ASSUMPTIONS / RISKS

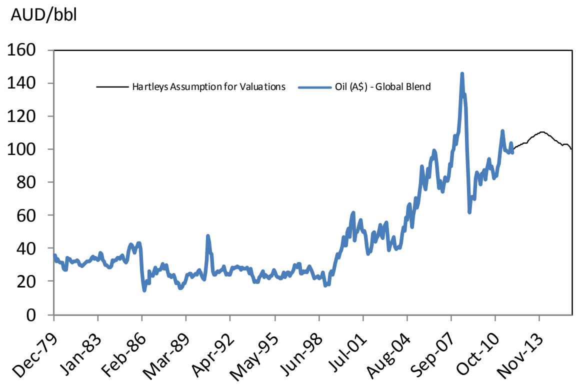
Our valuation methodology is based on risked value of resource potential using notional in ground valuation and conservative estimates for probability of success. This methodology results in Net Asset Value of 85cps.

Our price target is a qualitative discount to our valuation based on market cap, liquidity and takeover premium. In PCL's case, this discount has been estimated at 40% resulting in a price target of 51cps.

Fig. 1: Commodity price assumptions

Oil





Source: Hartleys, Bloomberg

Fig. 2: Key assumptions and risks for valuation

Assumption	Risk of not realising assumption	Downside risk to valuation if assumption is incorrect	Comment
Exploration Risk	Moderate	Moderate-High	The recent success at Mbawa has significantly de-risked our valuation for PCL and increased the likelihood of further discoveries on its acreage.
Schedule Risk	Low	Low-Moderate	Now that there has been a discovery, we predict that drilling activity will significantly increase offshore Kenya, with up to 10 wells expected in 2013.
Funding Risk	Low	Low-Moderate	PCL has $47m in cash and is fully funded for the foreseeable future.
Valuation Risk	Low	Low-Moderate	Our exploration valuation includes a risked metric based on prospect sizes. It assumes that the market will recognise a portion of potential value before the results of a well are known. In most cases, we include ~10% of potential prospect value in our valuations. However, this may increase or decrease depending on the type of well drilled and confidence in the prospect
Conclusion	*We believe the assumptions we have used have a low-moderate risk of not being achieved, which would have a moderate impact on our valuation.*		

SOURCE: Hartleys

HARTLEYS CORPORATE DIRECTORY

Research

Trent Barnett	Head of Research	+61 8 9268 3052
Mike Millikan	Resources Analyst	+61 8 9268 2805
Ben Crowley	Resources Analyst	+61 8 9268 3045
David Wall	Energy Analyst	+61 8 9268 2826
Peter Gray	Research Analyst	+61 8 9268 2837
Janine Bell	Research Assistant	+61 8 9268 2831

Corporate Finance

Grey Egerton-Warburton	Head of Corp Fin.	+61 8 9268 2851
Richard Simpson	Director –Corp. Fin.	+61 8 9268 2824
Paul Fryer	Director–Corp. Fin.	+61 8 9268 2819
Dale Bryan	Director–Corp. Fin.	+61 8 9268 2829
Ben Wale	Snr Mgr–Corp. Fin.	+61 8 9268 3055
Ben Crossing	Snr Mgr – Corp.Fin.	+61 8 9268 3047
Stephen Kite	Snr Mgr- Corp. Fin.	+61 8 9268 3050
Scott Weir	Mgr - Corp Fin.	+61 8 9268 2821

Registered Office

Level 6, 141 St Georges Tce Postal Address:

PerthWA 6000	GPO Box 2777
Australia	Perth WA 6001
PH:+61 8 9268 2888	FX: +61 8 9268 2800
www.hartleys.com.au	info@hartleys.com.au

Note: personal email addresses of company employees are structured in the following manner:firstname_lastname@hartleys.com.au

Hartleys Recommendation Categories

Buy	Share price appreciation anticipated.
Accumulate	Share price appreciation anticipated but the risk/reward is not as attractive as a "Buy". Alternatively, for the share price to rise it may be contingent on the outcome of an uncertain or distant event. Analyst will often indicate a price level at which it may become a "Buy".
Neutral	Take no action. Upside & downside risk/reward is evenly balanced.
Reduce / Take profits	It is anticipated to be unlikely that there will be gains over the investment time horizon but there is a possibility of some price weakness over that period.
Sell	Significant price depreciation anticipated.
No Rating	No recommendation.
Speculative Buy	Share price could be volatile. While it is anticipated that, on a risk/reward basis, an investment is attractive, there is at least one identifiable risk that has a meaningful possibility of occurring, which, if it did occur, could lead to significant share price reduction. Consequently, the investment is considered high risk.

Institutional Sales

Carrick Ryan	+61 8 9268 2864
Justin Stewart	+61 8 9268 3062
Simon van den Berg	+61 8 9268 2867
Chris Chong	+61 8 9268 2817
Simon Andrew	+61 8 9268 3020
Veronika Tkacova	+61 8 9268 3053

Wealth Management

Nicola Bond	+61 8 9268 2840
Bradley Booth	+61 8 9268 2873
Adrian Brant	+61 8 9268 3065
Nathan Bray	+61 8 9268 2874
Sven Burrell	+61 8 9268 2847
Simon Casey	+61 8 9268 2875
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David Hainsworth	+61 8 9268 3040
Neil Inglis	+61 8 9268 2894
Murray Jacob	+61 8 9268 2892
Bradley Knight	+61 8 9268 2823
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Shane Lehmann	+61 8 9268 2897
Steven Loxley	+61 8 9268 2857
Andrew Macnaughtan	+61 8 9268 2898
Scott Metcalf	+61 8 9268 2807
David Michael	+61 8 9268 2835
Damir Mikulic	+61 8 9268 3027
Jamie Moullin	+61 8 9268 2856
Chris Munro	+61 8 9268 2858
Michael Munro	+61 8 9268 2820
Ian Parker	+61 8 9268 2810
Ian Plowman	+61 8 9268 3054
Margaret Radici	+61 8 9268 3051
Charlie Ransom	+61 8 9268 2868
Brenton Reynolds	+61 8 9268 2866
Conlie Salvemini	+61 8 9268 2833
David Smyth	+61 8 9268 2839
Greg Soudure	+61 8 9268 2834
Sonya Soudure	+61 8 9268 2865
Dirk Vanderstruyf	+61 8 9268 2855
Jayme Walsh	+61 8 9268 2828
Samuel Williams	+61 8 9268 3041