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Linc Energy Limited

What a Gem! LNC signs HOA for Emerald Sale

LNC **A$4.35**
BUY

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Linc Energy Limited (LNC) have entered into a Heads of Agreement (HOA) with Xinwen Mining Group Ltd of China (Xinwen) for the sale of its Teresa coal exploration permits at Emerald for A$1.5B. The parties have agreed to negotiate the formal sale and purchase contract, and complete due diligence over the next month. We view this announcement positively. Once the transaction has been approved it will give LNC the necessary funds to construct its commercial 20,000 barrel per day Gas to Liquids (GTL) facility. We maintain our BUY recommendation and upgrade our DCF valuation to A$7.43/sh (prev A$6.40/sh) as LNC will now be able to use the funds from the sale to fully finance its first facility without the need for extra debt or equity. We lift our share price target to A$6.50/sh (prev A$5.50/sh), a discount to our DCF valuation as we wait for the completion of due diligence and approvals by State and Federal government, including FIRB approval.

Further Terms of the HOA

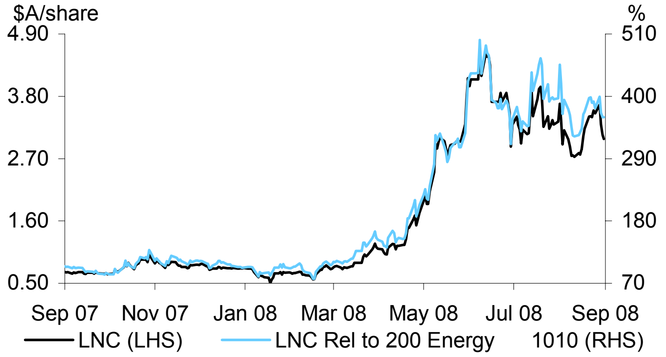
- **Timing and nature of Payments** – Commences with a A$150M payment to LNC immediately after receipt of all necessary State and Federal government approvals - 6 more tranches each of A$150M will then be paid monthly before the final balance is paid. It is expected that all payments will be completed by June 2009.
- **Execution of Contract –** Both LNC and Xinwen are now undertaking a 30 day due diligence period. Both parties are aiming to execute the formal Sale and Purchase Agreement by 5 October 2008.
- **State and Federal Approvals –** Once the formal contract has been signed, both parties will immediately seek the necessary State and Federal government approvals which are expected to take approximately 45 days.

Our View

We view the HOA with Xinwen very positively. Once the transaction has been approved it will give LNC the necessary internal funds to construct its 20,000 barrel per day GTL plant. It also puts a floor on the share price. We maintain our BUY recommendation. We do note that the key risk to the announcement is that due diligence is not completed satisfactorily or that government approvals are not granted.

Company Data	
Number of shares	397.6M
Market capitalisation	$1,729.6M
12 month high/low	$4.92 / $0.48
Average monthly turnover	$31.9M
All Ordinaries Index	4950
% All Ordinaries	n/a

LNC versus 200 Energy 1010 Index



Financial Summary

Gas Production					
Plant capacity	20,000	bbl/day			
Availability Factor	90.4	%	Plant Availability Time	7,920	hours / year
Gas Production	1,397,023	Nm3 / hour	Total Gas Production	11,064,424,587	Nm3 / year
Gas Calorific Value	5.23	MJ / Nm3	Total Energy Output	57,866,941	GJ / year
By-Product Production - Hydrocarbons					
Hydrocarbon Production	15.27	g / Nm3	Total Hydrocarbon Production	168,996	tn / year
Sale Value of Hydrocarbons	100	$ / tn	Total Hydrocarbon Revenue	16,899,589	$ / year
By-Product Production - Naphtha					
Naphtalene Production	10.16	g / Nm3	Total Naphtalene Production	112,415	tn / year
Sale Value of Naphtha	400	$ / tn	Total Naphtalene Revenue	44,965,822	$ / year
Diesel Production					
GTL Plant Energy Efficiency	70	%	Diesel Calorific Value	6.137	GJ / barrel
Maximum Energy Output	40,506,858	GJ / year	Maximum Diesel Production	6,600,003	barrels / year
Availability Factor - year 1	85.0	%	Diesel Production - year 1	5,610,003	barrels / year
Availability Factor - year 2	90.0	%	Diesel Production - year 2	5,940,003	barrels / year
Availability Factor - years 3+	95.0	%	Diesel Production - years 3+	6,270,003	barrels / year
Diesel Selling Price * 75 US$ / bbl	107.14	$ / barrel	Total Diesel Revenue (Year 3+):	671,786,020	$
Federal Tax Exemption	no		Federal Tax Rate	0.36	$/litre
Economic Factors			**WACC:**	13.0	%
Exchange Rate $/US$	0.80				
Capital Expenditure Details					
Gas Process Plant	70,000,000	$			
Clean Up Plant	180,000,000	$	Total Capital Required	900,000,000	A$
GTL Plant	650,000,000	$			
Operating Costs					
Gas Process Plant	28,900,000	$ / year			
Clean Up Plant	14,200,000	$ / year			
GTL Plant	50,000,000	$ / year	Total Opex	93,100,000	$ / year
Summary per year (no inflation)					
Total Revenues (year 3+)	733,651,430	$ / year	DCF @ 13 %	3,062,249,638	$
Total Opex	93,100,000	$ / year	Internal Rate of Return	781.09	%
Total Site Admin Cost	4,000,000	$ / year	Plant Capacity to Break Even	1,616	bbl/day
Total HQ Admin Cost	7,000,000	$ / year			
Federal Tax Exemption	0	$ / year			
EBITDA	629,551,430	$ / year			

Source: BBY, Company Reports

Xinwen Mining Group Ltd of China (Xinwen)

Xinwen's main office is located within the province of Tai'an City and Laiwu City, China. Xinwen produces in excess of 35m tonnes of coal per year and possess more than 30bn tonnes of coal reserves. They also have interests in a number of Chinese steel mills. The Group ranks 220th among National Large Enterprises and 7th among National Top 100 Coal Enterprises. The Enterprise Credit Prestige of the Company has been graded as AAA. The company's structure includes: (i) a primary focus on coal, (ii) a focus on power, chemical and building materials; and (iii) eight supporting divisions being logistics, machinery processing, textile, metallurgy, pharmacy, farming, financial service and paper making.

We understand that the two parties had been in dialogue for some time.

What the Sale Means for LNC

We view the HOA with Xinwen very positively. It has two key benefits for LNC:

- **Financing for Chinchilla** - We expect the sale (once approved) of Teresa will allow LNC to fully finance its 20,000 barrel per day GTL facility located at Chinchilla (estimated at around A$900M). At a time where debt/equity issuance is a struggle, even for the best of projects, this stands the company in good stead and removes a key project risk.
- **Floor on LNC's share price** - Being able to crystalise the company's Teresa coal deposit into cash puts a floor on LNC's share price. We assume that LNC pays approximately 20% tax on the A$1.5B, (as a result of a deductions and some roll-over relief), the net effect being A$1.20B to LNC or a floor at approximately A$3.00 in the share price. This does not include any of the other LNC exploration tenements (which are not being used for UCG), one of which LNC intends to sell within the next 12 months.

How Does the Transaction Compare with other Coal Deals?

We believe that the price which Xinwen has agreed to pay LNC under the HOA is favourable when compared to the most recent transaction in the domestic coal sector.

The most recent and relevant transaction done in the QLD coal market was New Hope Corporation (NHC) selling its New Saraji Coal Project to the BHP Billiton Mitsubishi Alliance (BMA) for A$2.45B in cash. At that time NHC had identified and had a JORC statement for 690M tonnes of coking coal. On a strict per tonne in the ground basis, for every one tonne of coking coal, this equated to approximately A$3.50/t in cash to NHC. We do note that as part of the transaction NHC gave the BMA alliance port capacity and both parties agreed that there was significant scope to increase the tonnage at New Saraji. The transaction was also done in mid July 2008. Since then, we have seen a fall in the share prices of coal companies as a result of fears relating to a drop in both thermal and coking coal prices.

While LNC has not released a JORC compliant resource statement to the market (we expect to see an interim statement released in the next few weeks), they did announce on 28 July 2008 that they were targeting an exploration target at Emerald of between 400M to 500M tonnes of coal (both coking and thermal) with a view to selling the deposit to help finance the company's commercial GTL plant by year end. In the same announcement, LNC announced that "there is a further exploration target of around 600M tonnes within the same seams".

If we conservatively assume that LNC would have eventually proven up approximately 300MT of coking coal and 600MT of thermal coal (1/3rd coking; 2/3rd thermal) at Teresa and use a slightly lower valuation metric for coking coal in the ground (i.e. A$3.00/t) than the New Saraji deal (which we believe is still generous given the comparisons between New Saraji and Emerald due to: i) no port capacity in this deal; ii) no JORC defined resource as yet; and iii) the volatility in the commodity markets) and use A$1.00/t for thermal coal, BBY's numbers come in-line with the purchase price to be paid by Xinwen:

- **Coking Coal – 300MT x A$3.00/T = A$900M**
- **Thermal Coal – 600MT x A1.00/T= A$600M**
- **Total = A$1.5BN**

FIGURE 1: LOCATION OF LNC'S EMERALD DEPOSIT

LNC's Tenement

Source: www.mining-technology.com

BBY Valuation Changes

BBY has upgraded our DCF valuation to A$7.43/sh (prev A$6.40/sh) as LNC will now be able to use the funds from the sale to internally fully finance its first facility without the need to raise additional debt or equity. We had previously conservatively assumed that A$200M of the c.A$900M needed for constructing the commercial GTL reactor would come from the sale of LNC's coal tenements. We chose to be conservative, preferring to wait for LNC to actually sell the tenements than to guess what Teresa was worth especially given the volatile environment.

We now expect that the funds received from the sale (once due diligence and government approvals have been given) will be sufficient to fund ALL of LNC's CAPEX for its 20,000 barrel per day plant. Not only does the sale reduce the need for share issuance and raising of debt, but it also mitigates the risk of LNC being unable to obtain these funds in an environment that is currently unfriendly to debt issuances.

We also note that our current valuation only encompasses one commercial 20,000 barrel per day plant and uses a long term WTI oil price assumption of US$75/bbl.

Will Another Bidder Emerge?

We cannot rule out that now that LNC have announced that Xinwen is willing to pay A$1.5B for its Teresa coal deposit that another competing bid may surface. We understand that LNC has fielded enquiries from a number of both domestic and international parties interested in Teresa (although discussions are not at an advanced stage with these parties). Another bid would have to be made within the next thirty days before LNC and Xinwen sign a formal contract.

Risks to the Transaction

We point out that there are a few risks to the transaction being fully completed:

- **Due Diligence –** Both parties are to carry out due diligence for the next 30 days. There is obviously a small chance that due diligence will not be completed satisfactorily by Xinwen.
- **Government Approvals** – FIRB approval will be necessary for the transaction to occur. Whilst we believe that FIRB approval will be granted (also a possibility it could take longer than the 45 day period LNC have suggested), it is still an important milestone for the LNC to get tick off.

GTL Pilot Plant Update

LNC has also provided an updated on its Chinchilla GTL pilot plant. Over the past week, LNC's team have loaded the catalyst into the Fischer Tropsch (FT) reactors. Once the catalyst has been properly reduced the GTL team will commence feeding gas into the FT reactors with the aim of making liquids shortly thereafter.

Whilst progress has been slower than anticipated, the update shows that LNC is very close to producing liquids. This would be a major milestone for the company and would result in another significant re-rating for the stock.

ASX 200 and ASX 300

Also on Friday, the Standard and Poor's Index Services announced a rebalancing of the ASX 200 and ASX 300 from the close of trade 19 September 2008. Positively for LNC, they have been included in both these indices.

Our View

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Contact with LNC has been made during the preparation of this report for assistance with verification of facts.

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