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Origin Energy Limited (ORG)

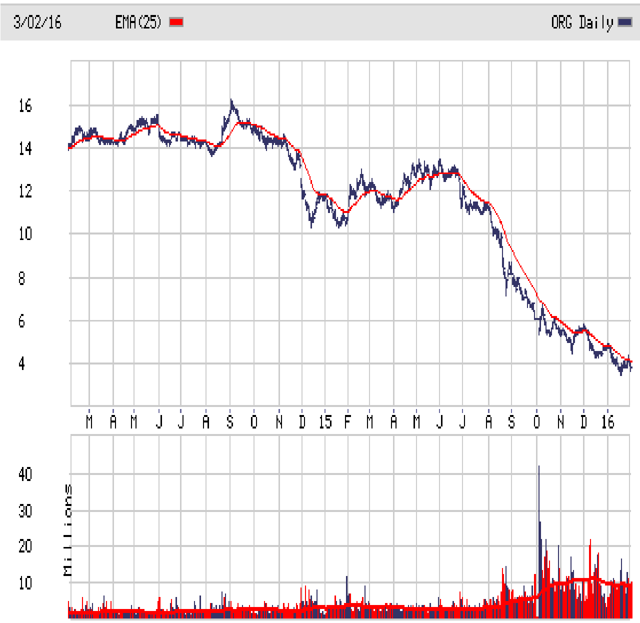
"Free LNG Project" with downside covered

ASX INFORMATION

ASX Code:	ORG
Current Price	$3.79
52 week Share Price Range:	$3.44 - $11.77
Market Capitalisation:	$6980 million
Shares on Issue:	1749.5 million
Unlisted Options:	31.4 million
Employee shares plans (various strikes)	

Bloomberg estimates

SHARE PRICE CHART



MAJOR SHAREHOLDERS

Vanguard	5.3%
T Rowe Price Group	1.6%
State Street	1.1%

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January 2016

Interesting Value Play

Origin's share price has been dragged down by:

- The fall in global oil prices;
- Dilutive capital raising;
- Concerns over debt levels.

Investment Summary

ORG is an energy retailer, with an upstream oil & gas division and also has a 37.5% stake in APLNG (a 9m tpa LNG project located at Gladstone, QLD). We think the questions investors should be considering are:

- What returns will ORG generate from its stake in APLNG,
- Will the base business generate sufficient returns to fund distributions to shareholders, and cover interest costs,
- How attractive is the stock relative to other players in energy retailing and LNG.

We view AGL, STO, and CEN as the market's comparable to Origin.

Comparing AGL and ORG, it is clear that the APLNG project is essentially "free" in Origin's share price.

Comparing STO and ORG, we think that both stocks are materially undervalued, however, ORG has better credit metrics, and in our view, the base business ensures that even if oil prices were to remain depressed for a further 18-months or so, ORG can ride out the storm.

In terms of upside, ORG's equity accounted share of LNG production is within 10% of STO's, and in our view, its coal seam methane project is materially better in terms of flow rates per well, while plant performance will be at least comparable.

In short, ORG offers investor's excellent leverage to an eventual rebound in oil prices via its stake in APLNG, while the downside is protected for a minimum of 18 months via the recently purchased oil put options. Should oil prices rebound (to say US$55-65/bbl) over this period, ORG's share price is likely to rally strongly.

INTRODUCTION

Origin Energy was demerged from Boral and listed on the ASX in February 2000. Initially the assets comprised:

- 13-20% in SACBJV, 85% of Oil Co of Australia (some coal seam methane assets in QLD);
- Energy retailing assets in South Australia (SAGASCO);
- Electricity generation assets, circa 380MW.

Since listing, ORG has grown via development of new power generation assets, development of both conventional and unconventional oil & gas assets, and acquisition of retail customer bases across Australia and New Zealand.

The following chart outlines the DPS and EPS over the last 7-years. This includes the equity accounted share of Contact Energy (CEN.NZ), which arguably overstates the economic performance of the group, as returns back to ORG comprise dividends on its shares of CEN. Arguably, ORG has paid out too high a percentage of earnings to shareholders, given the heavy capital expenditure during construction of the APLNG project.

	2009	2010	2011	2012	2013	2014	2015
EPS	50.4	51.0	55.3	72.1	60.5	56.2	66.0
DPS	50	50	50	50	50	50	50

Source: Etrade/Bloomberg data

ORG has provided guidance of 20cps dividend for FY16 and FY17.

RELATIVE TO OTHER ASX

AGL and CEN are directly comparable to Origin's retail businesses. STO and ORG have comparable LNG projects in Queensland.

	Mk Cap $m	EV $m	Customers 000's	Retail EBITDA $m	MW Capcity	Equity LNG (mtpa)	2P reserves	Comment
ORG	$ 6,981	$ 14,778	4300	1260	6000	3.38	1093	Excld APLNG, approx 60% developed
AGL	$ 12,759	$ 16,382	3735	1505	10508	0	849	approx 20% developed
CEN	$ 3,256	$ 5,002	556	525	2371	0	n/a	Long hydro capacity in NZ
STO	$ 5,544	$ 11,744	n/a	n/a	n/a	3.70	5579	reserves Excld GLNG

Source: Company reports.

What this highlights is

1. ORG's EV is almost identical to AGL's, but Origin has excess gas assets, plus its stake in APLNG, conversely AGL has excess generation capacity.
2. CEN EV/EBITDA multiples are practically the same as AGL's, total EV is 3 times the size – unsurprising given very similar businesses. Again this indicates that ORG's excess gas assets and/or its stake in APLNG is not being fully valued by the market.
3. Using the recent Woodside offer for Oil Search, we estimate that excluding STO's 13.5% stake in PNG-LNG (circa $6.6bn), all its other assets are being valued by the market at circa $6.1bn. Given recent asset transactions (Apache-Quadrant), STO's 30% stake in GLNG is not being valued by the market, perhaps due to STO having contractual obligations to supply the project from a diverse portfolio of other gas resources.

APLNG versus GLNG

	EV $m	1P Reserves (Pj)	2P Reserves (Pj)	Tj/day capacity	LNG Plant (m tpa)	Opex/ A$ bbl	"Break-even A$/bbl"	Comment
ORG	$ 14,777.5	4581	13778	640	9.0	$22.00	$54-57	excess gas
STO	$ 11,744.0	2245	5603	111	7.8	$25.00	$55-57	gas supply from 3rd parties
BG		3096	10326	580	9.0	n/a	n/a	Shell takeover offer for BG Group

Sources: RMLS Gas reports, company data

BG's asset has been operating reliably now for around 12 months, while ORG and STO are still in the commissioning phase. All of the projects have sufficient reserves / contingent resources to meet future production requirements. ORG has the highest installed productive capacity, while the STO project is relying on gas from 3rd parties:

Supplier	Quantity	TJ/day	Starts	Term	Delivery point	Price basis
Santos portfolio 'Horizon'	750 PJ	140	2015	15 years	Wallumbilla	Oil-linked
Origin	365 PJ	100	2015	10 years	Wallumbilla	Oil-linked
Origin	194 PJ	50-100	2016	5 years	Wallumbilla	Oil-linked
Other suppliers	85 PJ	70-115	2015-16		Wallumbilla	Oil-linked
Meridian JV	445 PJ	20-65	2015	20 years	GLNG GTP	Oil-linked
Combabula/ Spring Gully	389 PJ	4 30	2015	20 years	Fairview	Oil-linked

Sources: STO April 2015

While the Santos approach may be less capital intensive, it is likely to lower margins for the LNG project. We note that Origin and Beach Energy (as Cooper Basin joint venture partners) elected to not participate in the Horizon contract. Essentially, STO will have to carry additional "gas inventory" to supply gas to the GLNG project.

ORG (and the other APLNG joint venture partners) have funded the development of the project via $8.5bn of project finance debt, and up to $14bn in MRCPS (Mandatorily Redeemable Cumulative Preference Shares), which are issued by APLNG. At 30 June, ORG had $3.75 billion of MRCPS. These are a funding mechanism, provided by the joint venture partners in proportion to their ordinary equity interests. The MRCPS have a fixed rate dividend obligation based on the relevant observable market interest rates and estimated credit margin at the date of issue. The dividend is paid twice per annum. The mandatory redemption date for all MRCPS is 31 December 2022.

Essentially, these are a form of shareholder loan to APLNG, and, assuming oil prices recover, are likely to be re-financed in 2022 by conventional debt. This means that if oil prices were to remain depressed (below circa A$55/bbl), ORG and JV partners would NOT receive distributions out of APLNG. The minimum value that is ascribable to ORG's 37.5% share must be the estimated $4.5bn in MRCPS shares held in APLNG.

KEY DEVELOPMENTS

With the collapse in oil prices, ORG addressed its balance sheet (arguably it should have done this in early 2015) via:

- Sale of Contact Energy ($1.6bn);
- Capital raising ($2.5bn);
- Reduction in dividend guidance (20 cents per share for FY2016 and FY2017) which is supported by cash flow from the existing businesses;
- $1 billion planned reduction in capital expenditure and working capital requirements across FY2016 and FY2017
- Asset sales of up to $800 million by FY2017 (Perth basin, International exploration, potentially Cooper Basin);

Finally, ORG purchased put options on oil (Oil Puts) for FY2017, and has forward sold LNG cargoes at a fixed price, at a cost of $82m. The Oil Puts cover 15 million barrels of Japan Customs-cleared Crude (JCC) at a strike price of A$55/bbl for 75 per cent of the volume and US$40/bbl for 25 per cent of the volume. Essentially, this is a capital preservation strategy so that once the final $1.8bn contributions to Australia Pacific LNG is made, ORG is much less likely to have to provide additional funding to the project.

We note the comment "Dividends will be supported by strength of cash flow generated by the existing businesses without reliance on any distributions from APLNG", and "Should oil prices materially increase, the dividend policy will be reviewed".

Every A$10/bbl movement in oil results in approximately A$200m change in free cash flow available for distribution from APLNG to Origin.

	EV $m	FY16 EBITDA	FY17 EBITDA	2016 NPAT	2017 NPAT	FY16 EPS	FY17 EPS	EV/EBITDA FY17	FY17 PER	Comment
ORG	$ 14,778	1674	2916	408	959	23.3	54.8	5.1	7.3	Clearly the cheapest stock.
AGL	$ 16,382	1668	1785	703	793	104.2	117.5	9.2	16.1	Likely to inc dividends.
CEN	$ 5,002	527	586	162	187	22.1	25.5	8.5	17.4	Steady growth in N.Z.
STO	$ 11,744	1578	2156	116	388	6.6	22.0	5.4	14.3	Possibly higher oil price leverage than ORG, but more expensive
Oil Price						$40	$45			US$/bbl

Sources: Bloomberg data

SUMMARY

It is clear that the market remains concerned about cashflows from the major CSM-LNG projects in QLD. Balance sheet stress forced both ORG and STO to conduct dilutive capital raisings, during a period of weakness in world oil prices. Arguably, both ORG and STO still have too high debt levels, however, ORG has announced measures that ensure the downside is protected until the end of 2017.

On forward earnings estimates, ORG is clearly the least expensive LNG play, and from 2017, we expect debt to fall quickly.

$m	Price	Net Debt	FY16 EBITDA	FY17 EBITDA	Debt/EBITDA FY16	Debt/EBITDA FY17	Comment
ORG	$ 3.99	7797	1674	2916	4.7	2.7	Excludes asset sales
AGL	$18.91	3623	1668	1785	2.2	2.0	Refi Loy Yand in 2016, excludes gas capex
CEN	$4.44	1746	527	586	3.3	3.0	Further share buy-backs?
STO	$3.14	6200	1578	2156	3.9	2.9	Excludes further asset sales

Sources: Bloomberg data

We view ORG as an inexpensive call option over future oil prices, with downside protection in place for 18+ months. It is trading at a large discount to comparable companies on FY17 earnings multiples (almost 50%), while we view its CSM to LNG project is of better quality than STO's (greater reserves, better average well performance, higher installed productive capacity). There will be "teething issues" during ramp-up of APLNG, however, these projects are 15-20 year investments. The capital has already been sunk, and while oil prices remain depressed, the market will not value these long-term assets.

Clearly, the risks are A$ versus US$ appreciation, further falls in US$ oil price, operational risks, and obviously financial risk. There is the potential for a write-down in APLNG carrying value, evidenced by BG Group's write-down for QGC-LNG. Beach Petroleum has already indicated the quantum of write-downs for the Cooper Basin assets (net to ORG circa $320m).

BRIEF CORPORATE HISTORY

Origin was spun-out of Boral, listing on the ASX in 2000. Since then, ORG has developed CSM assets in QLD, new generation assets across the country, new gas developments (Kupe, BassGas etc) and acquired additional retail customers (Sun Retail, Country Energy, Integral Energy).

ORG formed a 50:50 joint venture with ConocoPhillip, with ORG receiving an upfront payment of US$5 billion. The APLNG JV then sold down 25% to Sinopec for circa US$3.1bn in 2011/12. Sinopec and Kansai signed offtake agreements for 95% of plant output. The project will be fully operational in mid-late 2016.

DIRECTORS & SENIOR MANAGEMENT

Grant King - Managing Director – Has been MD since the demerger from Boral, previously the MD of Boral Energy from 1994. Prior to that, he was GM of AGL Gas Companies. He holds Civil Engineering degree from the University of NSW and a Master of Management from the University of Wollongong

Frank Calabria – CFO - Joined ORG as CFO in November 2001, was appointed CEO Energy Markets in March 2009, and is responsible for the integrated business within Australia including retailing and trading of natural gas, electricity and LPG, power generation and the solar and emerging business. Prior to joining ORG, Frank held roles with Pioneer International Ltd, Hanson plc and Hutchison Telecommunications. He has a Bachelor of Economics from Macquarie University and a MBA (Executive) from the Australian Graduate School of Management.

Gordon Cairns - Non Exec Chairman - Gordon was elected Chairman in October 2013. His experiences in senior executive positions include: CEO of Lion Nathan Ltd, senior management positions in marketing, operations and finance with PepsiCo, Cadbury Ltd and Nestlé, a senior advisor to McKinsey & Company and is a Director of Macquarie Group Limited.

David Baldwin – Non Exec Director David joined ORG in 2006 and is responsible for ORG's Integrated Gas business, which manages the Company's portfolio of natural gas and LNG interests across Australia, New Zealand and internationally. Integrated Gas includes Origin's interests in APLNG, as operator of the upstream and pipeline components of the joint venture and as gas marketing agent. Prior to joining Origin, David held senior roles with MidAmerican Energy Holdings Company (now Berkshire Hathaway Energy) in Asia and the United States, and with Shell in N.Z. and the Netherlands. He holds a MBA from Victoria University and a Bachelor of Engineering (Chemical) from Canterbury University.

Ralph Norris – Independent Non Exec Director - Ralph joined the Board in April 2012, formerly the MD and CEO of the Commonwealth Bank of Australia. He has in excess of 40 years in business and the banking sector in Australia and New Zealand. During his career, he had a number of senior executive roles including Chief Executive Officer of ASB Bank and Air New Zealand Ltd. He is Chairman of Fletcher Building Ltd (since October 2014), a Director of Fonterra Ltd (since May 2012), New Zealand Treasury, FSF Funds Management Ltd, the Advisory Board of Tax Management Ltd and Families Inc and a former Director of the Business Council of Australia, the International Monetary Conference. Extremely well regarded in banking and business circles.

John Akehurst – Independent Non Exec Director John joined the Board in 2009. His executive career was in the upstream oil and gas, initially with Royal Dutch Shell, and then with Woodside as CEO. He is currently a member of the Board of the Reserve Bank of Australia, a Director of CSL Ltd (since August 2003), and Chairman of Transform Exploration Pty Ltd. He holds a Masters in Engineering Science from Oxford University and is a Fellow of the Institution of Mechanical Engineers

Dr Helen Nugent - – Independent Non Exec Director Helen joined the Board in 2003, she has significant experience in the financial services and resources sectors. She is Chairman of Veda Group Limited (since September 2013) and Funds SA (the $26 billion investment fund of the South Australian Government). She is a former Non-executive Director of Macquarie Group Limited (August 2007 - July 2014), Macquarie Bank Limited (June 1999 - July 2014), Chairman of Swiss Re Life and Health (Australia) (2001-2010). Formerly a partner at McKinsey & Company. Dr Nugent holds a Bachelor of Arts (Hons), a Doctorate of Philosophy in Indian History and an Honorary Doctorate in Business from the University of Queensland. She also holds a Master of Business Administration (with Distinction) from the Harvard Business School

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