

Alto Energy (AOI)

Date: 19 January 2007

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Current Share Price **\$0.076**
Recommendation **SPECULATIVE BUY**

Market Statistics

ASX Code	AOI
Sector	Energy
Ordinary Shares	185.3m
Capitalisation	\$14.1m
Cash	\$5.9m
Year High	21.0cps
Year Low	4.3cps

Directors

Charles Morgan	Chairman
James Trimble	Managing
Tony Grist	Non-Executive
Stephen Keenihan	Non-Executive
Allan Boss	Non-Executive

New Interests

Foothills Project, Oklahoma	6.50%
Waterloo, Louisiana	25.00%
Phase 3B, Louisiana	3.75% - 10.90%

Major Shareholders

James Trimble	13.1%
Charles Morgan	8.1%
Macquarie Bank	7.9%
Argonaut	6.2%

Important Disclosures

Argonaut Securities acted as manager to the placement of 50.0 million AOI fully paid shares at \$0.05 per share in December 2006 and received fees commensurate with this service. The Argonaut Group has an interest in and / or controls 11,414,062 (6.16%) AOI fully paid Shares and 1,342,385 AOI unlisted options. For further important disclosures, please see page 6.

Alto Altered

- After a period languishing under unexciting prospects in the Appalachian Basin, AOI has re-invigorated itself with a new strategy, assets, capital and board.
 - × AOI is to divest itself of the Appalachian assets and focus on low risk conventional oil and gas prospects in Louisiana and Oklahoma.
 - × A placement in December raised \$2.5m, taking cash on hand post placement to \$5.9m (worth 3.2cps). More recently, a \$4.0m working capital facility has been established with Macquarie Bank.
 - × The new MD, James Trimble, is based in Houston and brings decades of experience in US oil and gas. Other new board members bring further knowledge and US experience.
- The new assets include:
 - × Phase 3B in Louisiana (3.75% - 10.90%), where AOI is farming into a 5 well drilling programme set to commence this quarter.
 - × The Napoleonville Salt Dome in Louisiana, where AOI will fund 37.5% of 3D seismic costs and 28.5% of the costs of the first three wells to casing point to earn a 25% working interest in the project.
 - × The acquisition of the Foothills Project in Oklahoma (6.50%) from Jim Trimble, which has since acquired 24 square miles of 3D seismic in a JV with BP.
- Our **Speculative Buy** recommendation is based on:
 - × The experience and associations in the US of the new board and management.
 - × The new focus on conventional projects which appear to have significantly more potential and less risk.
 - × The likely sale of the residual Appalachian assets, which would add further to the Company's cash position.
 - × Support from solid investors.

REFOCUS

- After a period of languishing under unexciting prospects in the Appalachian Basin, AOI has reinvigorated itself with new strategy, assets, capital, and board.

Recent Events	Date
Sale of West Virginia Project Announced	18 Sep 06
Acquires interest in Foothills Project (Oklahoma)	4 Oct 06
James Trimble appointed MD	4 Oct 06
Enters into 5 well drilling programme (Louisiana) – to commence this quarter	12 Oct 06
Closes sale of West Virginia Project (realises ~US\$1.5m)	8 Nov 06
Acquires Waterloo Salt Dome asset (Louisiana)	9 Nov 06
Appoints new Directors	13 Nov 06
\$2.5m Placement (50m ords @ 5cps) completed	21 Dec 06
A\$4m working capital facility from Macquarie Bank	10 Jan 07

- × Little Sandy (30% working interest, Kentucky).
- × Paint Mountain (100% working interest, West Virginia).

- Although AOI is opting out of the Appalachian Basin, there is increasing interest in the area from large E&P companies such as Chesapeake.
- This has seen the value of larger parcels of land increase in recent times, which should allow AOI to exit at a profit. This has already occurred with the West Virginia sale.
- Apart from the remaining Appalachian assets, AOI now also holds interests in:

Louisiana and Oklahoma Assets	Interests
Foothills Project, Oklahoma	6.50%
Waterloo, Louisiana	25.00%
Phase 3B, Louisiana	3.75% - 10.90%

- Further details on these projects are provided below.

Strategy

- AOI will divest the Appalachian Assets and focus on conventional oil and gas prospects onshore Louisiana and Oklahoma that:
 - × are adjacent to and/or within producing fields,
 - × are close to infrastructure,
 - × and utilise 3D seismic and existing well data.

Capital

- The recent capital raising has provided a further \$2.5m cash to fund the new strategy. Post raising the Company had 164.3m shares on issue and \$5.9m in cash.
- A further 21m shares have subsequently been issued to James Trimble in payment for the purchase of the Foothills Project.

Assets

- Following the sale of its 29% interest in the West Virginia assets (Cornstalk, Bug Run and Green Park), AOI remains with:
 - × Home Run (Kentucky), where AOI:
 - has earned 50% - 75% interests through funding a 4-well completion, and a 5-well drilling, programme, and
 - has the option to earn an interest in the entire project (which we assume is unlikely given the change in focus).

Capital Structure	Shares
Shares in Issue pre Capital Raising	114.3
Placement at \$0.05 per share	50.0
Vendor Shares for Foothills Project (J Trimble)	21.0
Shares in Issue Post Vend and Placement	185.3

- On 10 January, AOI announced that it had entered into a A\$4.0m working capital facility with Macquarie Bank (who is also a major shareholder).

Board and Management

- Importantly the new MD and CEO, James Trimble, is based on the ground in Houston and has had 34 years' experience in US oil and gas.
- Existing board members Charles Morgan (non-executive Chairman) and Tony Grist (NED) have been joined by two non-executive directors in Stephen Keenihan and Allan Boss.
- Mr. Keenihan is an experienced (32 years) geologist and Allan Boss is an experienced (30 years) US Banker and Attorney, also based in Houston.

THE NEW ASSETS

- The Company's recently acquired assets are in proven producing areas of Louisiana and Oklahoma.

Figure 1: Location of Louisiana and Oklahoma Assets



Source: AOI

Phase 3B (Louisiana) – 3.75% - 10.90%

- AOI is farming into five onshore wells in Terrebonne and Vermillion parishes (Louisiana) that have been identified by Legend Petroleum based on 3D seismic and absorption interpretations.
- The wells will cost AOI in the region of US\$1.3m (funding 1¹/₃ : 1) to earn the varying interests. Total well costs are expected to be ~US\$2.5m each (dry well cost ~US\$2.0m).
- Following delays, drilling will take place this quarter, and flow rates of 5mmcf/d – 15mmcf/d are anticipated.

Figure 1: Phase 3B, Louisiana



Source: AOI

Louisiana Phase 3B			Preliminary Potential Reserve Exposure		
Well	Parish	Expected Drill Date	AOI Interest	Potential Reserves (bcf)	AOI Interest (bcf)
3B1	Terrebonne	Feb 07	10.90%	4	0.4
3B2	Terrebonne	Feb 07	7.50%	7	0.5
3B3	Terrebonne	Mar 07	7.50%	11	0.8
3B4	Terrebonne	Mar 07	7.50%	13	1.0
3B5	Vermillion	Mar 07	3.75%	30	1.1
Total				65	3.9

Source: AOI, Argonaut estimates for drill dates following delays

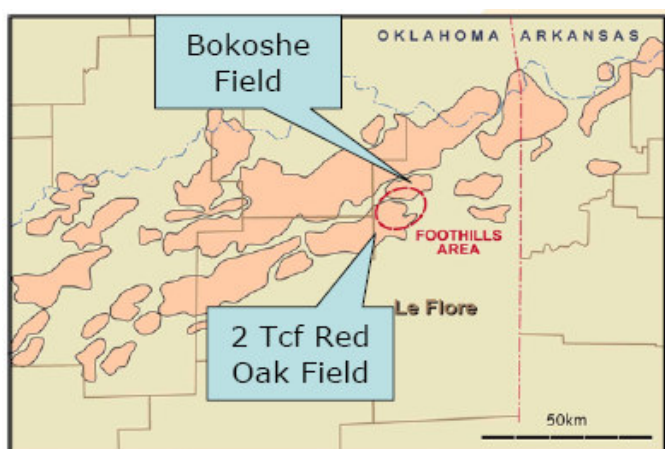
Napoleonville Salt Dome (Louisiana) – 25%

- The Napoleonville Salt Dome is another JV with Legend Petroleum, and covers 30,000 gross acres. It has already produced approximately 18mmbbl and 200bcf.
- Napoleonville has not had 3D seismic previously applied and evidence from other salt domes in Louisiana is that 3D evaluation can increase production by 10% to 25%.
- AOI will fund 37.5% of 3D seismic costs and 28.5% of the costs of the first three wells to casing point to earn a 25% working interest in the project.
- The Company's mid-case estimates, based on existing pre-3D well data, are for remaining hydrocarbons at Napoleonville of a gross 8.3mmbbl oil and 13bcf gas (with upside).
- Following the processing and interpretation of the 3D seismic data, AOI anticipates that a drilling programme will commence in mid 2007.

Foothills Project (Oklahoma) – 6.5%

- The Company has purchased a 12.5% interest in Foothills Energy LLC from James Trimble for 21m AOI shares.
- Foothills LLC is in a JV with BP to acquire 24 square miles of 3D seismic in LeFlore County. This programme is expected to identify up to 22 prospects for drilling between 2007 and 2009.
- The acquisition includes 3 wells that are currently producing 650mcf/d gross (~40mcf/d net). A number of offset locations have been generated by these wells.

Figure 3: Foothills Area



Source: AOI

Foothills JV Project			Preliminary Potential Reserve Exposure	
Formation	Potential bcf/well	# Locations	Potential Reserves (bcf)	AOI Interest (bcf)
Red Oak	0.7	28	20	1.3
Brazil	0.4	10	4	0.3
Spiro	2.5	20	50	3.3
Wapanucka	0.5	20	10	0.7
Cromwell	1.5	10	15	1.0
Caney / Woodford	0.5	20	10	0.7
Hunton	1.0	10	10	0.7
Ordovician	2.0	16	32	2.1
Total			151	9.8

Source: AOI

SUMMARY

- The funds raised from the placement will be applied to:
 - × The Phase 3B five well drilling programme.
 - × The Napoleonville 3D seismic survey.
- The funds made available through the Macquarie working capital facility will be applied to:
 - × The acquisition of further acreage.
 - × The Foothills 3D seismic survey.
 - × Future drilling at Napoleonville and Foothills.
- Timing:
 - × Over the next 6 months. AOI intends to:
 - Drill 5 wells in the Phase 3B programme and commence production
 - Acquire 3D seismic and develop prospects over the Napoleonville Salt Dome
 - Identify prospects from the Foothills JV 3D seismic programme
 - × In the following 6 months, AOI expects to:
 - Acquire further interests
 - Finance, drill and commence production at the Foothills Project and Napoleonville Salt Dome

AOI Net Potential Reserves Exposure & Timing				
	Gas (bcf)	Oil (mmbbl)	Total (bcfe)	Timing
Phase 3B	3.9		3.9	Q1 07
Napoleonville	3.3	2.1	15.9	Q3 07 onwards
Foothills	9.8		9.8	Q3 07 onwards
Total	17.0	2.1	29.6	

Source: AOI, Argonaut

- These figures are unrisked. It is early days and the concepts and prospects will need to be proved by drilling.

VALUATION

- It is too early to derive a value for AOI. However, taking the total indicative gas equivalent potential from the table above (as provided by AOI), we provide below an indication of ranges in potential values based on:
 - × different risk factors applied to the resource,
 - × and different values per billion cubic feet of gas.

Indicative Value Tables per Project (cents per share):

Phase 3B Indicative Value Range (cps)		Risk Factor				
		5%	10%	25%	50%	100%
Value (US\$m/bcf)	1.00	0.1	0.3	0.7	1.4	2.8
	1.50	0.2	0.4	1.1	2.1	4.2
	2.00	0.3	0.6	1.4	2.8	5.6

Napoleonville Indicative Value Range (cps)		Risk Factor				
		5%	10%	25%	50%	100%
Value (US\$m/bcfe)	1.00	0.6	1.1	2.9	5.7	11.4
	1.50	0.9	1.7	4.3	8.6	17.2
	2.00	1.1	2.3	5.7	11.4	22.9

Foothills Indicative Value Range (cps)		Risk Factor				
		5%	10%	25%	50%	100%
Value (US\$m/bcf)	1.00	0.4	0.7	1.8	3.5	7.1
	1.50	0.5	1.1	2.6	5.3	10.6
	2.00	0.7	1.4	3.5	7.1	14.1

- On completion of the placement in December, AOI's cash position was ~\$5.9m (or 3.2cps). With cash constituting a significant portion of the current market price of 7.6cps, buying below 8.0cps is supportable at this point, pending the outcome of upcoming drilling activity.
- There is also the potential for AOI to realise value from the sale of the remaining Appalachian assets. The recent sale of a portion of the West Virginia assets realised ~US\$1.5m in November.

RECOMMENDATION

- We rate AOI as a **Speculative Buy** for the following reasons:
 - × Experienced US-based management and project-generating partnerships.
 - × The new focus on conventional projects (which appear to have significantly more potential).
 - × The likely sale of the Appalachian shale gas assets.
 - × Support from solid investors including Macquarie Bank and Argonaut.
 - × Cash on hand (worth >3cps) and facilities available to allow considerable progress in the execution of the Company's new strategy.

Disclosures & Disclaimer

Important Disclosures:

- Argonaut Securities acted as manager to the placement of 50.0 million AOI fully paid shares at \$0.05 per share in December 2006 and received fees commensurate with this service.
- Argonaut Capital has acted as Corporate Advisor to AOI and received fees commensurate with this service.
- The Argonaut Group has an interest and / or controls 11,414,062 (6.16%) AOI fully paid Shares and 1,342,385 AOI unlisted options.
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- This report was produced by Ian Christie, CFA and Director of Research, Argonaut Securities Pty Limited.
- Ian has an immaterial interest in AOI shares.

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