



## INITIATION | COMMENT

AUGUST 26, 2011

**Neon Energy Limited (ASX: NEN)**

A drilling play with Asian upside

**Outperform  
Speculative Risk**

Price:	0.34	Price Target:	0.70
Shares O/S (MM):	431.0	Implied All-In Return:	106%
Dividend:	0.00	Market Cap (MM):	147
NAVPS:	0.73	Yield:	0.0%
BVPS:	0.14	P/NAVPS:	0.5x
ROE:	0.0%	P/BVPS:	2.4x
		Tr. 12 ROE:	(0.06)%

Priced at market close Aug. 25, 2011 AST.

**Initiating Coverage**

We are initiating coverage with an Outperform, Speculative Risk rating, and a target price of A\$0.70.

**Investment Opinion**

Neon Energy (NEN.AX) is a conventional oil and gas exploration play with assets in Vietnam and California which presents an attractive portfolio of development, appraisal and exploration assets with profitable production from California complimented by transformational exploration in Vietnam.

Based on a recent Netherland Sewell estimate of 'unrisked gross prospective resource potential' of 2.7Bn barrels (oil) in the company's Block-120 (Vietnam), an oil discovery and development in the order of 225Mb could generate a value of between \$2-4/share on a stand-alone basis. The exploration neighbours include ExxonMobil, Chevron and Premier in adjoining tenements, which bring credibility to the high-risk exploration play in our opinion

Important events and news flow in the next 12 months with the potential for re-rating the shares include :

- Continuation of drilling and a cyclic steam injection at North San Ardo to deliver and sustain production upside,
- Ongoing appraisal of the Paris Valley heavy oilfield in California,
- Drilling in the Paloma oil field, with a well now scheduled for August 2011,
- Neon, and Exxon Mobil exploration drilling in Vietnam; and
- Potential farm-out of acreage to reduce risk exposure and free up capital for near-term expansion activities.

**Catalysts**

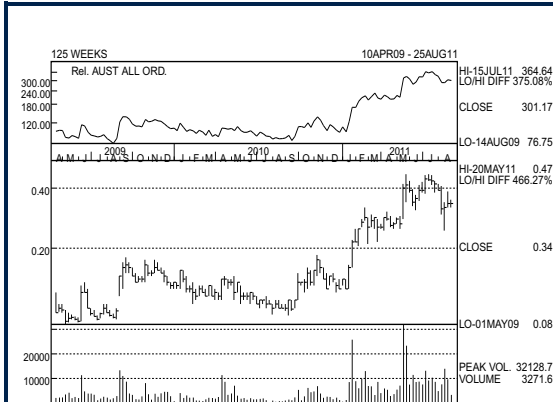
The drilling programme must deliver positive results, most particularly from Vietnam, to underwrite a re-rating of the exploration portfolio. While upside success in California will be favourable, Vietnam represents the transformational opportunity.

**Valuation and Target Price**

We value the company by risk weightings assigned particularly to its Vietnamese exploration portfolio and a DCF-based calculation on existing production. We estimate an NAV of A\$0.73 and set our price target at A\$0.70 on that basis, but note that success in the Vietnamese drilling programme has the potential to push the stock price well above our target.

Priced as of prior trading day's market close, EST (unless otherwise noted).

For Required Non-U.S. Analyst and Conflicts Disclosures, see page 27.

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FY Jun	2010A	2011E	2012E
Prod. (mboe/d)	0	0	1
EPS (Op) - Basic	(0.71)	0.05	0.43
Adj CFPS - Basic	0.10	0.50	3.60

Adj CFPS: cents per share  
EPS (Op): cents per share

All values in AUD unless otherwise noted.

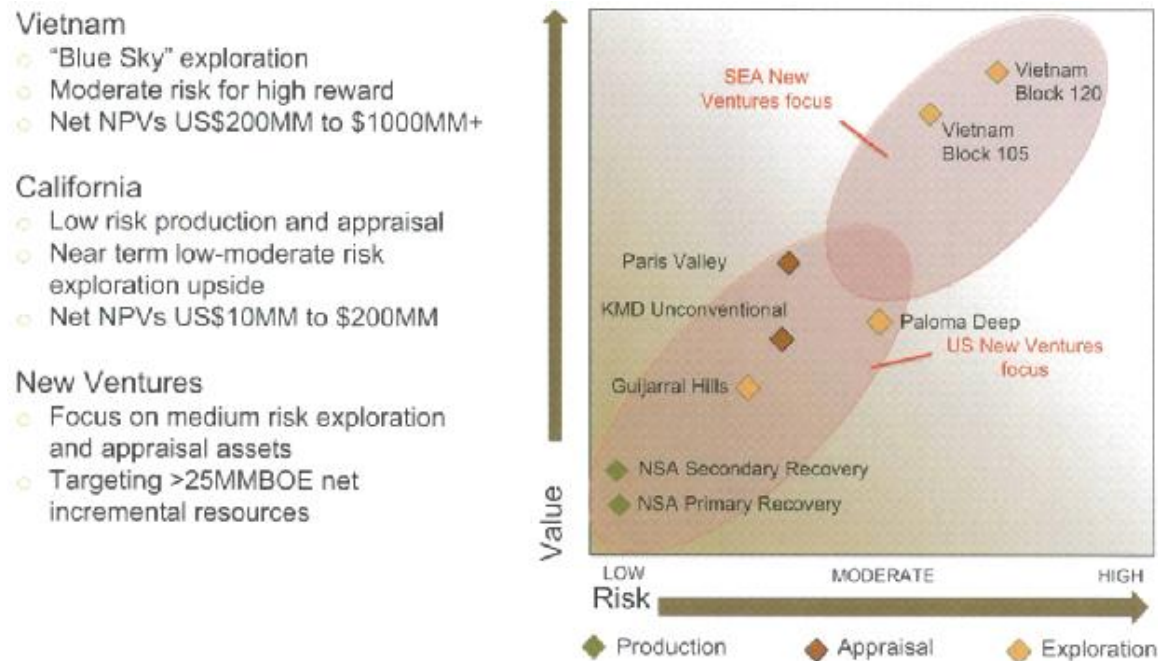
## Neon Energy Limited - a drilling play

Neon Energy Limited (NEN.AX) was formerly named Salinas Energy Limited and is a conventional oil and gas exploration play with assets in Vietnam and California.

The company holds material interests in exploration Blocks-120 and 105, offshore Vietnam and a portfolio of operated exploration, appraisal and production assets onshore California, including 100% ownership of the producing North San Ardo oil field and the Paris Valley oil field appraisal project.

The company offers a reasonably balanced opportunity set with relatively low-risk production plays from the North San Ardo project (California) through to the high-risk, transformational, exploration exposures in its offshore Vietnam portfolio, as illustrated in Exhibit 1.

Exhibit 1: Neon Energy - Value & Risk bubbles



Source: Company reports

## Investment Thesis

We have set a **Target Price of A\$0.70/share for Neon Energy** based on a number of drilling catalysts most importantly in its high impact Vietnamese portfolio where **we suggest the upside on a successful oil discovery could range from \$2-4/share**. Although Neon will only begin drilling in its own right in Vietnam from the June half of 2012, the catalysts for a stock re-rating may be pre-empted by the results of Exxon’s Vietnamese drilling campaign in adjacent permits currently in progress.

We base our upside valuation premise on a recent Netherland Sewell estimate of **‘unrisked gross prospective resource potential’ of 2.7Bn barrels (gross oil) in the company’s Block-120 (Vietnam)** and a potential oil discovery and development in the order of 225Mb (average of the 12 mapped leads and prospects).

### Vietnam...the transformational attraction

The real upside in the company’s portfolio is its two offshore blocks in Vietnam that have transformational potential and room to farm-down. The exploration neighbours include ExxonMobil, Chevron and Premier in adjoining tenements, so anecdotally, the upside potential is significant enough to make it worth the while for major oil companies to chase. This association brings credibility to the exploration play, in our opinion.

Neon holds large blocks within a proven petroleum system with the offshore Vietnam area significantly underexplored. Recent discoveries in the adjoining permit areas underpin the strong belief in the prospectivity of the region and any commercial discoveries are likely to be brought into production with fairly short lead times (even for gas) to supply the country’s large projected, growing, energy demand.

We note that Exxon Mobil is drilling three wells immediately north of Neon's Block-120 providing perhaps a 'free look' and extrapolation into the company's acreage. **Any success could significantly upgrade the prospectivity of the surrounding exploration plays.** Exxon is drilling these wells as 'tight holes' in terms of information releases to the market, so any information flow back to the market may be sporadic and well after the event.

We caution that the geological risks are much higher but highlight that Santos (STO.AX, TP A\$16.00, Sector Perform, Average risk) is close to commissioning its first Vietnamese development and there have been numerous other exploration successes. We do not suggest that it is anything other than a high-risk play, but as part of the portfolio, it seems very appropriate. At the current price of the stock we'd suggest the market is valuing the company on an ex-Vietnam basis.

#### Californian oil production - the oil production building block

The assets in California (Salinas Basin and South San Joaquin Basin) are interesting and range from relatively low to high risk. Traditionally, this is not an area that Australian companies have exploited well; however, the limiting factor has really always been capital: you just need to get after these assets. The success rates are generally high and even heavy oil economics looks acceptable.

We think the Californian assets potentially provide a sustainable production and revenue base to support the company's high-impact ambitions for the remainder of the portfolio.

Neon currently has production from its North San Ardo field at slightly more than 1,000 barrels of oil per day (bopd) after the recent completions at the Lombardi 20-27H and 21-27H wells and application of its cyclic steam injection recovery technique.

The North San Ardo field is located immediately adjacent to the giant producing San Ardo oil field from which almost 500Mb of heavy oil has been produced, stimulated by steam recovery techniques. The producing San Ardo oil field is operated by Chevron and AERA (a joint venture between Exxon Mobil and Shell).

The company's Paris Valley field redevelopment has notionally more than 100Mb oil initially in place (OIIP) potential and is estimated only to return some 9Mb as recoverable, but these types of assets are about beating the 'average', particularly on a resource base this large. We note the Paloma field opportunity is c. 300Mboe (barrels of oil equivalent) 'in place'.

The Paris Valley field is the second-largest heavy oil field (10-14 API gravity oil) discovered in the Salinas Basin and has been effectively shut-in since the late 1970s. Since December 2009, Neon has owned a 100% working interest in the project and is the project operator.

**The company is targeting to add more than 25Mboe (net) of incremental resources to the Californian portfolio** on its current reserve base of 13.0Mboe (at 2P) and is looking to leverage its profitable Californian production to fund blue sky exploration in Southeast Asia.

We anticipate there will be some important (re-rating) events and news flow during the next 12 months or so and on a chronological basis:

- Continuation of drilling and cyclic steam injection activity at North San Ardo – this may provide some production upside potential
- Ongoing appraisal of the Paris Valley heavy oilfield, California,
- Drilling in the Paloma oil field, with a well now scheduled for early September 2011,
- Potential farm-out of Vietnamese acreage to reduce risk exposure and free up capital for near term expansion activities, and
- Neon and ExxonMobil exploration drilling in Vietnam.

We believe Neon presents an attractive portfolio of development, appraisal, and prospective exploration assets with profitable production from mature Californian projects, complimented by transformational exploration upside exposure in Vietnam.

The company is largely an asset play with the majority of its value determined by risk weightings assigned particularly to its Vietnamese exploration portfolio rather than a DCF-based NAV, given the small effect the current production assets have on the overall valuation.

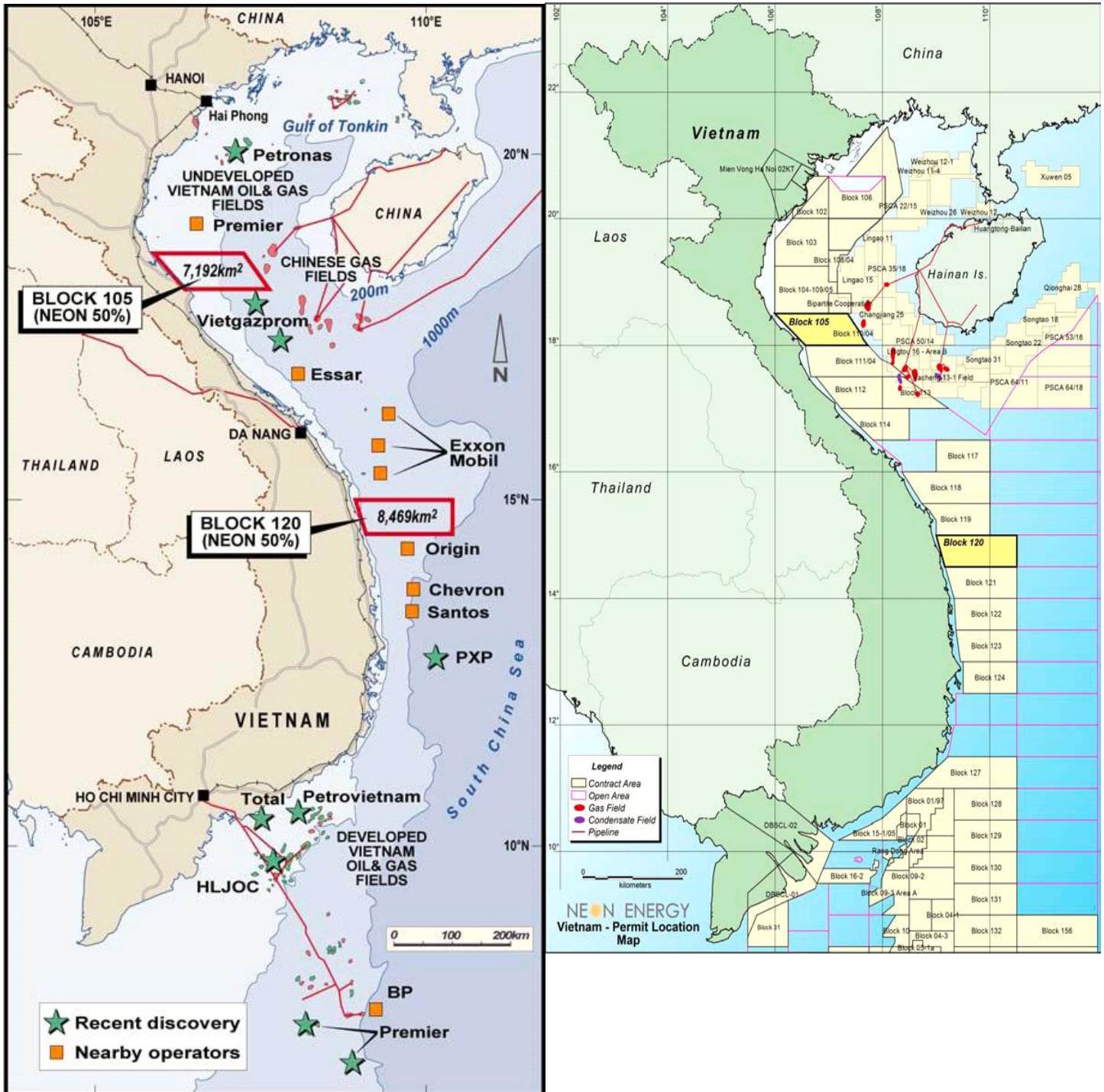
Under our premise, some 70% of the value of the stock (A\$0.73/share) resides in its exploration portfolio, which remains subject to initial success and appraisal, thereby leading to commercial developments.

**We benchmark our Target Price of A\$0.70 against the NAV at A\$0.73/share which would generate total returns for 2011-12 of 109% (based on the closing price of A\$0.335/share, 25Aug 2011) but categorise these as highly speculative. We rate the stock Outperform, with a Speculative Risk rating.**

**Vietnam**

The company holds 50% interests in each of two blocks, offshore Vietnam (Block-105 and Block-120) that provide the quantum upside potential within the asset portfolio...big structures with leverage to success.

Exhibit 2: Vietnam Exploration Location Map



Source: Company reports

The company categorises the assets as providing ‘high reward for moderate risk’; however, we would still classify these opportunities as ‘wildcat exploration’ thereby falling in the high-risk category...such is the nature of wildcat drilling.

Neon Energy's Blocks are well situated adjacent to acreage held by international and domestic majors and with a significant partner in KrisEnergy Limited, an independent upstream oil and gas company established in September 2009. KrisEnergy has now assumed operatorship of these blocks.

Interestingly and critically, Neon will benefit from activity in adjacent permits, mostly via Exxon Mobil that will drill three wells in permits immediately to the north of Block-120.

KrisEnergy has described the Vietnam portfolio (Blocks-105 and 120) as follows:

"These are frontier exploration blocks but our detailed mapping of the recently acquired seismic data and our geological assessment indicate there is excellent potential for hydrocarbon accumulations in both blocks. There has not been a single well drilled in Block 105 but it is located on the same trend as the adjacent cluster of gas fields in Chinese waters. In Block 120, one exploration well was drilled almost 20 years ago which encountered oil shows."

Source: KrisEnergy Ltd Press Release - 25 May 2011

Vietnam is an evolving petroleum province with a number of recent oil and gas discoveries and a growing (but still fairly small) production base.

### Exhibit 3: Asia-Pacific Production History

#### Liquids (kbpd)

Asia Pacific	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	5Yr CAGR
China	3252	3306	3346	3401	3481	3627	3684	3743	3901	3790	4%
Indonesia	1456	1389	1289	1183	1129	1087	1017	969	1031	1021	-6%
India	726	727	753	756	773	738	762	769	768	754	2%
Malaysia	735	719	757	776	793	759	747	763	768	740	-3%
Australia	809	733	730	624	582	580	554	567	556	559	-4%
<b>Vietnam</b>	<b>328</b>	<b>350</b>	<b>354</b>	<b>364</b>	<b>427</b>	<b>398</b>	<b>367</b>	<b>337</b>	<b>317</b>	<b>345</b>	<b>-13%</b>
Thailand	176	191	204	236	223	265	286	305	321	330	25%
Other Asia-Pac	200	195	193	195	235	286	305	320	340	328	15%
Brunei	193	203	210	214	210	206	221	194	175	168	-18%
	<b>7874</b>	<b>7610</b>	<b>7626</b>	<b>7750</b>	<b>7643</b>	<b>7740</b>	<b>7942</b>	<b>7968</b>	<b>8175</b>	<b>7867</b>	<b>2%</b>

#### Gas (Bc fpa)

Asia Pacific	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	5Yr CAGR
China	961	1070	1155	1236	1466	1741	2069	2444	2836	3009	73%
Indonesia	2303	2235	2461	2585	2483	2514	2483	2387	2461	2539	1%
Malaysia	1600	1656	1706	1829	1903	2158	2235	2281	2292	2214	3%
Australia	1102	1148	1151	1172	1257	1310	1374	1413	1353	1494	14%
India	932	932	975	1042	1031	1045	1035	1063	1077	1388	33%
Pakistan	759	802	869	1074	1218	1254	1275	1300	1324	1338	7%
Thailand	713	692	724	770	791	837	858	918	1017	1091	30%
Bangladesh	353	378	403	434	466	512	540	576	632	696	36%
Other Asia-Pac	117	127	187	226	219	247	357	441	484	480	94%
Myanmar	120	247	297	339	360	431	445	477	438	406	-6%
Brunei	399	403	406	438	431	424	445	434	431	403	-5%
<b>Vietnam</b>	<b>57</b>	<b>71</b>	<b>85</b>	<b>85</b>	<b>148</b>	<b>244</b>	<b>240</b>	<b>251</b>	<b>279</b>	<b>283</b>	<b>16%</b>
New Zealand	198	208	198	152	138	127	131	145	134	141	11%
	<b>9609</b>	<b>9973</b>	<b>10616</b>	<b>11382</b>	<b>11894</b>	<b>12844</b>	<b>13480</b>	<b>14126</b>	<b>14758</b>	<b>15482</b>	<b>21%</b>

Source: BP Statistical Energy Review 2010

We note the recent discoveries made by Petronas in Blocks-103, 107, and 106 from April 2009 until September 2010:

- Hac Long field, which flowed c.14mmcf (million cubic feet per day) on test and is estimated to contain 1.8Tcf and 45Mb of condensate, and
- Ham Rong field with test flows of 6300bpd (oil) and 8mmcf (gas).

Vietgazprom has also had nearby success with a gas discovery at Bao Wang (Block-112), which tested a more modest 3.7mmcf with 46bpd of associated condensate.

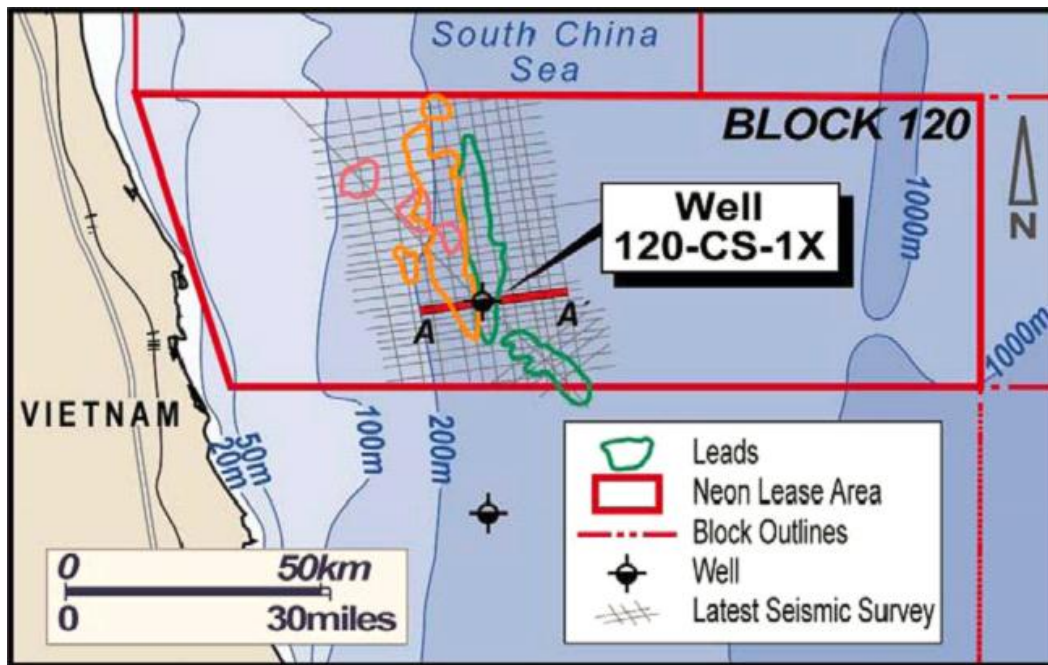
Vietnam operates a PSC (Production Sharing Contract) style fiscal system, and Neon has been able to secure favourable fiscal outcomes during its initial four-year exploration period although the contract terms remain fairly generic.

We believe the favourable aspects of the PSC relate to when additional bonus payments are made related to specific production targets. An outline of a generic PSC is appended to the end of this report (Please see Appendix I).

### Vietnam Block-120

Block-120 is a large underexplored area, extending out some 140-150km directly offshore. The focus of activity to date has been seismic acquisition concentrating in the area to approximately 400m water depth, although water depth does range across the permit between 50–1,100m.

Exhibit 4: Block-120 Leads Map



Source: Company reports

The seismic has outlined a number of large structures considered to be prospective for oil given the results of the only exploration well drilled within the permit (120-CS-1X), which intersected 6m of oil above 32m of additional shows.

The well was drilled in 1993 and failed because of an interpreted lack of lateral seal on the primary target.

Neon has mapped some 12 drillable targets to date and considers there to be the potential for prospects with more than 500Mb of upside. Importantly, the recently acquired seismic data display numerous amplitude versus offset (AVO – refer Appendix III) anomalies, therein suggesting gas charge and the potential for oil legs. Although seismic anomalies are not definitive in commercial oil and gas terms, they are net positive indicators...rather have them than not.

Although the permit displays strong elements consistent with a working petroleum system, which reduces the drilling risk, the key uncertainties are associated with the 120-CS-1X well that may have a 'breached seal' or lack the hydrocarbon generation to fill the structures in this area to spill-point.

We note, as is the trend among oil companies these days, that Neon has commissioned an independent assessment of the 'unrisked prospective resource potential' of Block-120 by Netherland, Sewell and Associates Inc. (NSAI), and not surprisingly, the analysis confirms that the block has the potential to hold significant volumes of oil with a range estimated at 633–7,947Mb (gross).

## Exhibit 5: Unrisked Gross (100%) Prospective Resources (Mb of oil)

Low Estimate	Best Estimate	High Estimate
632.8	2,673.5	7,947.0

Source: Company reports, NSAI estimates

The analysis includes only the 12 leads already identified within the permit. Some of the leads are considered to have multi-hundred million barrel potential.

Within Block 120 the Rua Bien and Ca Lang oil prospects are estimated by NSAI to have best estimate prospective resources of 611Mb and 461Mb respectively.

The significance of the NSAI report needs to be taken in context: The estimate is ‘unrisked’ and makes no judgement as to the probabilities of success (technical or commercial) or any allowance for the size distribution of previous discoveries. However, there have been significant discoveries such as the Bach Ho (White Tiger) field, classified as a giant oil field with recoverable reserve of 1.0–1.4Mb (although Bach Ho represents a completely different geological setting).

What the estimate indicates is the upside potential that is confirmed anecdotally by the number of major oil companies also exploring in the region, with significantly larger minimum economic thresholds than Neon.

Using a prospective resource size of 225Mb (average of the 12 mapped leads and prospects) we estimate an oil discovery and development could be worth between \$2-4/share to Neon, depending on the negotiation of fiscal terms and farm-out dilution. This would equate to an NPV of c.US\$25 per barrel against the RBC long-term assumption of US\$100 per barrel and compares favourably to many royalty/excise fiscal regimes across the globe.

It is worthwhile noting the total oil reserves booked for the country stand at c.4.5 billion barrels compared to the high end of the range ascribed to Block-120 on a standalone basis. It suffices to say that, as an evolving petroleum province, we suspect there is significant remaining oil potential in Vietnam and that the acreage (Block-120) offers strong leverage to a successful case outcome.

## Exhibit 6: Total Oil Reserves - Asia Pacific Region Block-120

Oil (Billion barrels)					
Asia Pacific	At end 1989	At end 1999	At end 2008	At end 2009	% of world reserves
China	16	15.1	14.8	14.8	1.1%
Indonesia	4.3	5	5.8	5.8	0.4%
Malaysia	3.7	5	5.5	5.5	0.4%
India	5.1	5.2	3.7	4.4	0.3%
<b>Vietnam</b>	<b>0.1</b>	<b>1.8</b>	<b>4.7</b>	<b>4.5</b>	<b>0.3%</b>
Australia	3.1	4.7	4.2	4.2	0.3%
Other Asia-Pac	0.9	1.4	1.4	1.3	0.1%
Brunei	1.2	1.3	1.1	1.1	0.1%
Thailand	0.2	0.4	0.5	0.5	<0.05%
	<b>34.7</b>	<b>39.9</b>	<b>41.7</b>	<b>42.2</b>	<b>3.2%</b>

Source: BP Statistical Energy Review 2010

A well is scheduled for early 2012 that Neon hopes to fund via a farm-out.

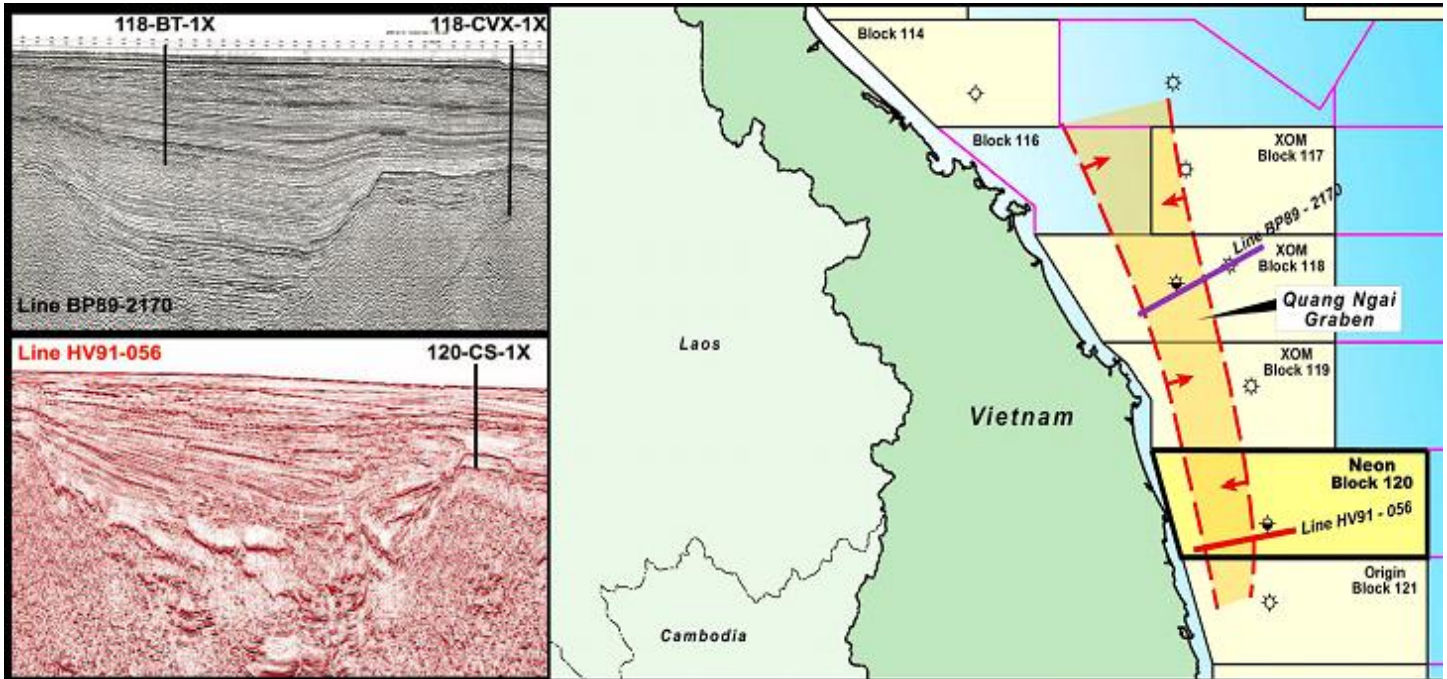
The critical events potentially affecting the farm-out process will be the drilling of the three Exxon wells in Blocks 117 and 119 that are immediately adjacent to the north of this permit—tagging along trend the same play types and structural setting as evidenced in Block-120.

From the Neon Energy JunQ 2011 Activity Report:

“...significant exploration activity is ongoing in blocks neighbouring Neon’s acreage. ExxonMobil are believed to have commenced with their drilling programme of up to three wells over blocks 117, 118 and 119, however, no announcement has been made regarding progress to date.

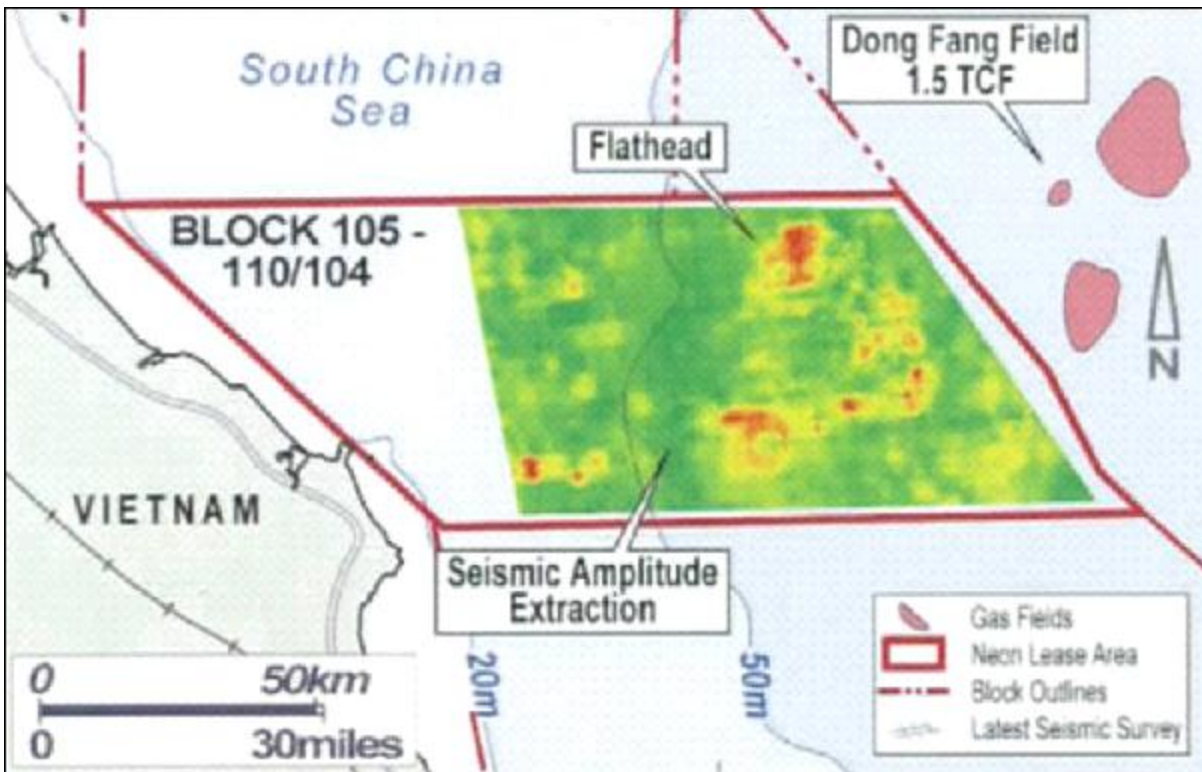
Origin Energy and Santos are planning to drill on blocks 121 and 123 respectively in 2011 and Premier Oil is preparing to drill Block 104-109/05.”

Exhibit 7: Permit and Play Map: Block-120



Source: Company reports

Exhibit 8: Permit - Block-105



Source: Company reports

**Vietnam Block-105**

Block-105 is a large underexplored area in northern offshore Vietnam on the border with China. In a similar vein to Block-120, the principal focus of activity to date has been seismic acquisition.

No wells have been drilled in this permit yet and Neon has until January 2014 to drill its commitment well.

Water depths across this permit range between 25–50m only, not technically challenging.

The initial seismic interpretation has delineated seven significant leads with anomalies (direct hydrocarbon indicators or DHI's), and the permit is well situated being on trend with VietGazprom gas discoveries to the south and adjacent to (suggested) analogue discoveries across the border in China.

The potential of this permit is more likely to be gas than oil. In fact, the company is quite confident that there is gas within this block. The risks as identified relate primarily to gas composition (CO<sub>2</sub> content and liquids yields) and flow rates.

NSAI completed an independent assessment of the 'unrisked prospective resource potential' of Block-105 assessing the block potential to lie within a range estimated at 1,716–21,420Bcf (gross), with condensate volumes ranging between 10–178Mb. This analysis includes only the seven gas and condensate leads already identified within the permit.

Of the seven leads, three are deemed to lie within an 'oil potential fairway' and on the basis of an oil rather than gas discovery were assessed as having resource potential of 1,545–19,554Bcf with 40–650Mb of liquids.

**Exhibit 9: Unrisked Gross (100%) Prospective Resources (Bcf of gas and Mb of liquids)**

Low Estimate		Best Estimate		High Estimate	
Gas (Bcf)	Condensate (Mb)	Gas (Bcf)	Condensate (Mb)	Gas (Bcf)	Condensate (Mb)
1,716.0	9.7	6,268.9	46.3	21,420.0	177.9

Low Estimate		Best Estimate		High Estimate	
Gas (Bcf)	Oil (Mb)	Gas (Bcf)	Oil (Mb)	Gas (Bcf)	Oil (Mb)
1,544.9	40.3	5,641.9	197.4	19,544.1	649.1

Source: NSAI estimates

Although the fiscal metrics for gas developments are similar to that for oil in terms of royalties and Government participation, the value of any project would be constrained by the domestic price of gas and volume opportunity. Based on a sales opportunity of up to 50Bcf per annum and US\$7/mcf gas price, we estimate a unit NPV of c.US\$0.50 - 1.00/mcf. A 1Tcf development (gross) could be worth some \$0.60-1.20/share for Neon.

Higher sales volume opportunities could deliver upside to this unit value but would come at a higher cost and discoveries at the high end of the prospective range would perhaps require a LNG outcome for commerciality.

With a similar note to the assessment of the Block-120 potential, what we can take from this as an indication of the upside potential and leverage to success that the acreage provides.

A significant point of interest is the recent spudding (3-Aug) of the Salamander Energy 101-CB-1X ("Cat Ba-1X") exploration well in Block 101-100/04, offshore northern Vietnam, which lies to the north of Neon's Block-105, in the Gulf of Tonkin.

The 101-CB-1X well could perhaps be a lead indicator for Neon's prospects in this area of offshore Vietnam, but in any respect would provide another data point (result) ahead of the commencement of the company's field programme. The 'Cat Ba' well is planned to be drilled to a depth of approximately 1,900m with a mean gross pre-drill estimate of prospective recoverable resource of approximately 100Mb.

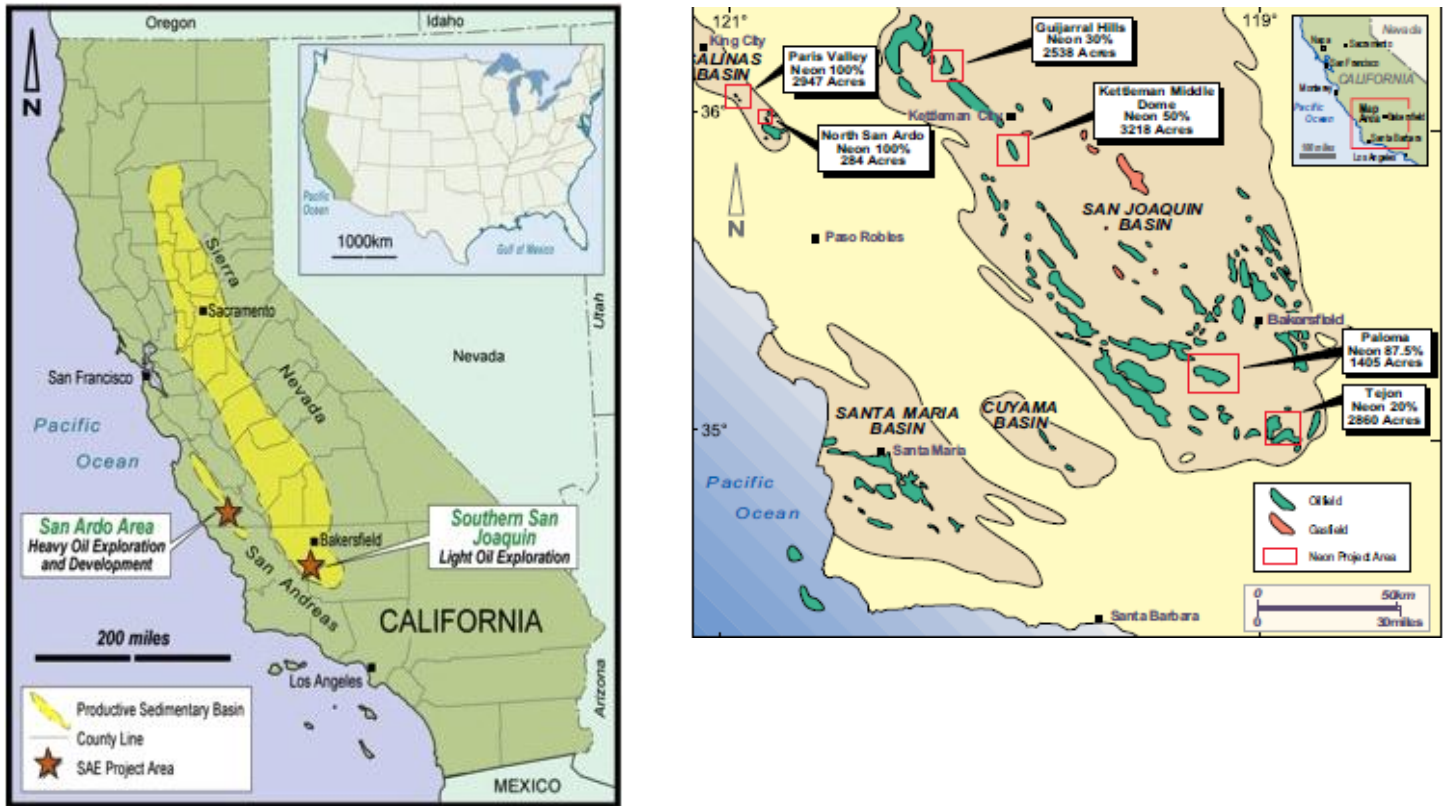
The well will be drilled in water depths of 49m and is expected to take approximately 25 days to complete on a dry hole basis.

US

Neon has a portfolio of exploration and appraisal opportunities located in the Salinas and San Joaquin Basins in California across differing exploration plays:

- The Salinas Basin assets are mostly heavy crude oil opportunities reservoired in shallow clastic reservoirs and requiring steam injection to enhance recovery rates, and
- The San Joaquin Basin offers large structural and stratigraphic traps with medium to light gravity oils reservoired at depth.

Exhibit 10: Permit and Play Location Map



Source: Company reports

Production

North San Ardo (Neon 100%)

Neon currently produces from the North San Ardo oil field (Neon: 100%) in the Salinas Basin. The field is the northern culmination of the giant San Ardo field, which has been in production since 1947 and has delivered some 500Mb of heavy crude oil.

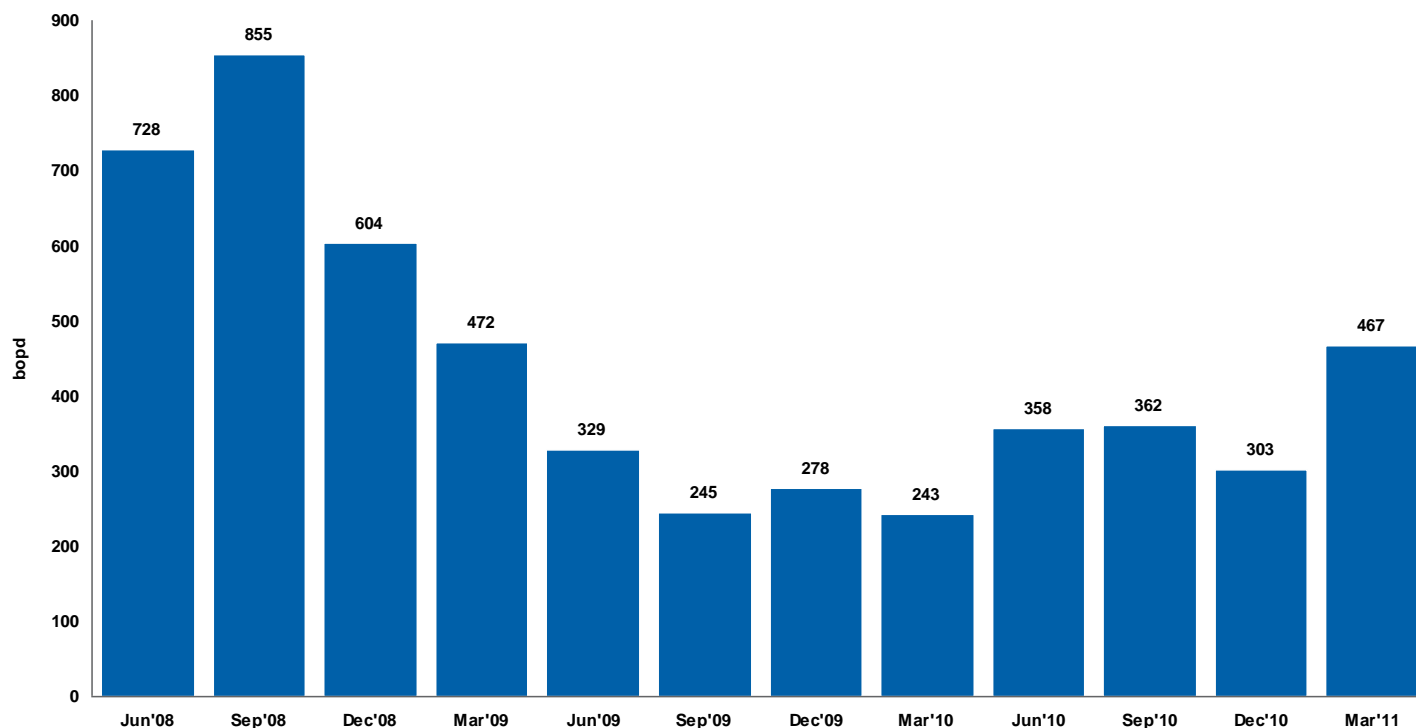
Both the North San Ardo and San Ardo fields produce heavy oil (c. 12° API) from the Lombardi Sandstones but require pumping and secondary recovery methods in the form of steam flooding. Critically, like all low flow reservoirs, the upside comes from ‘beating the averages’ (i.e., producing more per completion) to maintain low-unit operating costs.

The forward work programme for Neon is essentially more drilling and steam injection (cyclic steam flooding), with facilities optimisation to reduce bottlenecks (currently being the level of water handling capacity).

A field-wide steam cycling programme was commenced during June 2010 with immediate positive results; however, meaningful production increases require (essentially) more holes in the ground, and cycling capital can become the limiting factor. Recovery rates from the field are estimated to be around 40%, but the San Ardo field (as the analogue) is expected to have an ultimate recovery factor closer to 60%.

As of commencement of production (2006), the North San Ardo field contained indicated OIIP volumes of 8.4–12.5Mb, and on a recovery rate of 40% would deliver recoverable reserves in the order of 3.4–5.0Mb. The company has largely managed to achieve reserves replacement, so the current 1P reserves at the field are 3.8Mb.

Exhibit 11: Daily Production Rate from North San Ardo Field



Source: Company reports

With the addition of two recently completed horizontal wells, **the latest production data estimate has the field generating more than 1,000bopd** (AXS release dated 26 May 2011), compared to the indicated March quarter of 2011 average of 467bopd.

Although the increase from the initial production (IP) rates is positive, we note that the decline rates after the IP are strong and in the order of 60–80% during the first six months. Importantly, drilling and completions are fairly inexpensive with the two recent wells (Lombardi 20-27H and 21-27H) **costing only in the order of US\$1.3 million with a payback period of less than one month.**

Exhibit 12: North San Ardo - Quick Look

Discovered	1947
First production	2006
OIIP	15Mb
1P reserves	c.3.4Mb
Depth	c.2,100 feet
Producing wells	12
Water disposal wells	2

Source: Company reports

Despite being a heavy oil, the North San Ardo crude prices off a Midway-Sunset benchmark, which recently has been trading at a small premium to WTI (more than US\$100/b during the June quarter) but traditionally has been priced at a 12–13% discount to WTI.

The work programme on North San Ardo is extremely flexible as advised, with the company likely to focus more on continuous steam flooding operations rather than more wells although another two or three wells could be drilled out to the end of 2011.

The company intends to test an East Lombardi prospect that is some 500m outside of the current operations and could ultimately be developed from the existing drilling pad. Should the East Lombardi well prove successful, further drilling would be scheduled for the development phase. The target has a mean prospective recoverable resource of 2.5Mb of oil.

**We rate this part of the portfolio as a low-risk growth play because there is a working production methodology. The field is more about engineering and completion risk than geology...the oil is there. We value the asset at A\$0.17 per share.**

## Exploration and appraisal

The company has a reasonably deep portfolio of exploration and appraisal opportunities in the Salinas and San Joaquin Basins, and we highlight two projects of particular interest and the focus of recent field work at Paris Valley and Paloma.

### Exhibit 13: Asset Portfolio

Basin	Project	Working Interest	Category	Comments	Risk
Salinas	Paris Valley	100%	Appraisal/Development	Work-over, re-develop old Paris Valley Oil Field which has been inactive since late 1970's. Estimated to contain 100Mb OIIP	Moderate
	East San Ardo	100%	Exploration/Appraisal	On NE flank of San Ardo field but data is inconclusive as to prospectivity. No wells have been drilled here yet	High
San Joaquin	Paloma	87.5%	Exploration/Appraisal	Leases cover NW extent of Paloma oil and gas field...most mature prospect is Paloma Deep with Prospective Resource Potential of	Moderate
	Tejon	100%	Exploration	Southern margin of San Joaquin Basin...acreage surrounded by small and large oil and gas fields. Most mature prospect is Merlot with a Prospective Resource Potential of 36Mb	High
	Buena Vista Valley	100%	Exploration	Acreage surrounding giant Buena Vista and Yowlumne oil and gas fields. The targets are estimated at 7,000 - 13,000 feet	High
	South Buena Vista	25%	Exploration	Two wells drilled but non-commercial. Investment under review	High

Moderate risk = 15-25% probability of success, high risk = 5-10%, and very high risk = less than 5%

Source: Company reports

## Paris Valley (Neon: 100%)

The Paris Valley oil field is the second-largest heavy oil field (10–14° API) discovered in the Salinas Basin and has essentially been shut-in since the late 1970s. It is estimated that the field has more than 100Mb of OIIP according to the California Division of Oil, Gas and Geothermal Resources (DOGGR).

Neon moved to a 100% working interest in the field in December 2009 and drilled an appraisal well (North Paris Valley-1) on the northern compartment. The well recovered oil but is considered to be uncommercial at this time with steam injection having produced no significant improvement to flow rates.

Independent assessment (MHA Petroleum Consultants) suggests the Central Paris Valley compartment contains 2P reserves of 9.1Mb and that the entire Paris Valley play (Central and Northern compartments) could contain up to 130Mb of OIIP. The estimates, while pointing to positive prospectivity, need to be viewed in context:

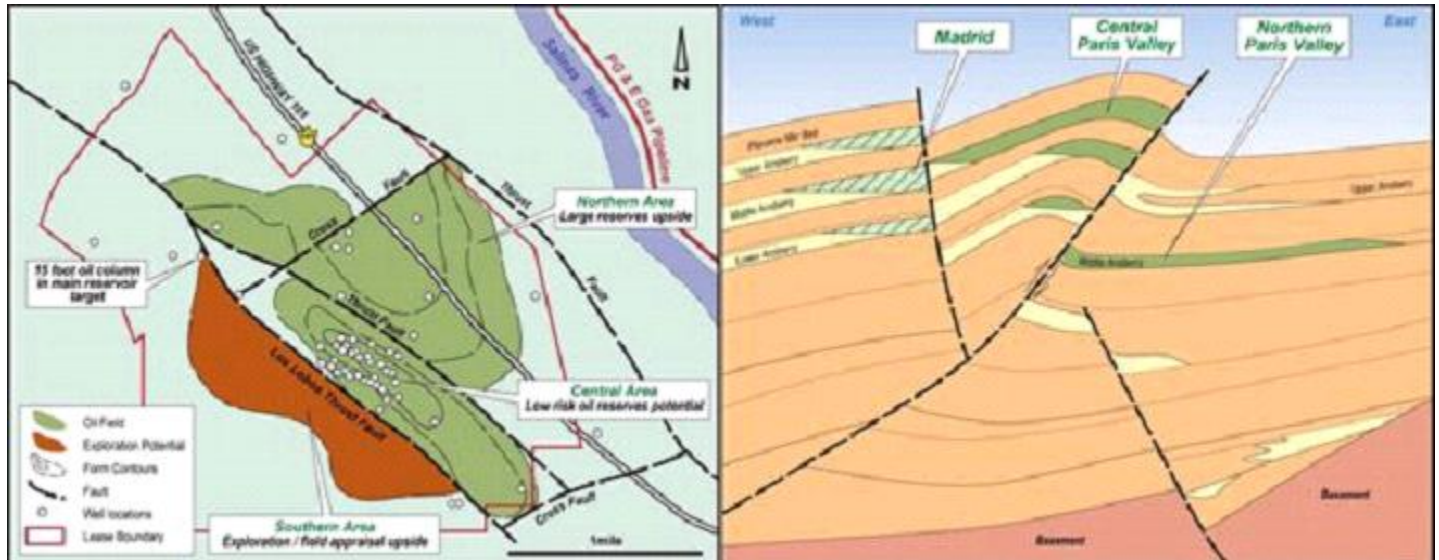
- The field is not producing at the moment, and the initial development trial at NPV-1 was commercially unsuccessful.

More field analysis needs to be undertaken in our opinion before much confidence can be attributed to any commercial upside and notional recovery rates of c.20% can be confirmed. We also note the historical IP rates for Paris Valley have been only around the 140bopd level.

The company is preparing to drill the first of up to three appraisal or production wells to demonstrate the commercial viability of oil production via a combination of horizontal drilling and steam. The first well is expected to commence drilling in September 2011.

**We rate this opportunity as a moderate-risk potential play and value the asset at A\$0.03 per share.**

## Exhibit 14: Paris Valley Oil Field



Source: Company reports

### Paloma (Neon: 87.5%)

The Paloma area leases cover the northwest extent of the Paloma oil and gas field, which has produced some 60Mb of light oil and more than 400Bcf of gas. The Paloma prospects contain multiple-target horizons with both conventional and unconventional play types—we note the Paloma Deep prospect contains some seven zones of interest.

The most mature prospect as identified by the company is Paloma Deep, which is defined by 3D seismic data as is considered to be a possible extension of the Paloma field.

As reported in its recent operational update (Jun-28):

“Neon is preparing to drill the Paloma Deep prospect commencing between late July and early August, 2011. Neon is farming out a portion of its current 87.5% working interest on a promoted basis to one or two parties and the Company's final working interest in Paloma Deep will be between 67.5% and 75%. The Paloma Deep location lies over the Paloma oil field and provides an opportunity to evaluate up to seven prospective horizons with a single vertical well.

Drilling is expected to cost approximately US\$4.9mn (gross dry hole cost). The primary objectives of Paloma Deep are the Western Flank Sand and the deeper Round Mountain Formation. The Western Flank Sand is part of the Middle Stevens Unit which has been produced in the Paloma field, to the southeast of the Paloma Deep test well. It is also found to be hydrocarbon bearing in all offset wells. The Round Mountain objective has been sparsely explored in the area but displays a seismic amplitude anomaly in this prospect. Other targets include the unconventional Antelope and Fruitvale shales of the Monterey Formation, the former already producing oil and gas from a single well in the Paloma Field.”

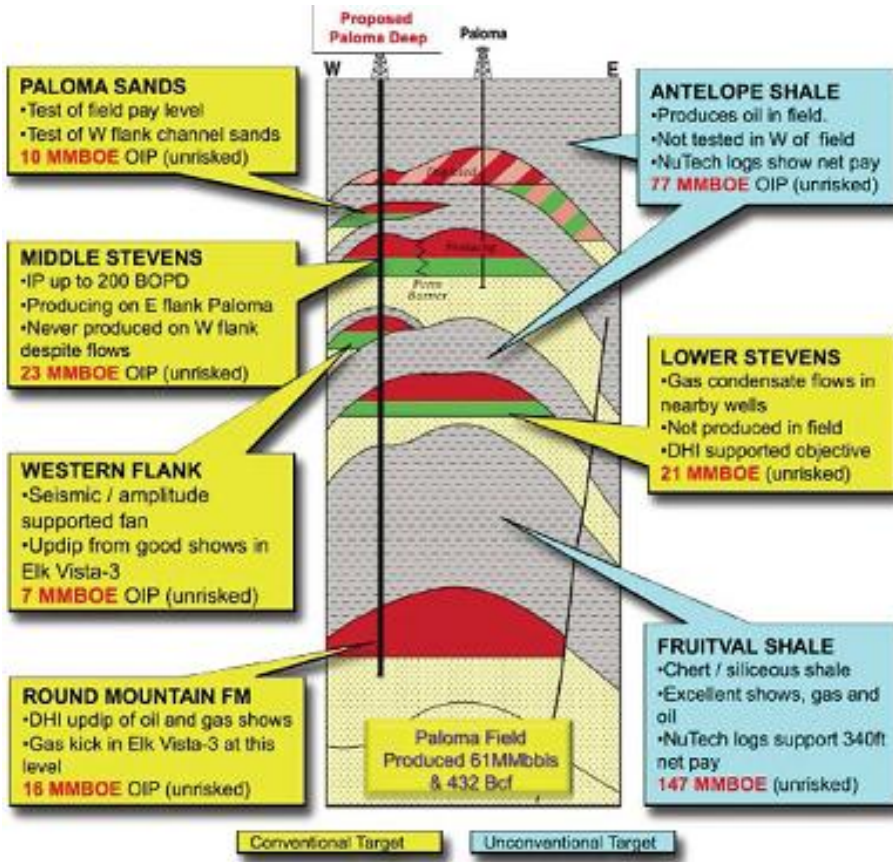
We consider the conventional sand targets to be still generally high risk given the proximity of producing analogues, and the shale potential would require significant follow-up. Although other companies in the region are also targeting the shale play, exploitation of these formations is at an early stage, production is not significant, and we assess this opportunity also to be a high risk.

Neon aims to farm down its interest to between 67.5 - 75.0% to Solimar Energy (SGY.AX, not rated) and others; the well is expected to spud sometime in early September. The farm out deal is a ‘legacy agreement’ entered into under the previous company management, which Neon is happy to continue with and is confident will be funded by Solimar. It is worth noting that Neon is able and prepared to fund the additional interest should Solimar not be able to meet its commitments to this agreement.

**We rate this opportunity as a generally moderate-risk potential play, with a probability of success of around 15% despite the location within an existing proven field. We value the asset at A\$0.10 per share.**

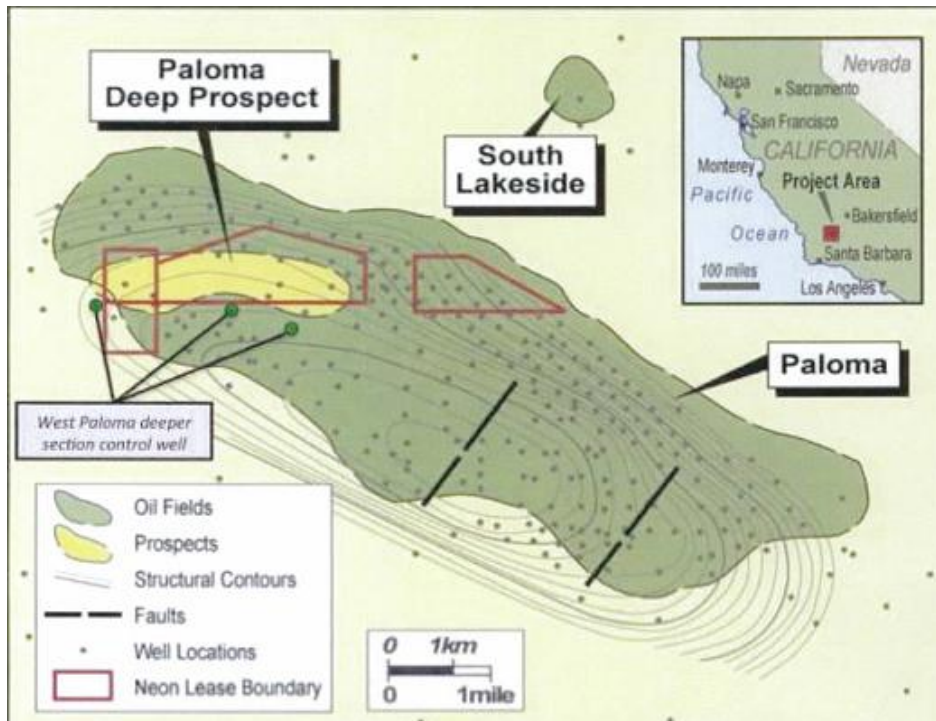
Note for valuation purposes we have used a NEN working interest of 87.5% (pre farm-out)...on a notional farm-out deal, reducing the working interest to (say) 70% our value for this asset would be A\$0.08 per share and our NAV would reduce to A\$0.71.

Exhibit 15: Paloma Deep Prospect - Schematic



Source: Company reports

Exhibit 16: Paloma Permit and Play Location Map



Source: Company reports

## Reserves, resources, and prospectivity

As a set of absolute numbers, the current booked 1P+2P reserves held by Neon do not present a compelling picture, with only the North San Ardo field in production and ultimately the economics of the Paris Valley 2P reserves dependent on the Neon delivering some commercial success from the next round of drilling.

However, this can be somewhat misleading because it is likely that the reserves picture from these two assets is likely to change very little, with new development wells acting to replace produced volumes on an ongoing and incremental basis—there is low risk to the resource side of the equation and this is more of an engineering play than geological.

The downside is that it is unlikely that these assets can be grown in a transformational sense given Neon's capital constraints and the low IP of new wells, which makes building a strong and sustainable production growth profile very difficult.

### Exhibit 17: Neon net reserves and prospective resources

	1P	2P	Prospective			In-Place			Mboe
	Oil	Oil	Oil	Gas	Cond	Oil	Gas	Cond	
	Mb	Mb	Mb	Bcf	Mb	Mb	Bcf	Mb	
<i>Vietnam</i>									
Block 120			1337						
Block 105			78	3135	23				
<i>California</i>									
North San Ardo	4								
Paris Valley		9				130			
Paloma									300

1P and 2P estimates as per 30 June 2010 reported reserves (unadjusted for 2010-2011 production); Prospective and In-place resources as per recent company announcements

Source: Company reports

The comparison of reserves to prospective resources underscores the transformational potential of the Vietnam exploration portfolio and illustrates why this is the key investment feature of the company.

As mentioned previously and not to be understated, the potential of the Vietnamese Blocks is 'unrisked', subject to successful drilling outcomes and must be considered high risk at this stage given the under-explored nature of the region.

Risk weightings applied to exploration are subjective, but even modest (commercial) success here would be significant in comparison to the existing production and exploration portfolio in California. We reiterate that an 'average' oil success could be worth \$2 - 4/share to Neon whilst a 1Tcf gas discovery could deliver between \$0.60 - 1.20/share.

## Production and Earnings

Neon is currently producing a modest amount of oil from its North San Ardo field in California. With the addition of two recently completed horizontal wells, **the latest production data estimate has the field generating more than 1,000bopd**, compared to the indicated March quarter (2011) average of 467bopd.

### Exhibit 18: Neon Forecast Oil Production (June 30 year end)

		2009-10a	2010-11e	2011-12e	2012-13e	2013-14e
Ave Production rate	bpd	281	406	834	803	816
TOTAL	Mb	0.103	0.148	0.304	0.293	0.298

Source: Company reports, RBC Capital Markets estimates

We assume a stabilised flow rate from North San Ardo after the rapid decline from the early production kicker with sufficient in field work to offset the decline rates. There is likely to be a reasonably equal probability of downside to upside risk on these estimates, which are dependent on maintaining a minimum output performance from new wells.

We assume two successful new production wells per annum during the forecast period out of every three drilled. The ultimate production rate will be dependent on how aggressive the company wishes to be after the prospect potential of this asset, but given the high decline rate of the field, we believe that the company is more likely to allocate resources to those assets where the upside leverage is significantly stronger.

#### Exhibit 19: RBC Commodity Assumptions (June 30 year end)

		2010-11	2011-12	2012-13	2013-14	LT
WTI	US\$/b	83.14	95.25	101.00	100.00	100.00
A\$/US\$		0.977	1.007	0.965	0.930	0.750

Source: RBC Capital Markets estimates

Our earnings outlook for Neon Energy is based on the RBC commodity assumptions as indicated in Exhibit 19.

#### Exhibit 20: Neon Energy Forecast Earnings (A\$000 except per share data)

	2009-10a	2010-11e	2011-12e	2012-13e	2013-14e	CAGR
<b>Revenue from Operations</b>	<b>7452</b>	<b>12953</b>	<b>31502</b>	<b>32177</b>	<b>33681</b>	<b>352%</b>
Cost of Sales	5027	7029	13581	13905	15573	
<b>Gross Profit</b>	<b>2425</b>	<b>5923</b>	<b>17920</b>	<b>18272</b>	<b>18108</b>	
Other Income	137	72	1352	1229	1563	
Corporate and admin costs	4805	4904	5000	5000	5000	
Exploration write-downs			11500	1500	1500	
Other expenses	36	20	20	20	20	
Total Other Expenses	4841	4924	16520	6520	6520	
<b>Profit before Tax and Financing</b>	<b>-2279</b>	<b>1071</b>	<b>2752</b>	<b>12981</b>	<b>13151</b>	
Net Finance costs	14	96	100	100	100	
<b>Profit before Tax</b>	<b>-2293</b>	<b>975</b>	<b>2652</b>	<b>12881</b>	<b>13051</b>	
Tax		743	796	3864	3915	
<b>NPAT Attributable</b>	<b>-2293</b>	<b>232</b>	<b>1857</b>	<b>9017</b>	<b>9135</b>	<b>298%</b>
Foreign currency translation gain/(loss)	-1678	-4736				
<b>NPAT Post Significant Items</b>	<b>-3971</b>	<b>-4504</b>	<b>1857</b>	<b>9017</b>	<b>9135</b>	
EPS (\$A cents) pre-significant items	-0.7	0.1	0.4	2.1	2.1	
EPS (\$A cents) post-significant items	-1.2	-1.0	0.4	2.1	2.1	

Source: Company reports, RBC Capital Markets estimates

Under our production assumptions, we have the company generating a sustainable NPAT of around A\$8mn per annum based on the stabilised flow rates applicable to the North San Ardo field, but we highlight that the bottom line profit is very dependent on the assumptions made with respect to exploration expenditure and write-offs (particularly) on the Vietnamese assets.

We assumed a net contribution to the drilling of two wells in the offshore Vietnamese permits of A\$15 million (gross cost of A\$75 million) in the June-half of 2011-2012 with a write-off of 75% but caution that even a cost over-run of as little as 10% could send the 2011-2012 NPAT to zero.

Our forecasts simply highlight the investment premise that Neon is an exploration play, particularly on high-impact drilling in Vietnam.

## Cash Flow and Balance Sheet

The recent (March 2011) A\$26 million capital raising has put the company in a healthy cash position, which assuming our production and revenue assumptions can be delivered, should maintain a robust cash reserve during the forecast period with which to pursue an accelerated work programme or new venture opportunities.

### Exhibit 21: Cash Position and Balance Sheet (A\$'000)

	2009-10a	2010-11e	2011-12e	2012-13e	2013-14e
<b>Cash Position</b>					
<b>Net Operating cash flow</b>	<b>243</b>	<b>2167</b>	<b>15359</b>	<b>14025</b>	<b>14927</b>
Payments for PPE	-63	-974	0	0	0
Payments for investments	-1428	0	0	0	0
Payments for exploration & evaluation	-2544	-5807	-16000	-6000	-6000
Development expenditure	-3029	-2303	-1500	-1500	-1500
Proceeds from sale of tenement		6574	0	0	0
<b>Net Investing cash flow</b>	<b>-7063</b>	<b>-2511</b>	<b>-17500</b>	<b>-7500</b>	<b>-7500</b>
Net Proceeds from issue of shares	5342	23941	0	0	0
Repayments of borrowings		-145	-350	0	0
<b>Net Financing cash flow</b>	<b>5261</b>	<b>23796</b>	<b>-350</b>	<b>0</b>	<b>0</b>
Net Change in Cash	-1869	23328	-2522	6486	7388
<b>Cash at end of Year</b>	<b>1841</b>	<b>25208</b>	<b>22725</b>	<b>29250</b>	<b>36677</b>
<b>Balance Sheet</b>					
Cash	1841	25208	22725	29250	36677
Plant and equipment	392	1148	998	998	998
Exploration and evaluation expenditure	18434	16415	20861	25361	29861
Oil and gas properties	25017	21806	21849	21891	21934
<b>Total assets</b>	<b>46835</b>	<b>66401</b>	<b>69914</b>	<b>80984</b>	<b>93174</b>
Short term borrowings		350	0	0	0
Long term borrowings					
<b>Total liabilities</b>	<b>5225</b>	<b>5089</b>	<b>6745</b>	<b>8799</b>	<b>11853</b>
<b>Net Assets/Equity</b>	<b>41609</b>	<b>61312</b>	<b>63169</b>	<b>72185</b>	<b>81321</b>
<b>Net Debt</b>		<b>Nil debt through forecast period</b>			
<b>Net Debt/EBITDA</b>					
<b>BV/share (A\$ps)</b>		<b>0.14</b>	<b>0.15</b>	<b>0.17</b>	<b>0.19</b>

Source: Company reports, RBC Capital Markets estimates

Our forecasts indicate that the company will be generating a cash surplus of around A\$7–8 million per annum pre large-scale exploration commitments (i.e. Vietnamese drilling) but is ideally placed with no debt should drilling success lead to an expanded appraisal programme or early development expenditures.

## Valuation

The company is largely an asset play with the majority of its value determined by risk weightings assigned particularly to its Vietnamese exploration portfolio rather than a DCF-based NAV, given the small effect the current production assets have on the overall valuation.

The risk weightings as applied to any particular asset are subjective and skewed to the high-risk end of the range, although we rank some of the prospect inventory as 'moderate' risk. In an exploration sense, we consider moderate risk to mean a 15–25% probability of success only, with high risk at 5–10%, and very high risk as less than 5% (as applied to Vietnam).

Under our premise, some 70% of the value of the stock resides in its exploration portfolio, which remains subject to initial success and appraisal leading to commercial developments.

The company needs to deliver exploration success during 2011-2012 to approach our asset value, but given the resource potential and upside on success, any positive news has the potential to drive the share price well beyond the currently assigned NAV.

## Target Price

Setting a Target Price for a stock that is essentially an exploration play is a highly subjective exercise, particularly when the key play is high risk in an underexplored basin (Vietnam). We take confidence from the presence of large multi-nationals in adjoining permits that are chasing similar geological targets, but there is no portfolio of historical success on which to base probabilities at this stage.

We have attempted to reflect the inherent risk of the portfolio within our probability weightings (noting the somewhat subjective nature of this assessment) and are buoyed by the significant premium (75%) to the share price represented by the risked asset value.

Accordingly, we set our **Target Price benchmarked against the NAV at A\$0.70/share.**

The catalysts for a stock re-rating may be pre-empted by the results of Exxon's Vietnamese drilling campaign underway now, but Neon will only be drilling here in the June half of 2012.

**On our Target Price, we forecast Neon to generate total returns for 2011-2012 of 109% (based on the closing price of A\$0.335 25-Aug), but categorise these as highly speculative. We rate the stock Outperform, with a Speculative Risk rating.**

## Exhibit 22: Neon Energy Valuation (A\$ per share)

	WI	A\$mn	\$ps	Comments
<i>Production</i>				
North San Ardo	100%	72	0.17	High NPV per barrel but reserves small (3.6Mb @ 1P)
<i>Exploration</i>				
California	various		0.13	Significant 'in-place' potential at Paloma and Tejon
Vietnam			0.38	Unrisked resource potential is massive but extremely high risk, the attraction and reward of the stock resides in this part of the portfolio
<i>Block 120</i>	50%	27	0.06	
<i>Block 105</i>	50%	137	0.32	
<b>Asset Value</b>			<b>0.68</b>	
Net Cash		23	0.05	
Other				
<b>TOTAL</b>			<b>0.73</b>	<b>Small changes in risk assessment to the Vietnamese assets trigger large upside/downside to company valuation</b>

Source: RBC Capital Markets estimates

## Price Target Impediments

The inherent risks to any target price based on exploration outcomes relate to the success weightings applied to the drilling programme, which are subjective and attempt to apply a probabilistic result to what is essentially a binary outcome—the company either finds a commercial success or it does not and any risk or success weighting applied is effectively one potential outcome in a continuous range. We attempt to mitigate this risk by assigning the risk to a minimum economic case for success thereby underpinning a minimum positive outcome.

Although there are numerous associated political risks with the geography of the Vietnamese assets from a target price specific perspective, these are largely irrelevant and only a successful drilling outcome will sustain our target price assumption.

## Other Risks

### Geological

Our thesis on the value upside in the company's exploration portfolio is predicted on ultimately delivering an initial discovery to confirm the geological and economic model. We noted previously that although there has been some success in the surrounding permits, the acreage is very under-explored and that geological risks must be considered as very high.

To make a successful new field discovery, all the geological parameters, being inter-related (i.e., generation, reservoir, seal, and migration) must be positive—if one fails, then the well fails.

Even within the comparatively lower-risk Californian assets, there are significant geological risks, particularly in reservoir character terms and; these prospects and opportunities should not be considered as easy or certain.

### Commercial

Positive drilling results do not automatically lead to commercial success, particularly in wildcat and under-explored areas where economics thresholds are by definition larger and need to be robust enough to underpin the establishment of infrastructure, especially pipelines.

The outlook for Neon during the forecast period will be strongly dependent on the commercial environment for gas in Vietnam and the critical mass to achieve economic returns either for domestic supply or export.

The Vietnamese domestic market is forecast to grow strongly during the next decade with the growth projections supporting the establishment of an initial LNG import terminal (1Mtpa or c.60PJ) for operation from 2014. We think it is likely that local (domestic) gas opportunities will arise from natural market growth, especially in power generation and we also see an opportunity to supply into the export projects, particularly where new gas discoveries are large compared to the capacity of the local market to absorb volumes.

*State-owned PetroVietnam has submitted plans for a 1Mtpa LNG import terminal in southern Vietnam. If the project starts up as planned, then it will be the first operational LNG import terminal in the country.*

*PetroVietnam dropped its original plan of importing LNG for south Vietnam via a floating storage and regasification unit, or FSRU, due to an electricity and power shortage in the region...(but the) company would still import LNG using an FSRU for north Vietnam by 2018 before building a land-based terminal.*

*A second 3Mtpa terminal could be built at Son My in southern Vietnam, which could be expanded to 6Mtpa.*

*PetroVietnam also has plans to build a 2.2Mtpa import terminal by 2015, Platts reported in mid-April.*

Source: LNG World News - 1 June

Changes in commodity pricing and user demand could affect the capacity of buyers (domestic or export) to seek new supply commitments. Conversely, these events could also deliver risks to the upside.

## Sovereign Issues

### Security of Vietnam Leases

We note an ASX release by Neon Energy dated 2 June:

*Further to recent reports concerning a confrontation between a Vietnamese seismic vessel and a Chinese patrol vessel over the jurisdictional sovereignty of the waters in which the seismic vessel was operating, Neon Energy wishes to clarify the situation regarding the Company's offshore Vietnam exploration acreage. (RBC emphasis added)*

*Neon's Block 105-110/04 ("Block 105") is unaffected as no border dispute exists in that area. Block 120 does have a portion of the block on which there has been a longstanding dispute between China and Vietnam.*

*However, Neon has restricted all activity, analysis and reporting to only that portion of the block on which there is no dispute. Block 120 is wholly located within the 200 nautical mile exclusive economic area of Vietnam, as defined by the United Nations Convention on the Law of the Sea 1982, and International Law. As such the Company has no concerns regarding security of title for either of the blocks as preparations for drilling in early 2012 continue.*

Further to this issue we also highlight a recent article from the Asian Wall Street Journal (3-Aug) reporting on increased 'tension' in disputed parts of the South China Sea. Field activity is increasing in the area with a Philippino company planning to drill two wells

and shoot seismic, whilst the China National Offshore Oil Corp. (CNOOC) is reported to be deploying a recently acquired deepwater rig and various service vessels, before the end of 2011.

US Department of Energy estimates the South China Sea could contain anywhere from 28 billion barrels of oil up to 213 billion barrels.

We understand the border issue has been long-running and that the countries have been in discussions for a prolonged period. This is an issue that flairs on a reasonably regular basis, often coinciding with significant exploration activity. We highlight the dispute only as recognition that there is an element of risk to discoveries and activity in or near the disputed boundary zone but add that Neon's acreage is somewhat distant from the region of dispute.

#### **Other technical issues**

We note that the Californian assets in particular require the application of enhanced recovery methodology, notably cyclic steam flooding, which provides another element of risk from both an engineering and commercial aspect.

## Neon Energy Directors and Senior Management

The Board and Executive team of Neon Energy (as listed) are relatively recent additions and bring a collectively strong background of oil industry management experience to the company and in the case of Dr Stein, a track record of success in building and delivering shareholder value. We view senior management as a positive for the company, particularly with respect to the international exposures.

We note from the most recent shareholder data that the Board and senior Executives hold approximately 10% of the company's ordinary shares.

### Directors

#### Non-Executive Chairman Dr. Alan Stein

- Petroleum geologist with a broad range of international experience.
- Founder and Director of IKODA Limited, a petroleum exploration consultancy based in London and Perth.
- Founder and Director of FIL Resources Limited.
- Founder and Managing Director of AIM-listed Fusion Oil & Gas plc.
- Following the sale of Fusion Oil & Gas to Sterling Resources Dr. Stein, together with several Fusion colleagues, established Ophir Energy, an oil and gas exploration company focused on Africa of which he is presently Managing Director.
- Dr Stein was appointed a Director of the company on 27 October 2009.

#### Managing Director Ken Charsinsky

- More than 32 years of worldwide international E&P experience in both technical and management roles.
- MS Geology degree from Rensselaer Polytechnic Institute.
- Previously worked for Cities Service Oil and Gas Company, Maxus Energy, CMS (Nomeco) Oil and Gas Company. and Noble Energy Inc.
- He has held several management positions at Noble including assignments as Managing Director in Congo and Tunisia and as a manager of Noble's International New Ventures group.
- Most recently Exploration Director for Noble.
- Mr. Charsinsky was appointed a Director of the company on 27 October 2009.

#### Non-Executive Director John Lander

- More than 40 years of experience in the international and domestic oil industry.
- He has held a number of directorships in successful oil and gas companies listed in the United Kingdom.
- Currently, he is the non-executive director of three UK-based companies, namely: Canadian North Sea Ltd, Alkane Energy Plc (AIM: ALK), and Ophir Energy Plc.
- Mr Lander was appointed as a Director of the company on 27 October 2009.

#### Chief Financial Officer Ben Newtown

- Mr. Newtown is a CPA with more than 15 years of experience in the resources sector in Australia.
- Before joining the oil industry in 1998, he held several accounting roles in the mining sector.
- His oil and gas industry experience includes senior finance roles with Eni Australia and Amity Oil Ltd.
- In 2003, Mr. Newtown joined Oceaneering Australia (a subsidiary of the US oilfield services company) as Financial Controller where he was responsible for all of the financial and corporate affairs of the company in Australia.
- From 2005 to mid 2010, Mr. Newtown served as a Managing Director for Oceaneering Australia.

Neon Energy Limited													
ASX: NEN	Share Price: (A\$ps)	0.335	Year end:			Jun	Stock Rating:	Outperform	Price Target:			A\$0.70	
	Mkt Cap: (A\$m)	145	Issued shares (m)			432	Risk Qualifier:	Speculative	NAV:			A\$0.73	

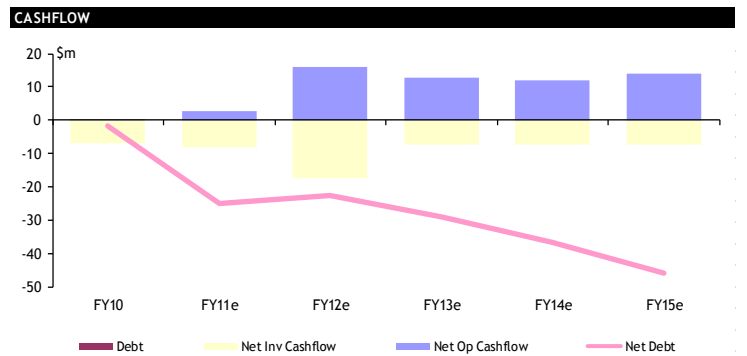
ASSUMPTIONS		FY 10	FY 11e	FY 12e	FY 13e	FY 14e	FY 15e	PRODUCTION STATS		FY 10	FY 11e	FY 12e	FY 13e	FY 14e	FY 15e
WTI crude oil price	US\$/b	96.00	102.00	100.00	100.00	100.00	100.00	Oil	kb	103	148	304	293	298	313
Exchange Rate	A\$/US\$	0.98	0.94	0.90	0.87	0.85		Gas	bcf						
Domestic gas	A\$/gj														

RATIO ANALYSIS		FY 10	FY 11e	FY 12e	FY 13e	FY 14e	FY 15e
Shares outstanding	mm	324	432	432	432	432	432
EPS (pre sig. items)	A¢	-0.7	0.1	0.4	2.1	2.1	2.3
EPS (post sig. items)	A¢	-1.2	-1.0	0.4	2.1	2.1	2.3
P/E	x						
OpCFPS	A¢	0.1	0.5	3.6	3.2	3.5	3.9
P/CF	x						
DPS	A¢	0	0	0	0	0	0
Dividend yield	%	0%	0%	0%	0%	0%	0%
Franking Level	%	0%	0%	0%	0%	0%	0%
Book value per share	A\$ps	0.10	0.14	0.15	0.17	0.19	0.21
P/Book value	x		2.4x	2.3x	2.0x	1.8x	1.6x
R.O.E. (pre sig items)	%	-6%	2%	7%	6%	6%	6%
R.O.A. (pre sig items)	%		2%	4%	3%	3%	3%
Interest Cover	x						
Gross Profit per share	A\$Cps		1.37	4.15	4.23	4.19	4.30
EV/EBITDA	x						
EBITDA ratio	%						

Oil Revenue	A\$m	7.4	13.0	31.5	32.2	33.7	35.7
Gas Revenue	A\$m						
Average Price Realised	A\$/b	71.93	87.39	103.48	109.78	113.08	113.95
Cash Costs	A\$/b	49.02	47.43	44.61	47.44	52.28	54.64
Cash Margin		22.91	39.96	58.86	62.34	60.80	59.31
		32%	46%	57%	57%	54%	52%

RESERVES AND RESOURCES		1P	2P	Prospective Unrisked		In-Place Unrisked	
Permit - (Project)				Oil	Gas	Oil	Gas
		Mb	Mb	Mb	Bcf	Mb	Bcf
<i>Vietnam</i>							
Block 120					1337		
Block 105					101	3135	
<i>California</i>							
North San Ardo	4					130	
Paris Valley		9					
Paloma							300

EARNINGS	A\$m	FY 10	FY 11e	FY 12e	FY 13e	FY 14e	FY 15e
Product Sales		7.5	13.0	31.5	32.2	33.7	35.7
Cost of Sales		(5.0)	(7.0)	(13.6)	(13.9)	(15.6)	(17.1)
Gross Profit		2.4	5.9	17.9	18.3	18.1	18.6
Other Revenue		0.0	1.0	2.0	3.0	4.0	5.0
Other Income		0.0	0.0	0.0	0.0	0.0	0.0
Other Expenses		(4.8)	(4.9)	(16.5)	(6.5)	(6.5)	(6.5)
Operating Profit		(2.4)	2.0	3.4	14.8	15.6	17.0
Financial Income		0.1	0.1	1.4	1.2	1.6	2.0
Financial Expenses		(0.0)	(0.1)	(0.1)	(0.1)	(0.1)	(0.1)
Net Financing		0.1	(0.0)	1.3	1.1	1.5	1.9
Other							
Pre-Tax Profit		(2.3)	2.0	4.7	15.9	17.1	18.9
Income Tax		0.0	(0.7)	(0.8)	(3.9)	(3.9)	(4.2)
Royalty related tax							
Reported NPAT		(2.3)	1.2	3.9	12.0	13.1	14.7
Net Significant Items		(1.7)	(4.7)	0.0	0.0	0.0	0.0
Underlying NPAT		(4.0)	(3.5)	3.9	12.0	13.1	14.7



CASHFLOW	A\$m	FY 10	FY 11e	FY 12e	FY 13e	FY 14e	FY 15e
Operational Cash Flow		0.2	2.7	16.0	15.3	15.4	17.5
Net Interest		(0.0)	0.6	0.7	1.3	0.5	0.6
Taxes Paid		0.0	0.0	0.0	0.0	0.0	0.0
Other		0.0	(0.7)	(0.8)	(3.9)	(3.9)	(4.2)
Net Operating Cashflow		0.2	2.6	15.9	12.7	12.0	13.9
Exploration		(2.5)	(5.8)	(16.0)	(6.0)	(6.0)	(6.0)
Capital Expenditure		(3.0)	(2.3)	(1.5)	(1.5)	(1.5)	(1.5)
Investments		(1.4)	0.0	0.0	0.0	0.0	0.0
Sale of PPE and Other		0.0	0.0	0.0	0.0	0.0	0.0
Net Investing Cashflow		(7.0)	(8.1)	(17.5)	(7.5)	(7.5)	(7.5)
Dividends Paid							
Net Debt Drawdown		(0.1)	(0.1)	(0.4)	0.0	0.0	0.0
Equity Issues		5.3	23.9	0.0	0.0	0.0	0.0
Other (e.g. prepayments, leasing)							
Net Financing Cashflow		5.3	23.8	(0.4)	0.0	0.0	0.0
Net Change in Cash		(1.5)	18.3	(1.9)	5.2	4.5	6.4
Operating Free Cash Flow		(6.8)	(5.5)	(1.6)	5.2	4.5	6.4

EQUITY NAV VALUATION		Pr (risk)	A\$m	A\$ps
<i>Projects</i>				
<i>Production</i>				
North San Ardo	85%		72	0.17
<i>Exploration - California</i>				
Paris Valley			14	0.03
Paloma			43	0.10
<i>Exploration - Vietnam</i>				
Block 120			27	0.06
Block 105			137	0.32
<b>Total</b>			<b>72</b>	<b>0.68</b>
Net Cash			24	0.05
Other				

BALANCE SHEET	A\$m	FY 10	FY 11e	FY 12e	FY 13e	FY 14e	FY 15e
Cash & Equivalents		1.8	25.2	22.7	29.3	36.7	46.0
PP&E & Development		0.4	1.1	1.0	1.0	1.0	1.0
Exploration		18.4	16.4	20.9	25.4	29.9	34.4
Total Assets		46.8	66.4	69.9	81.0	93.2	107.0
Debt		0.0	0.0	0.0	0.0	0.0	0.0
Total Liabilities		5.2	5.1	6.7	8.8	11.9	15.9
Total Net Assets / Equity		41.6	61.3	63.2	72.2	81.3	91.1

WACC		11.0%		
LT WTI	US\$/b	100.00		
Cash Producing Assets		72	0.17	P / NAV
Shares on issue (mm)		432		0.46x

## Appendix I

### Vietnam - Oil and Gas Background

The State-run Vietnam Oil and Gas Corporation, PetroVietnam, has exploited 178Mt of crude oil (c.1.2 Billion barrels) and 22Bcm of gas (c. 777Bcf) from Vietnam's offshore areas during the past three decades. Since 1986, the oil and gas yields have increased every year. PetroVietnam has plans to maintain an average output of 48kt (c.315kbpd) crude oil and 16Mcm (565mmcf) of gas daily.

PetroVietnam is the dominant player in the Vietnamese market. The company is the sole state-owned petroleum corporation for Vietnam. It has a full monopoly on all upstream exploration and exploitation, and plays a significant role in downstream operations as well. It has received investment licenses to build the country's first oil refineries. Any foreign oil company working on upstream projects will have to deal with PetroVietnam in some capacity.

PetroVietnam plans to start commercial operations of between 15–20 new oilfields in the 2011-2015 period.

### Vietnamese Fiscal Regime

#### Exhibit 23 Vietnamese PSC - General Terms and Conditions

Vietnamese PSC - General Terms and Conditions			
<b>Contract Type</b>		Production Sharing Contract	
<b>Contract Duration</b>		Up to 30 years with maximum 7 years for exploration phase	
<b>Contract Area</b>		Up to 2 blocks or 4 blocks in special cases (can be 30,000 sq km)	
<b>Work Programme and Budget</b>		As proposed by contractor based on the potential of the area, this is flexible with no minimum work or expenditure requirements	
<b>Profit Sharing</b>		Incremental tranches with agreed ratio between PetroVietnam and contractor	
<b>Participation of PetroVietnam</b>		Negotiable	
<b>Royalty</b>		4-25% for oil; 0-10% for gas depending on the production rate	
<b>Crude Oil</b>		<b>Normal</b>	<b>Incentive</b>
	<i>Up to 20kbpd</i>	6%	4%
	<i>20-50kbpd</i>	8%	6%
	<i>50-75kbpd</i>	10%	8%
	<i>75-100kbpd</i>	15%	10%
	<i>100-150kbpd</i>	20%	15%
	<i>&gt;150kbpd</i>	25%	20%
<b>Natural Gas</b>	<i>Up to 5mmcf</i>	<i>Nil</i>	<i>Nil</i>
	<i>5-10mmcf</i>	5%	3%
	<i>&gt;10mmcf</i>	10%	6%
<b>Enterprise Income Tax</b>		32% (exempt for first two years and 50% reduction for two subsequent years is possible)	
<b>Value Added Tax</b>		0-10%	
<b>Export Tax</b>		4 % for oil; 0% for gas (deductible)	
<b>Cost Recovery</b>		maximum 70%	
<b>Other Financial Contributions</b>		Negotiable	

Source: Danish Embassy of Hanoi (2006)

## Vietnamese Geological Setting

Vietnam's continental shelf is about one million km<sup>2</sup>, comprised of major tertiary basins and groups of basins: Song Hong, Phu Khanh, Cuu Long, Nam Con Son, Malay-Tho Chu, Tu Chinh-Vung May, Hoang Sa (the Paracel Islands), and Truong Sa Group (the Spratly Islands). Of these, the Cuu Long and Nam Con Son basins have shown the most hydrocarbon potential.

Exhibit 24 Major Tertiary Basin in Vietnam



Source: [www.petrovietnam.com.vn](http://www.petrovietnam.com.vn)

To date (end 2009), about 100 hydrocarbon-bearing prospects have been found in almost 50 fields. Among the 50 structures with oil and gas discoveries, there are 20 commercial fields.

From 1988 to 2008, PetroVietnam signed 60 oil and gas exploration and production contracts with foreign companies in the form of Product Share Contracts (PSC), Business Cooperation Contracts (BCC), Joint Ventures (JV) and Joint Operation Companies (JOC). Of these, 35 contracts are currently in effect.

In 2009, the country produced 24.3 million tons of oil equivalent, comprising 16.3 million tons of crude oil and condensate, and 8 billion cubic meters of gas, an increase of 8% compared to the company's 2008 production. In the medium term, oil production is expected to decline gradually due to the deteriorating performance of the White Tiger field while other new discoveries will not offset this loss in production.

Gas production, however, will rise significantly since several gas fields will be put in production in the near future. Presently, about 85% of the natural gas produced in Vietnam is used for power generation, 10% for fertilizer, and the remaining 5% for industries and households. Gas is transported via a network of gas pipelines from offshore gas fields to onshore processing facilities and power complexes.

Along with three gas pipelines, Bach Ho, Nam Con Son, and Ca Mau, PetroVietnam is building the fourth pipeline from the Thai frontier to Can Tho Province's O Mon and also the second Nam Con Son pipeline to drill gas in the West Ocean and Nam Con Son basin.

Vietnam's domestic demand for crude oil and gas in the future is expected to increase, especially as the country expands its refinery capacity.



## Valuation

We value the company by risk weightings assigned particularly to its Vietnamese exploration portfolio and a DCF-based calculation on existing production. We value the company at \$0.73 (NAV) and set our price target at \$0.70, on that basis.

## Price Target Impediment

### General

The inherent risks to any target price based on exploration outcomes relate to the success weightings applied to the drilling programme, which are subjective, and attempt to apply a probabilistic result to what is essentially a binary outcome...the company either finds a commercial success or it does not.

### Geological

Our thesis on the value upside in the company's exploration portfolio is predicated on ultimately delivering an initial discovery to confirm the geological and economic model. Although there has been some success in the surrounding permits (in Vietnam), the acreage is very under-explored and geological risks must be considered as very high.

### Security of Vietnam Leases

Although we think Neon is unlikely to be affected, there is an ongoing dispute between the Chinese and Vietnamese Governments over the jurisdictional sovereignty of the waters.

## Company Description

Neon Energy (NEN.AX) is a conventional oil and gas exploration play with assets in Vietnam and California. The company holds material interests in exploration Blocks-120 and 105, offshore Vietnam and a portfolio of operated exploration, appraisal, and production assets onshore California

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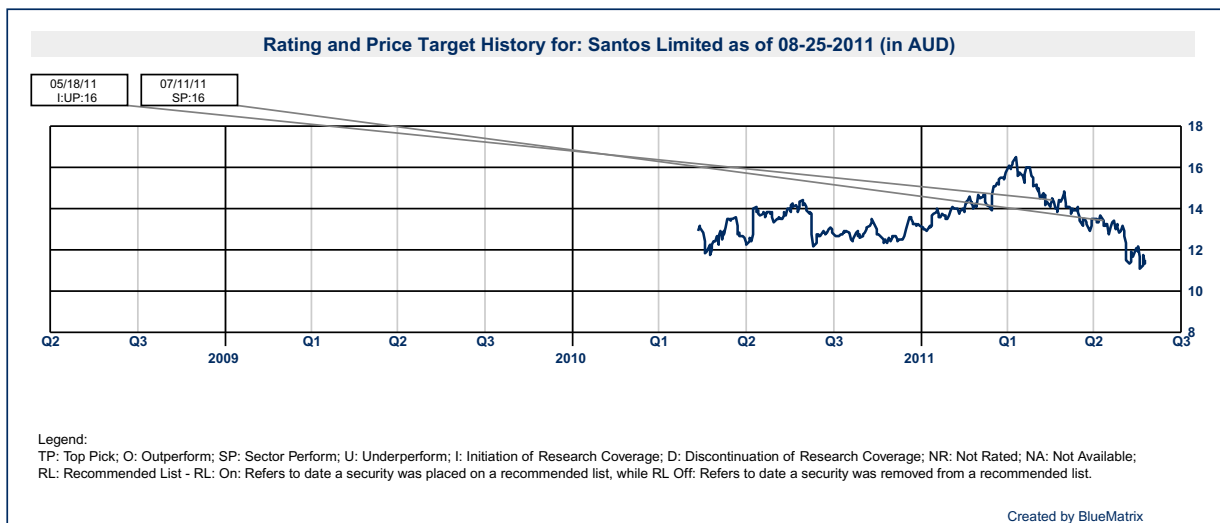
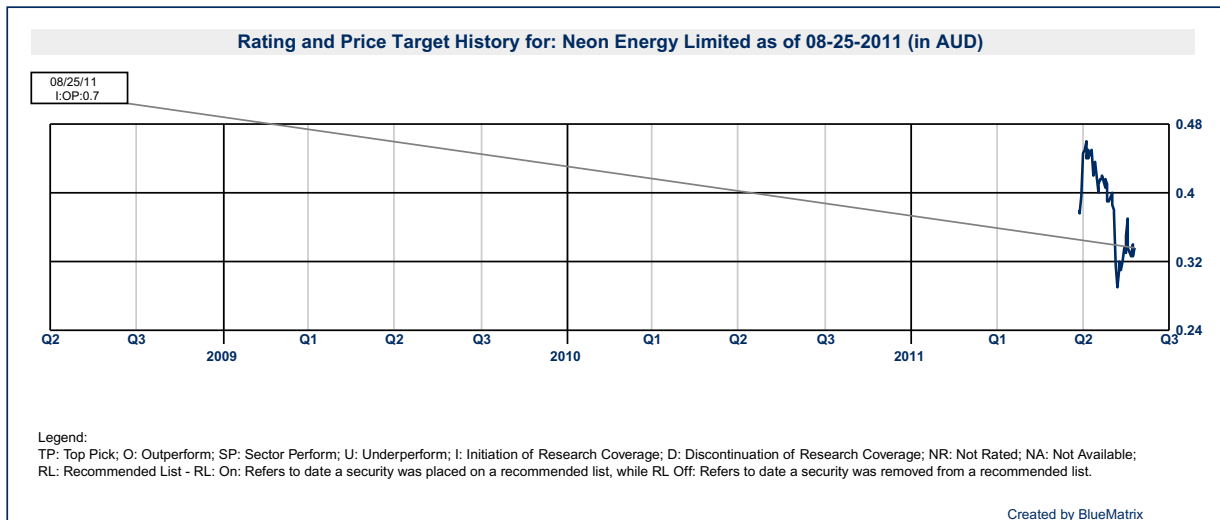
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