

Australian Power and Gas Company

FY08 Result: Powering up momentum

Event

APK announced its FY08 results. Sales revenue was \$34.5M, in line with the company's target and up from \$0.9M in prior year. Operating cashflow, as flagged in its latest cashflow statement, was negative \$18.2M. On a statutory basis, APK booked a net loss of \$10.8M versus a loss of \$6.4M in FY07.

Implications

This is a good result from APK, marginally beating our earnings and cash flow forecasts. APK's customer acquisitions to this point, revenue per customer and margins are all healthy considering the company is in its development phase. We see APK's biggest risk as its exposure to the volatile energy markets, but we are satisfied the company is taking all the right precautions in this area. Importantly, the company also has financial backing from major shareholders assisting its start-up phase providing it relatively good terms on its debt. Looking into FY09, we are confident the company's current agreements provide it with the financial capacity to maintain its working-capital requirements. APK's FY09 EBITDA forecast is around \$1.4M, targeting around 100,000 customer accounts transferred and revenue of circa \$80M. Our FY09 forecasts are consistent with management's guidance. If the company can hit its sales and earnings targets, we see significant potential in the stock. Management forecasts for EBITDA in FY10 and FY11 at a customer acquisition rate of 4,000 per month, are ~\$13M and ~\$23M, respectively. We marginally revise up our FY09 NPAT forecast from a circa \$4M loss to a \$3M loss and FY10 from ~\$3M up to ~\$6M. Our valuation of APK increases from \$0.30 to \$0.34.

Investment Opinion

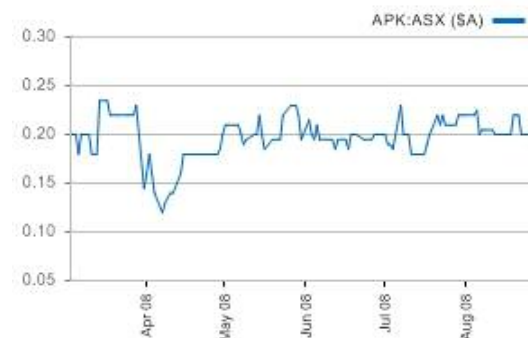
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Key Information

Share Price	\$0.20
Valuation	\$0.34

Price Performance



Market Statistics

Market Cap (M)	\$21
Shares (M)	119.8
% of All Ords	0.00
% of Sector	0.09
12 Month Range	\$0.12 - \$0.46
Company Risk	★☆☆☆☆
Share Price Risk	★☆☆☆☆
Ethical rating	★☆☆☆☆

Performance against indices (%)

	3 Months	6 Months	12 Months
APK	(17.4)	(5.0)	(57.8)
Sector	(10.8)	(6.3)	(26.4)
Market	(9.7)	(8.1)	(16.5)

Key Assumptions

Beta:	2.2
Market risk premium (%):	6.0
Risk free rate (%):	6.3
WACC (%):	17.1
Forecast cashflow (years):	10
Residual value % of total valuation:	28.0
Nominal terminal growth rate (%):	3.0

Earnings Summary

Yr to Jun	NPAT Rep \$M	NPAT ¹ Adj \$M	EPS ¹ c	EPS chg %	PER x	PER rel All Ords x	PER rel Sector x	DPS c	Yield %	Franking %	ROE %
2007A	(6.4)	(6.4)	0.0	n/a	0.0	0.0	0.0	0.0	0.0	0	(46.9)
2008A	(10.8)	(10.8)	(9.8)	n/a	(2.0)	(0.1)	(0.1)	0.0	0.0	0	(21.9)
2009F	(2.9)	(2.9)	(2.3)	n/a	(8.3)	(0.7)	(0.5)	0.0	0.0	0	(6.5)
2010F	5.6	5.6	4.8	n/a	4.1	0.4	0.3	0.0	0.0	0	12.6

¹ NPAT and EPS are adjusted by removing non-recurring items. All the above statistics are derived from normalised earnings.

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Valuation: \$0.34

Company risk ¹: ★★★★★

Share Price risk ¹: ★★★★★

Ethical rating ²: ★★★★★

Year end Jun. All figures in A\$M

Profit & loss summary					Ratio analysis				
	2007A	2008A	2009F	2010F		2007A	2008A	2009F	2010F
Operating revenue	0.7	34.5	78.7	136.3	Revenue growth (%)	0.0	>1000	128.2	73.2
Invest & other income	0.0	1.6	5.8	5.8	EBITDA growth (%)	n/a	n/a	n/a	807.5
EBITDA	(6.0)	(6.9)	1.4	12.8	EPS growth (%)	n/a	n/a	n/a	n/a
Depreciation/Amort	(0.7)	(5.3)	(3.5)	(3.5)	EBITDA/Sales margin (%)	(891.8)	(20.2)	1.8	9.4
EBIT	(6.7)	(12.3)	(2.0)	9.3	EBIT/Sales margin (%)	(991.3)	(35.6)	(2.6)	6.8
Net Interest	0.3	(3.3)	(1.8)	(1.8)	Tax rate (%)	0.0	30.8	25.0	25.0
Pre-tax profit	(6.4)	(15.6)	(3.8)	7.5	Net debt/equity (%)	(2.7)	30.0	46.0	29.1
Tax expense	0.0	4.8	1.0	(1.9)	Net debt/net debt + equity (%)	(2.8)	23.1	31.5	22.5
Minorities/Assoc./Prefs	0.0	0.0	0.0	0.0	Net interest cover (x)	n/a	(3.7)	(1.2)	5.1
NPAT	(6.4)	(10.8)	(2.9)	5.6	Payout ratio (%)	0.0	0.0	0.0	0.0
Non recurring items	0.0	0.0	0.0	0.0	Capex to deprec'n (%)	0.0	48.8	0.0	0.0
Reported profit	(6.4)	(10.8)	(2.9)	5.6	NTA per share (\$)	0.00	0.14	0.06	0.10
NPAT add Goodwill & Pref	0.0	0.0	0.0	0.0	ROA (%)	(37.7)	(16.9)	(2.5)	9.7
Adjusted profit	(6.4)	(10.8)	(2.9)	5.6	ROE (%)	(46.9)	(21.9)	(6.5)	12.6
Cashflow summary					Multiple analysis				
	2007A	2008A	2009F	2010F		2007A	2008A	2009F	2010F
EBITDA	(6.0)	(6.9)	1.4	12.8	Market cap (M)		21		
Working capital changes	0.0	7.1	0.3	1.1	Net debt (\$M)		19.5		
Interest and tax	(1.2)	(0.8)	(1.8)	(2.6)	Peripheral assets (\$M)		(0.0)		
Other operating items	(2.7)	(17.4)	(5.7)	(5.6)	Enterprise value (\$M)		40.4		
Operating cashflow	(9.9)	(18.2)	(5.8)	5.7	EV/EBIT (x)	(6.0)	(3.3)	(19.8)	4.3
Required capex	(0.3)	(0.0)	(0.1)	(0.1)	EV/EBITDA (x)	(6.7)	(5.8)	28.7	3.2
Maintainable cashflow	(10.2)	(18.2)	(5.8)	5.6	EV/EBITDA All Ind (x)	7.3	6.9	6.5	5.9
Dividends	0.0	0.0	0.0	0.0	EV/EBITDA rel All Ind (x)	(0.9)	(0.8)	4.4	0.5
Acq/Disp	(0.5)	0.1	0.0	0.0	P/E (x)	0.0	(2.0)	(8.3)	4.1
Other investing items	(1.0)	(0.9)	0.0	0.0	P/E rel All Ind (x)	0.0	(0.1)	(0.6)	0.4
Free cashflow	(11.7)	(19.0)	(5.8)	5.6	P/E rel All Ind ex banks (x)	0.0	(0.1)	(0.6)	0.3
Equity	11.3	3.5	0.0	0.0	P/E sector (x)	22.2	24.9	16.9	14.4
Debt inc/(red'n)	4.5	12.9	5.8	(5.6)	P/E rel sector (x)	0.0	(0.1)	(0.5)	0.3
Balance sheet					Assumptions				
	2007A	2008A	2009F	2010F		2007A	2008A	2009F	2010F
Cash & deposits	5.8	3.1	2.0	2.0	GDP growth (%)	3.29	3.70	3.18	3.00
Inventories	12.1	0.0	0.0	0.0	Interest Rates (%)	6.33	7.38	7.75	7.38
Trade debtors	2.4	14.3	22.2	36.7	Inflation (%)	2.92	3.13	3.30	2.90
Other curr assets	4.9	12.2	12.2	12.2					
Total current assets	25.2	29.6	36.5	50.9					
Prop., plant & equip.	0.3	0.1	0.1	0.1					
Non-curr intangibles	35.4	36.3	38.6	40.9					
Non-curr investments	0.0	3.8	3.8	3.8					
Other non-curr assets	10.0	5.6	6.5	6.5					
Total assets	70.9	75.4	85.6	102.3					
Trade creditors	5.0	10.1	18.3	33.8					
Curr borrowings	1.2	4.9	4.9	4.9					
Other curr liabilities	0.4	0.5	0.6	1.9					
Total current liab.	6.6	15.5	23.8	40.6					
Borrowings	3.1	11.9	14.8	9.2					
Other non-curr liabilities	6.8	2.8	4.6	4.6					
Total liabilities	16.5	30.1	43.2	54.4					
Minorities/Convertibles	0.0	0.0	0.0	0.0					
Shareholders equity	54.4	45.5	42.4	47.9					

Notes:1. The risk ratings are on a 12 month perspective, where five stars denotes low risk and one star denotes high risk. Company risk takes into account expected financial, strategic and execution risks associated with the company. Share price risk is a measure of the expected volatility of the price and other trading factors.

2. The Ethical rating rates a company on an ethical investment basis where five stars denote very good and one star a poor rating. The score is based on four key factors: areas of operating, environmental, corporate governance and social factors. For more information see www.aegis.com.au.

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TABLE 1: FY08 RESULT SUMMARY

For the 12 months ended**:		pcp	Aegis	Actual	Change	
		Jun-07	Jun-08		Jun-08	pcp
Sales revenue	:\$M	0.7	34.5	34.5	+5016%	-0%
EBITDA	:\$M	-6.0	-8.4	-6.9	+16%	-17%
Depreciation & amort	:\$M	-0.7	-4.2	-5.3	+695%	+26%
EBIT	:\$M	-6.7	-12.6	-12.3	+84%	-2%
Net Int Expense	:\$M	0.3	-2.5	-3.3	-1217%	+34%
Profit Before Tax	:\$M	-6.4	-15.1	-15.6	+144%	+4%
Tax on Recurring	:\$M	0.0	3.7	4.8		+31%
Profit After Tax	:\$M	-6.4	-11.4	-10.8	+69%	-5%
Minorities/Associates	:\$M	0.0	0.0	0.0		
Preference Dividends	:\$M	0.0	0.0	0.0		
NPAT	:\$M	-6.4	-11.4	-10.8	+69%	-5%
Non Recurring (net of Tax)	:\$M	0.0	0.0	0.0		
Reported Profit	:\$m	-6.4	-11.4	-10.8	+69%	-5%
** All numbers are adj. for non-recurring items except Reported Profit						
PER SHARE DATA		Jun-07	Jun-08	Jun-08		
Average weighted Capital, fully diluted	:M	0	110	110		+0%
E.P.S. on Adj profit	:cents	0.0	-10.4	-9.8		-5%
D.P.S.	:cents	0.0	0.0	0.0		
Franking	:%	0	0	0		
Payout Ratio		0%	0%	0%	+0%	+0%
RATIOS		Jun-07	Jun-08	Jun-08		
EBITDA Margin	:%	-891.8	-24.2	-20.2		
EBIT Margin	:%	-991.3	-36.5	-35.6		
Effective Tax rate	:%	0.0	24.4	30.8		

Source: APK / Aegis Equities

Result Highlights

- **FY08 revenue** was \$34.5M and averaged approximately \$1,100 per billable customer account. Revenue has increased substantially due to the continuing customer acquisition program, however the total and per customer account metrics are affected by the ramp-up in customer acquisitions and the time lag from the transfer process.
- **Cost of sales** was \$29.5M and resulted in a gross margin of 14.5%. This result was lower than the company expected due to wholesale price volatility, particularly during the 2007 winter peak. To address the volatility of wholesale energy costs APK has put in place a number of initiatives detailed overleaf.
- **Operating expenses** before interest, tax, depreciation and amortisation for the year totalled \$12.4M and represented 36% of revenue.
- **EBITDA** was a loss of \$6.9M and reflects the continuing development phase of APK.
- APK is in its infancy of operations, targeting a four-year time frame in order to build its active customer base to over 200,000. As a result, many of its fixed and start-up costs are not recoverable, thus the company, as forecast, reported a **net loss after tax** for the 2008 of \$10.8M. That said, APK does have a large variable cost base with the purchase of electricity and gas making up around two-thirds of its cost base. Thus when scale is reached variable costs will represent a greater proportion of the total cost base.
- The number of **customer accounts** that have been acquired and retained post the "cooling off" phase since the commencement of the acquisition process to 30 June 2008 was in-excess of 80,000 (FY07: 25,700). The majority of customer accounts were acquired via APK's door to door sales channel, however included in the total acquisition figures are approximately 11,000 customer accounts acquired from another energy retailer in July 2007. We note that customer acquisitions could have been a lot greater if APK had penetrated into NSW and QLD, however the company refrained from this due to high wholesale risks, and low expected contributions to earnings of the current retail pricing structures.
- As at 30 June 2008 18,500 accounts were pending transfer. This figure includes 10,600 customers relating to the Queensland market which are unlikely to be transferred in the short to medium term due to wholesale market constraints. Active (billable) customer accounts at 30 June 2008 totalled 54,000 (FY07: 5,700), with approximately 86% of customer accounts located in Victoria. Approximately 66% of customer accounts were electricity and the remainder gas, and 51% of electricity customers also held a gas account.

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New Pricing and Reallocation Agreements

- APK entered into an energy pricing and reallocation agreement with a Victorian based generator of electricity which was effective from 1 June 2007 for a three year period. This agreement ensures that electricity wholesale costs in Victoria are fixed at an amount for all electricity used by APK's customers. The company advised there is a maximum usage limit, however stated it does not expect this will be exceeded. Further, due to the favourable nature of the agreement an asset of \$7.5M was recorded in the Balance Sheet at 30 June 2008 (FY07: \$17.1M). The benefits of this prepayment arrangement will be progressively recorded in the Income Statement over the life of the agreement through offsetting payments between APK and the generator.
- APK also entered into a gas supply and pricing agreement with a major Victorian gas supplier that ensures over a four year period from 1 June 2008 that the wholesale costs for Victorian gas usage will be substantially within a known range. The agreement is for a range of volumes that is expected to cover most of the forecast load of APK's gas customers.

Cash Flow

- APK had cash and cash equivalents at 30 June 2008 of \$5.9M (FY07: \$6.9M). The cash balance includes amounts held as security for guarantees issued to suppliers of \$2.8M (FY07: \$1.1M). APK targets a minimum cash reserve to ensure there are sufficient funds on hand to address liquidity issues that may arise from wholesale market volatility as well as to meet debt facility requirements.
- The cash shortfall from operations totalled \$18.2M, which was funded via combination of:
 - application of cash \$2.6M
 - share issues net of costs of \$3.5M;
 - convertible instrument issues of \$3.0M; and
 - draw downs on debt facilities of \$10.0M, which included \$1.9M provided by substantial shareholders.
- The cash short fall came in much better than we anticipated, largely due to a positive working capital contribution and a more favourable tax outcome than forecast. APK's cash flow is a main area of risk and we are comfortable with the steps the company took in the year to rectify this position. The primary reason for cash flow short falls during the year and moving into FY09 relate to the company not reaching a sufficient level of customer acquisitions. Based on our customer acquisition forecasts, we expect APK to be cash flow positive in 1H10. In the mean time APK has the following debt facilities in place:
 1. APK's debt facility operates for a four year period from 22 June 2007, and no repayments are required prior to that time unless security ratios are exceeded. Given APK is funding customer acquisition growth, its debt levels will increase in FY09. APK's main debt facility has capacity to grow to \$100M, provided sufficient security is in place and performance conditions and other covenants are met.
 2. APK has a \$10M convertible note in place with Fortress Investments, which at 10 July 2008, was drawn to \$4M.
 3. This is also a \$3M convertible note with Cornell Capital and \$10M Standby Equity Facility undrawn also in place.
 4. Post balance date, APK announced that it allotted 1,800 convertible notes, each with a face value of \$1,000, under a convertible note facility to the amount of \$1.8M. The convertible notes were issued to APK's significant shareholder, Arthur Phillip Nominees Pty Ltd at a conversion price of \$0.20. The company has advised that the duration on the notes is two years. We have treated the convertible note as equity in our model and in-the-money, resulting in dilution of APK ordinary shares. The resolution at the shareholder's meeting approved a total of \$3.5M.
- **Other capital management** - On 24 August 2008, APK issued its CEO 2M ordinary share options in four equal parcels of 500,000 with exercise prices of \$0.50, \$0.60, \$0.70 and \$0.80.

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Summary and Outlook

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- APK's FY09 EBITDA forecast is around \$1.4M, targeting around 100,000 customer accounts transferred and revenue of circa \$80M. Our forecasts are consistent with management's guidance.
- We marginally revise up our FY09 NPAT forecast from a circa \$4M loss to a \$3M loss and FY10 from ~\$3M up to ~\$6M. Our valuation of APK increases from \$0.30 to \$0.34.



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