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Indonesia

Resources

Key takeaways



Negative investor perception from ownership disputes of Indonesian mine assets



Some of these problems are country & sector specific, but some are not



Perception tendency is for blanket negativity across broader energy sectors – this would be erroneous



Oil & gas is distinct and structurally more robust than mining

Tarred with the same brush?

Investor perception of foreign-listed miners with Indonesian assets has a negative bias, catalysed by two companies losing title to potentially world-class assets. The tendency is to assume the drivers are unique to Indonesia and that all companies within mining, and the broader energy sector, are similarly exposed. Our observation is that Intrepid Mines' situation is largely self-inflicted and not Indonesia or mining-unique. Churchill Mining appears to be a victim of the immaturity of the Indonesian mining system. Clear distinction should be made between sectors. In contrast to mining, Indonesian oil and gas is structurally and demonstrably more robust, offering greater clarity and protection for foreign participants.

Investor perception sours on a few foreign-listed Indo asset mining plays

Intrepid Mines and Churchill Mining are examples of foreign-listed miners focused on potential world-class Indonesian assets, who have subsequently unwillingly lost ownership. Both have seen their market capitalisations rise multifold on asset potential and, conversely, contract dramatically on challenged ownership. Investor perception of Indonesian resource exposure has been negatively impacted as a result.

Strip-out company and situation specific drivers

Company and situation specific factors leading to commercial strife occur universally and globally. They range from poor commercial and legal structuring, lack of partner alignment and ongoing maintenance of government relations to non-adherence to regulations. Intrepid appears to have been exposed in a number of these areas. While the consequences are maybe unfair and unjust, the causes are not Indonesia or mining-unique.

Indonesian mining has sector specific vulnerabilities

There is evident structural weakness in the Indonesian mining system. In part, this results from the significant change resultant from Indonesia's ongoing decentralisation. However, the system's immaturity means it lacks robustness, making it more susceptible to outside influences, whether from other ministries, local government or a challenging legal process. All these factors are exacerbated by ongoing nationalism. Churchill appears largely a victim of the sector's immaturity, although suggestions of its over-confidence in execution may have left it exposed. Ironically, if its project started today it would face a greater level of central oversight and protection.

Oil and gas is structurally more robust than mining

Indonesia's oil and gas sector is demonstrably more robust than the current mining system. It features a mature and historically proven regulatory and operating environment, with primary authority coming from central not local government. Against this backdrop, interference is thus more difficult compared to mining – a facet compounded by higher skill and capital barriers restricting domestic replacement options. While Indonesia's oil & gas investment attractiveness may be challenging on a global basis, relative to mining it offers greater clarity and protection for participants.

Are the mining issues country and sector driven?

Seeking to make observations and distinctions

Our aim with this note is to make observations regarding the current negative investor perceptions that exist following recent foreign miner ownership disputes. The context is whether these disputes are Indonesia and mining sector specific or not. Additionally, we seek to identify whether key distinctions in this regard exist between the Indonesian mining and oil and gas sectors.

Is oil & gas distinct?

Our aim is not to script an extensive history of Intrepid Mines and Churchill Mining, nor make detailed recommendations for how the mining system can be reformed. Rather it is a view from an oil & gas perspective on the issues and challenges emanating from these mining incidents and their applicability, if any, to oil & gas.

Intrepid Mines and Churchill Mining lost title to assets

Some miners have soured investor perceptions

Intrepid Mines (IAU AU) and Churchill Mining (CHL LN) are examples of foreign-listed, high potential Indonesian asset-focused miners embroiled in asset ownership disputes. Both have seen their market capitalisations rise multifold on their early stage asset potential and, conversely, contract dramatically on challenged asset ownership. Both of their assets have been touted as having world-class potential. Investor perception of foreign-listed resource plays in Indonesia has been negatively impacted as a result.

ASX investor perception is particularly negative

The ASX perception has arguably been the most negative. This is possibly exacerbated by historically larger NAV discounts on foreign vs domestic assets for ASX-listed companies, as well as a steady stream of unrelated negative media on Indonesia (from cattle import restrictions to illegal immigration).

These two examples impacting negative investor perception warrant some examination to identify key issues. We can then take a view if these detrimental issues were company/situation specific or more linked to structural negatives within Indonesia's mining sector. Ultimately, we would then want to contrast the potential for these limiting factors existing within Indonesia's upstream oil and gas sector and foreign-listed companies participating in its exploration and production.

Public sources (including press reports and company disclosures) have been used as the foundation for outlining both Intrepid and Churchill's situations. Identifying whether key detrimental issues were company or sector/country specific and the potential for crossover into the oil and gas sector represent Risco's view.

Example: Intrepid Mines (IAU AU)

Intrepid Mines is a dual Australian Stock Exchange (ASX) and Toronto Stock Exchange (TSX) listed mining company primarily focused on its indirect 80% interest in the Tujuh Bukit early stage copper and gold asset in East Java, Indonesia. Early drilling led to claims of estimated undeveloped resource potential of 19bn lbs copper, 30m oz gold and 73m oz silver – which, if eventuated, would rank top ten globally. Its ongoing project funding (US\$95m in total) was contractually in consideration for an ultimate 80% equity interest in its local partner who held the licenses due to existing foreign ownership restrictions. These licenses were moved to a subsidiary, which was subsequently sold to a third party and Intrepid was cut out.

Figure 1

Intrepid's market capitalisation rose to A\$1.4bn and is now approx. A\$150m



Source: Bloomberg, Risco Energy

The problem: lost claim on 80% of asset despite funding US\$95m

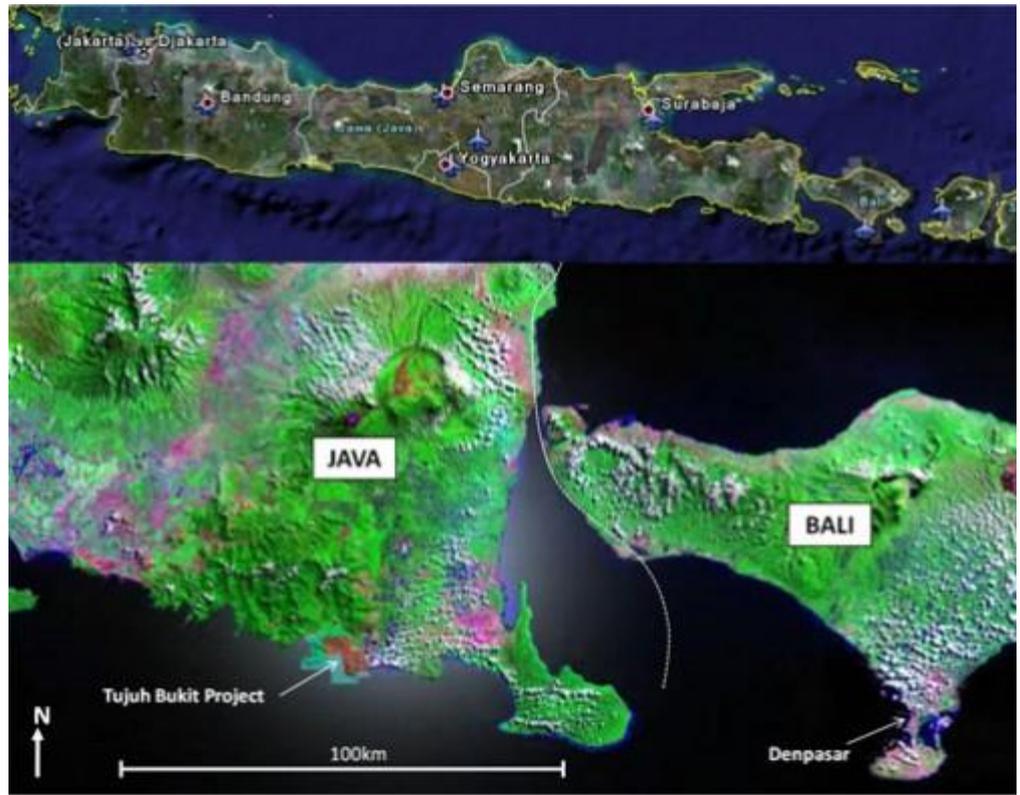
Intrepid essentially lost its claim to 80% ownership of mining licenses for the Tujuk Bukit copper & gold project in East Java, despite a contractual agreement guaranteeing such in return for funding already provided. Intrepid is currently contesting this loss.

Intrepid's indirect interest was sold on without its knowledge

Intrepid had provided US\$95m in funding for the asset

Figure 2

Tujuh Bukit is located on the eastern extremity of Java



Source: Intrepid Mines

Intrepid never converted from an indirect to a direct interest

Indirect ownership: without security or controls

Intrepid never had direct ownership of the mining licenses indirect owing to restrictions on direct foreign ownership that were in existence at the time. PT IMN (owned by Reza Nazaruddin and Maya Ambarsaar) held direct title via a locally granted license. A 2008 “Alliance Agreement” between Intrepid and IMN provided Intrepid with a future 80% interest (and IMN 20%) in the licenses in return for project funding. The transfer of the 80% interest was to be achieved by converting IMN into a foreign investment company (PMA), with IAU an 80% shareholder.

This agreement was not supported by security or pledges in the event of non-adherence. Furthermore, there were no contractual controls imposed on PT IMN by Intrepid.

There are essentially 3 iterations of ownership of the Tujuk Bukit licenses since 2006:

Original entity sought outside funding

2006-2008: IMN/IndoAust/Intrepid: The licenses were originally granted to IMN in 2006 by the local regent. IMN was working with Sam Garrett (a former geologist) and Paul Willis (a resources investor) of IndoAust, given direct foreign ownership restrictions on the latter. After some encouraging initial drilling, there was a need for funding partners and Paul Willis found Emperor Mines, with whom an initial, preliminary agreement was reached in August 2007. Emperor and Intrepid merged in 2008 into Intrepid Mines, the entity which went onto sign an Alliance Agreement with IMN.

In April 2008, Paul Willis and IndoAust were essentially pushed out of the project. Part of the justification used by IMN and Intrepid for his departure

Intrepid provided this in return for an 80% interest

was unauthorised communication with a local company PT Bumi Sukses Indo seeking their involvement in the project.

2008-2012: IMN/Intrepid: As detailed earlier, Intrepid entered into an economic agreement with IMN in 2008 to fund the project in return for an, initially indirect, 80% interest. This was enshrined in an Alliance agreement without security or pledge. Intrepid funded some US\$95m over the four years. Despite a 2009 change to Indonesia’s mining law allowing direct foreign ownership, IMN never converted to PMA (foreign investment company) status allowing it to then grant Intrepid a direct 80% interest.

In 2Q 2012, IMN moved the licenses to its subsidiary PT Bumi Sukses Indo (BSI), which was subsequently sold to third parties without the prior knowledge of Intrepid. The local regent approved the transfer of the licenses to BSI in September 2012, which technically required BSI to be a subsidiary of IMN at the time of transfer.

Which was later unknowingly sold on to BSI

2012-present: BSI: BSI is the current holder of the two Tujuk Bukit mining licenses and its underlying ownership is reportedly linked to prominent Indonesian businessmen Edwin Soeryadjaya. He is the founder of listed Saratoga Investama (SRTG IJ) and co-founder and Chairman of listed coal miner PT Adaro (ADRO IJ). Saratoga is an historic shareholder in Adaro and had previously expressed an interest in the Tujuk Bukit asset.

Specifically, PT Alfa Sukses Indo (5 per cent) and PT Merdeka Serasi Jaya (95 per cent). The latter is 44.7% owned by Provident Capital Partners and several Soeryadjaya linked parties. These include Garibaldi Thohir (CEO of Adaro) whose father, together with Soeryadjaya’s, was a co-founder of Astra International (ASII IJ)). Provident is an Indonesian fund run by Gavin Caudle, who is also a director of Saratoga.

Key issues:

No pledge on contractual agreement

No direct interest

How did things go wrong for Intrepid?

A fundamental defficiency for Intrepid was its lack of direct ownership – initially because direct foreign ownership was legally precluded. Its solution to this constraint, indirect ownership via a contractual agreement, did not provide for a pledge or security in the event of a breach.

Furthermore, when a revised 2009 Mining Law allowed direct foreign ownership of mining licenses, IMN did not change to PMA status and Intrepid was not granted an 80% equity stake in this entity. In spite of three years of inaction, Intrepid continued to fund the project – ultimately to US\$95m.

Current status: Intrepid appealing in local courts...

Intrepid is seeking to reverse the transfer of mining licenses from IMN to BSI via local courts and is currently appealing an initially unfavourable ruling.

This was a split decision with the majority opinion not reviewing the merits of the case on a procedural point of lack of legal standing: Intrepid could not challenge IMN’s transfer of mining licenses to a subsidiary as it was never a shareholder in IMN. The dissenting judge accepted Intrepid’s right to challenge and, in reviewing the merits of the case, ruled in favour of Intrepid.

...and has attempted commercial resolution locally...

Shortly after finally opening a Jakarta office, Intrepid placed approx. 5% of its own shares (plus a similar amount of performance rights, valid for one year) with Surya Paloh in July 2012. Paloh owns Indonesia’s broadsheet Media

Intrepid continues to pursue legal recourse

Indonesia and news channel Metro TV. This intended ‘white knight’ role has not to date borne fruit in securing a resolution with Edwin Soeryadjaya and BSI.

...while defending its own backyard

In a further twist in the tale, Intrepid faced demands to spill its board in June 2013 from a new shareholder of 5.4% of its stock, Hong Kong-based private equity fund Quantum Pacific. In the lead-up to a shareholder vote that failed to change the board, Intrepid highlighted a build-up in South East Asian investors of a 20% shareholding where they were unable to determine underlying identity.

Example: Churchill Mining (CHL LN)

Churchill Mining is a UK AIM listed miner primarily focused on a direct 75% interest in four licenses for the East Kutai Coal Project in East Kalimantan, Indonesia held since 1Q 2008. Drilling in May led to claims of estimated undeveloped resource potential of 150m tons, later upgraded to 2.7bn tons of coal, which would rank as the 7th largest undeveloped such asset globally. In July 2008, six original lapsed licenses for overlapping areas held by local Nusantara Group were extended by the local regent. In May 2010, the new local regent revoked Churchill’s licenses due to a claimed logging infraction in protected forestry areas without permits. This justification was subsequently supplemented with additional reasoning of forging mining licenses and holding licenses that overlapped with existing Nusantara rights. Churchill had injected US\$50m into the asset.

Churchill lost its 75% interest as a result of an alleged forestry infringement

Figure 3

Churchill has similarly seen the market both reward and punish its Indonesian activities



Source: Bloomberg, Risco Energy

The problem: mining license cancelled without compensation

Churchill acquired a 75% interest in coal mining licenses in Kalimantan in 2008. These licenses had been issued by the local regent and then cancelled, without compensation, by a subsequent regent in May 2010 due to an alleged forestry violation. The justification for cancellation was subsequently augmented with claims of fraudulent documents and overlapping areas with existing locally-held rights.

A more murky complication is the Nusantara Group and its alleged resuscitation of lapsed licenses for the same area following Churchill’s

Churchill directly held an interest in licenses from 2008-10 and funded US\$50m

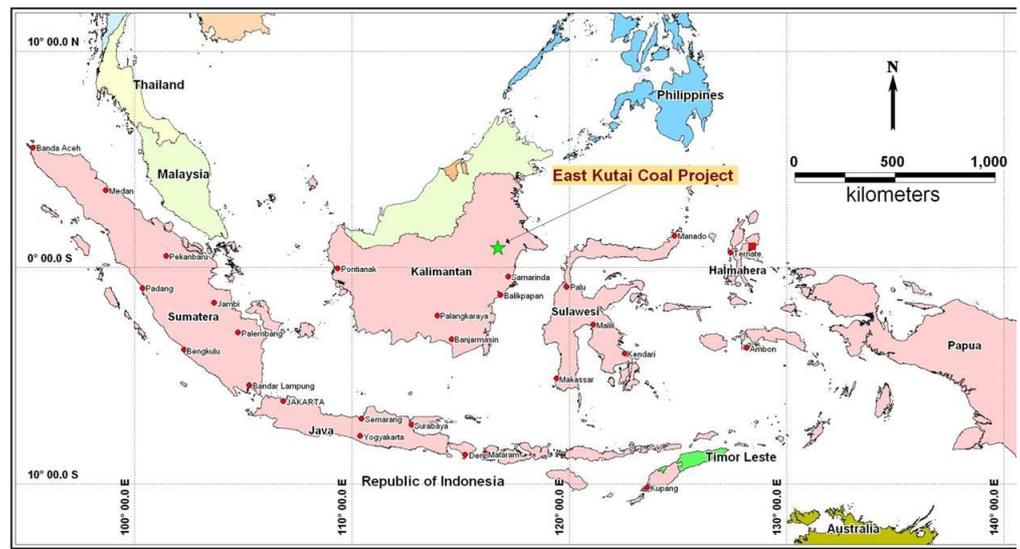
positive drilling results. Nusantara's underlying owner is Prabowo Subianto, a 2014 Indonesia Presidential candidate and former head of Kopassus (special forces command).

Direct ownership

Churchill directly held a 75% stake in the East Kutai licenses via a subsidiary. This occurred between late 2007 and early 2008.

Figure 4

East Kutai Coal Project is located in East Kalimantan



Source: Churchill Mining

Alleged forestry infraction gave the local authority its initial basis for cancellation

How did things go wrong for Churchill?

An alleged minor infraction (infringing on forest areas without permits) was the direct link to the loss of Churchill's mining licenses.

The authority for the issue and cancellation of mining licenses rests with the local regent and is driven by Indonesia's move to democracy and decentralization. This is in strict contrast to the earlier approach of centrally issued licensing (Contract of Work (CoW)). The law has changed since 2012, moving authority for license holders with foreign ownership (such as Churchill) to central government. Domestically held licenses still fall under the remit of local government.

A fundamental issue is that Indonesian law is civil, rather than common, law-based, emphasising form over substance. This allows a technical infraction to invalidate a binding contract (i.e. mining license).

There is the suggestion that Churchill may have made infractions that would not typically be an issue typically for an Indonesian company. It is important to note that a foreign company is held to a higher standard than a local one.

Current status: Churchill is seeking international dispute settlement

In May 2012, Churchill filed for arbitration with the World Bank's International Centre for Settlement of Investment Disputes (ICSID), which decides on cross-border business disputes between states and nationals of other states.

Churchill is seeking US\$2bn in damages, alleging that Indonesia breached its obligations under the UK-Indonesia Bilateral Investment Treaty when the licenses were revoked. Additionally, the company filed separate arbitration

Churchill may have been overconfident in its execution

Currently seeking international arbitration

via its Australian subsidiary, Planet Mining Pty Ltd (which also held an interest in the project via its 5% shareholding in PT Indonesia Coal Development), citing breach of the Australia-Indonesia Bilateral Investment Treaty. These two arbitrations were subsequently consolidated into a single proceeding.

Following the separate rejection of all reconsidered applications by Indonesia's Supreme Court in June 2012 (their decision being final), the ICSID arbitration process is ongoing. No formal timeline has been announced but a ruling is expected in 2014.

Are the drivers universal?

Strip-out company and situation specific drivers

There are many company and situation specific factors that can lead to commercial strife. They range from poor commercial and legal structuring, lack of partner alignment and ongoing maintenance of government relations to non-adherence to regulations, amongst others. The motivation for these to be leveraged to a company's disadvantage is clearly increased the greater the potential reward. In the main, these can occur universally are not country or sector specific. Intrepid appears to have been exposed in a number of these areas. While the consequences may be unfair and unjust, the issues that led to them could have occurred in many geographies globally and are not Indonesia-unique.

Demonstrable company and situation specific factors:

- Poor commercial and legal structuring.
- Lack of clear, direct interest and alignment of partners.
- Non-adherence to regulations and laws. Either through lack of knowledge or over-confidence. Small infractions can potentially have disproportionate impact owing to Indonesia's civil legal basis of form over substance. Additionally, foreign companies are held to a higher standard than local companies in terms of performance.
- The importance of maintaining ongoing good and professional relations with regional government.

Companies can leave themselves vulnerable anywhere...

...regardless of geography or sector

Intrepid could have avoided many of the issues

View: Intrepid impacted by self-inflicted weakness

Intrepid appears to have been commercially naïve and employed a weak structure denying them direct title to the asset which also lacked a pledge or security, as well as controls over the owning entity, in return for funding. Additionally, it appears that more effort could have been allocated to local and national relations. It was not until nearly four years after their alliance agreement with IMN that Adrianto Machribie (ex-CEO of PT Freeport Indonesia) took a board position and six months subsequent to this that the company opened an office in Jakarta. In short, many of the issues that led to the loss of their interest in the Tujuk Bukit asset were avoidable.

One factor that is specific to Indonesia's mining sector is the lack of checks and balances on local regents' authority in areas that can impact foreign investment. While remedies for this were made in 2012 and are ongoing, the bulk of issues leading to Intrepid's current situation appear avoidable. Furthermore, the consequences of such commercial oversights and opportunities, while unfair and unjust, could have occurred in many geographies globally and are not Indonesia-unique.

Are the drivers Indonesian mining sector specific?

Key weaknesses are immaturity in both regional authority and current mining system

...providing vulnerability to other influences

Sectoral weaknesses in Indonesian mining

There is evident structural weakness in the Indonesian mining system. In part, this is a function of the significant change that it has faced with Indonesia's ongoing evolution in decentralisation. However, the immaturity of the current mining system means it lacks robustness and is therefore more susceptible to outside influences, whether from other ministries, local government or a challenging legal process. All these factors are exacerbated by ongoing nationalism. Churchill appears to largely be a victim of the sector's immaturity, although suggestions of its own over-confidence in execution may have left it exposed. Ironically, if its project started today it would face a greater level of central oversight and protection.

Weaknesses in Indonesia's mining system:

Increased regional authority: A shift from national to regional decision making on mining licenses has meant a lack of state level oversight and redress. This overlooks deploying the full potential of national government's mining bodies that have considerable industry and commercial experience. The same cannot be said at the local level. Attempts have been, and are being, made to refine this. National oversight of foreign invested companies undertaking licensing was changed in 2012 and ongoing improvements are proposed.

Immature mining system: The system and regulations are still immature. In part understandable given the magnitude of the shift from central to local government. This laudable from the perspective of democratic and decentralized progress, but more negative consequences include the loss of application of considerable central skill set and an almost impossible skill challenge for local government.

For example, clearly scheduled sell-down requirements to locals do not provide for all eventualities. It is extremely likely that foreign companies will face a lack of commercial tension when obliged to sell a stake to local entities and consequent risk of achieving sub-market price.

A lack of robustness from other influences: The Indonesian mining system offers little protection from what internationally might be considered the idiosyncrasies of Indonesian law, whereby small, technical infractions can have disproportionate impact (i.e. cancellation of licenses). Similar leveraging of minor infractions can be observed in other geographies – for example, Russia's actions with tax infringements.

This typically then leads a company to seek legal redress and the counter-party is invariably a government related entity, whether local or national. Presently, it would be optimistic to expect a judicial ruling against government.

This lack of robustness in the Indonesian mining system is also evident when facing overlapping areas of responsibility with other government agencies, whether they are local or national.

Significant environmental impact...and potential to fall down: Mining has significant environmental impact – opening up the potential for infractions (forestry, community etc) which can then disproportionately impact a license holder.

Exposed to Nationalism: the mining system's lack of robustness, limited central oversight of regional authority and the need for ongoing refinement

Churchill negatively impacted by
weak mining system

mean that surging nationalism can have much greater impact in mining than other sectors less exposed to these limitations. Nationalism is also a challenging issue for central government and will likely have the effect of slowing down intended measure to improve the mining system.

View: Churchill victim of sector's structural immaturity

The cancellation of Churchill's license for a permitting infraction appears disproportionate. It highlights fundamental weaknesses in Indonesia's mining system, including the application of form vs. substance in law. Ultimately, if the sector and its regulation had matured further in its current evolution it would be more robust and able to provide the protection and clarity it intends.

However, there is the suggestion that Churchill may have been somewhat overconfident in some of its execution, demonstrating the importance for companies to adhere to regulations and maintain ongoing relationships with regional government. If an entity is aware that it is potentially exposed to disproportionate consequences of minor infractions, which Churchill should have been, it is critical that effective governance systems are put in place to prevent such infringements. Churchill did not do so.

Ironically, if Churchill was entering the East Kutai Coal Project today it would benefit from greater central government oversight and face materially greater protection than it has.

Oil and gas is NOT mining

Oil and gas is structurally more robust vs. mining

Indonesia's oil and gas sector is demonstrably more robust than the current mining system. It features a mature and historically proven regulatory and operating environment, with primary authority coming from central not local government. Against this backdrop, it is thus more difficult for national influences to interfere compared to mining – a facet compounded by higher skill and capital barriers making domestic replacement options much smaller. While Indonesia's oil & gas investment attractiveness may be challenging on a global basis, relative to mining it offers greater clarity and protection for participants.

Established system

Mature regulatory & operating environment: Oil & gas' regulatory and operating environment is mature and well-tested with historically established contract sanctity. This is not the case for mining which faces a more dynamic transformation currently.

Driven centrally

State not regional decision making: Production Sharing Contracts (PSC's) are determined with SKK Migas (an experienced, established state entity) not fledgling local government. In contrast, mining has moved from state (with CoW) to local (IUP).

Greater strength in oil and gas contracts: Mining is conducted via the issuance of a license to a miner, whereas oil and gas is centered on a contract (Production Sharing Contract (PSC)) between the state and contractor. A PSC is significantly 'stronger' than a license – for example, typically featuring international arbitration and greater contract sanctity and tenor.

Local government has less impact: Regional government is a pressure point rather than a project decider for oil & gas. Regional government can frustrate short-term operations for oil & gas (i.e. non-compliance with community, environmental etc.) but not determine the medium/long-term viability and ongoing operation of a project. This is not the case in mining.

One provincial exception in oil and gas is Aceh in North Sumatra. Aceh is governed not as a province but as a special territory ("daerah istimewa"). This is an administrative designation intended to give the area increased autonomy from the central government in Jakarta. This is similarly reflected in the provincial government's greater involvement in oil and gas decision making compared to other provinces.

A need for investment to raise production

Clear need to raise oil & gas production...and investment: Overall mining production is growing in Indonesia. In contrast, oil & gas faces at best stagnation and more realistically decline. This is occurring in the face of rapidly increasing domestic demand for both oil and gas. Thus there is motivation (if not always followed through into action) to raise production, which requires investment.

While Indonesia certainly does not have the most attractive investment environment for oil and gas globally, it is more attractive than that of mining on a relative sector basis. Expressed more cynically, assuming a stance of ambivalence to foreign investment by the State, oil and gas' greater requirement for incremental investment provides downside protection relative to mining. This is amplified by the next point...

With higher domestic barriers than mining

More difficult to replace domestically: Both skill and capital barriers are typically significantly higher for oil & gas. This means that the ability to replace foreign with domestic participants is considerably more limited vs.

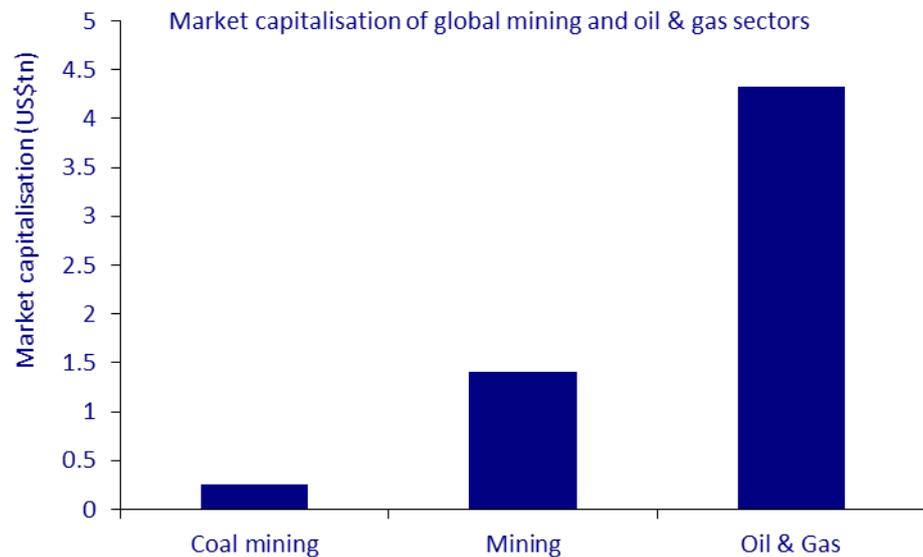
mining. This does not mean there is a lack of intent to offer preferential treatment to domestic oil and gas participants, merely less opportunity.

The underlying sentiment in Indonesia is that foreign investors are not essential for mining, while they are necessary for oil and gas.

Oil and gas is a far larger business globally than mining overall, with the global sector market capitalization being three times larger. This excludes unlisted companies, such as several large National Oil Companies (NOC's). Essentially, there are a greater number of very large (multi-nationals) oil and gas companies globally. Combined with the preponderance, and increasing activity, of NOC's the consequences of infractions are more severe than in mining.

Figure 5

Oil and gas is considerably larger as a sector globally than mining



Source: Bloomberg, Risco Energy

Less overt environmental impact than mining: Oil and gas extraction typically has a smaller footprint than mining, with less overt environmental impact. Consequently, the sector faces less of a pressure point in this area from environmentalists, government and local communities.

This is not to say that impactful events do not occur, but they are usually extraordinary (i.e. the Lapindo Brantas mudflow). One would also note that coal bed methane (CBM) operations have a larger footprint than conventional oil and gas.

Nationalistic factors have less opportunity to distort: Nationalism is negatively impacting oil and gas investment attractiveness in Indonesia. However, given the sector's relative robustness, this manifests more via a reluctance to adjust established PSC terms favorably for participants to stimulate incremental investment. This is in contrast to mining.

Appendix 1:

About Risco Energy

Incorporated in Singapore, Risco Energy Investments Pte Ltd ("Risco") is an energy investment company with pre-eminent sector expertise and capital to deploy focused on ASEAN upstream oil & gas.

Risco has a strong track record and balance sheet, having already delivered high annual returns on the creation and monetization of a multi-country oil & gas portfolio in less than two years. Its management team has some 150 years of combined experience acquiring, running, operating, dealing, managing, funding and commercializing oil and gas assets.

Team achievements with Risco's previous asset portfolio (2Q10 to 1Q13) include:

- Executed five investments across three geographies in less than two years.
- Grew production from zero to 7,500boepd and 2P reserves to 20.5mboe in just two years.
- Grew Ebitda from zero in 2H10 to US\$60m FY12A and an expected US\$90m FY13F.
- Drove portfolio value to deliver high double digit percentage annual returns.

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