Charles Stanley SECURITIES

Flash note

19 February 2014

Oil & Gas
FTSE AIM All Share

Parkmead

Company update

Buy (n/c)

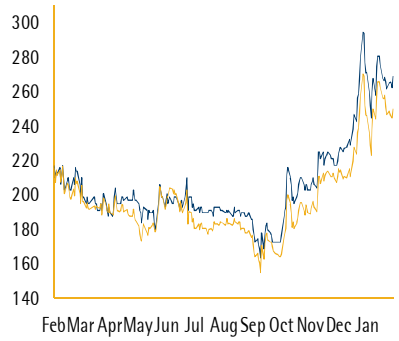
Price	270.0p
Price target	380.0p
12m high/low	294.5p /163.1p
Market cap.	£236m
Net cash	£44m
Enterprise value	£192m
Free float	72%
Avg. daily volume	441k
Shares in issue	87.4m
Company code	PMG.L

Next news	n/a
Confidence in estimates	Medium
Expected movement in estimates	◄►

Adviser	Yes
Broker	Yes
NOMAD	Yes

Brendan Long
020 7149 6763
brendan.long@csysecurities.com

Share price performance (1 year)



	1m	3m	12m
– Price	-8.4	30.4	19.6
– Rel all share	-7.1	29.3	11.1

Source: Thomson Datastream

Davaar: Out of the Deep

In the context of Parkmead's $66.0 million (£40.0 million) fundraise, which was announced on 28 January 2014, the company stated that an expected use of proceeds would be to drill the Davaar exploration prospect, located west of the Shetland Islands. Therefore, for the first time, we are adjusting our valuation to reflect the prospective value of this prospect. Davaar is an oil prospect near existing infrastructure operated and 30% held by Parkmead.

- **Scale:** On a P50 pre-drill basis, Davaar has an estimated scale of 186 million barrels of recoverable oil, making it the largest potential resource in Parkmead's exploration portfolio.
- **Value:** We estimate that if successful, Parkmead's interest in Davaar would have a value of $520.5 million or 339.9 p/share. We have included only 12.5% of this value in our updated target price (42.5 p/share) to reflect our assessment of geological risk (25.0% chance of success) and commercial risk (50.0% chance of success).
- **Triggers to Unlock Value:** As plans to drill a well take definition, inclusive of completing further seismic analysis, the detailing of a drilling schedule and the contracting of a rig, we will gradually increase our probability of commercial success. Ultimately the drilling of the well, which we expect to occur in 2015, has the most potential to unlock value by proving the geological success of the prospect.
- **Context:** Parkmead has an exemplary track record of successfully discovering oil and gas fields, as brought to light by the recent discovery of the Pharos gas field; nonetheless, Parkmead is not an exploration company *per se*. It has a balanced portfolio of developmental, appraisal and exploration assets consisting of both gas and oil fields. We estimate that the company has a core NAV, relating to discovered oil and gas fields, of 288.5 p/share (as detailed on pg. 8 of this note).
- **We like it:** Based on our review of the geology of this prospect we believe that it presents a very attractive risk/reward profile for shareholders. We expect the risk/reward profile to be further improved before a well is drilled by seismic reprocessing work being progressed by Parkmead.
- **Target price:** To reflect the inclusion of the Davaar prospect in our target price for the first time and to reflect the effects of the recent fundraise, we are increasing our target price by 1.6% to 380.0p/share.

Key financial data

Year to June	2012A	2013A	2014E	2015E	2016E
Production (boe/d)	250	261	1,935	2,699	6,430
Oil production / total production	0%	0%	89%	89%	82%
Revenue (£m)	2.9	4.1	36.5	49.6	129.9
EBITDA (£m)	-5.5	-5.6	14.9	24.9	84.1
Operating cash flow (£m)	-1.0	-1.4	14.0	24.1	77.5
Earnings (£m)	-4.9	-5.6	6.7	17.7	56.5
Brent oil price ($/bbl)	112.41	108.67	104.75	101.75	103.78
UK natural gas price ($/mcf)	9.23	10.40	11.47	11.76	11.99

Please see important disclaimers and disclosures on page 10

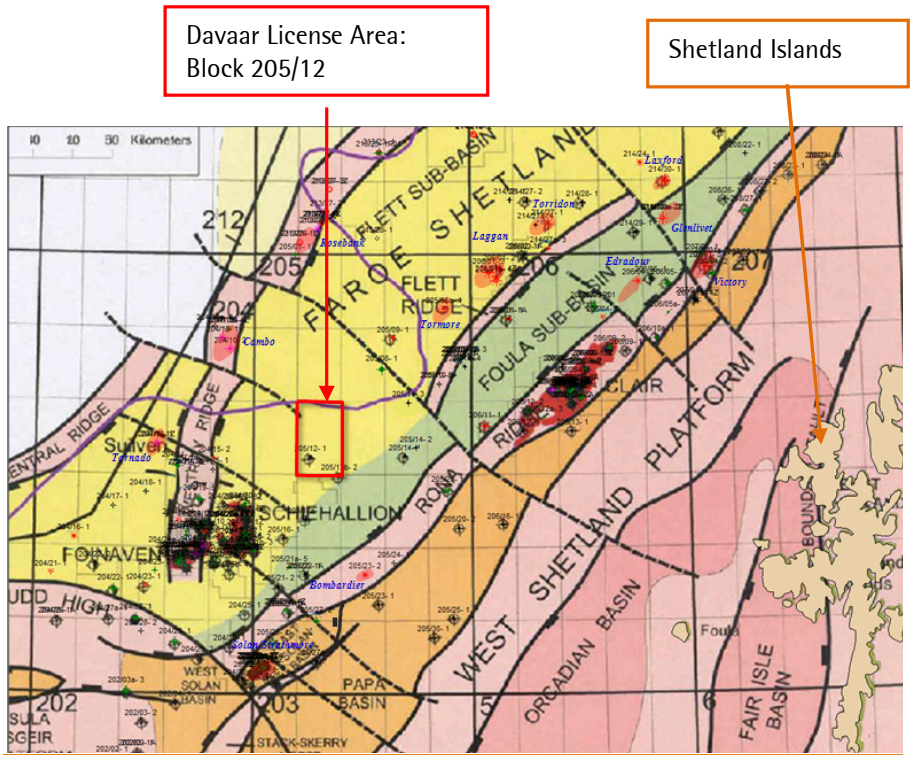
Davaar

- **License:** The relevant license for Davaar (P.2069) is a traditional four year exploration license. On 26 October 2012, the company announced that it had been awarded the license through the UKCS 27th Licensing Round. The partners in the license area are Parkmead (30%, operator), Atlantic (30%), Dyas (14%) and Summit Petroleum (26%). The main geological and geophysical work programme in respect of the license consists of reprocessing 551 km² of 3D seismic to generate AVO/Inversion volumes. For Parkmead to retain the license, it must drill a single exploration well in the current license period (to 3,250m tvdss or 50m into the Shetland Group). As with all traditional licenses, if a discovery is made the partners will apply for a subsequent four year license during which time a development plan will be produced and submitted for regulatory approval. Following this term, there is an 18 year production period, which can be extended if the field is set to produce over a longer time frame.
- **Geographic Location**: The field is located circa 100 km west of the Shetland Islands where water depths are around 500m. The closest producing fields to the Davaar prospect are the Foinaven and the Schiehallion fields, both of which are operated by BP.

Davaar is in the immediate proximity of two major producing oilfields, Foinaven and Schiehallion, for which there is existing infrastructure to export associated gas.

- **Regional Petroleum Setting:** The Davaar prospect is located in the Faroe Shetland Basin and more specifically in the Flett Sub-basin as shown in the image below. The locations of the Foinaven, Schiehallion and the Clair fields amongst others are also shown in the image.

Regional Geological Structure



Source: Parkmead

- **Foinaven:** Parkmead has used the Foinaven field as an analogous field to assess Davaar. There is also a considerable amount of information in the public domain relating to the Foinaven field. Therefore we believe it is interesting to provide some background on this field: It was discovered by BP in 1992 by a BP operated

Foinaven is a world class petroleum development operated by BP.

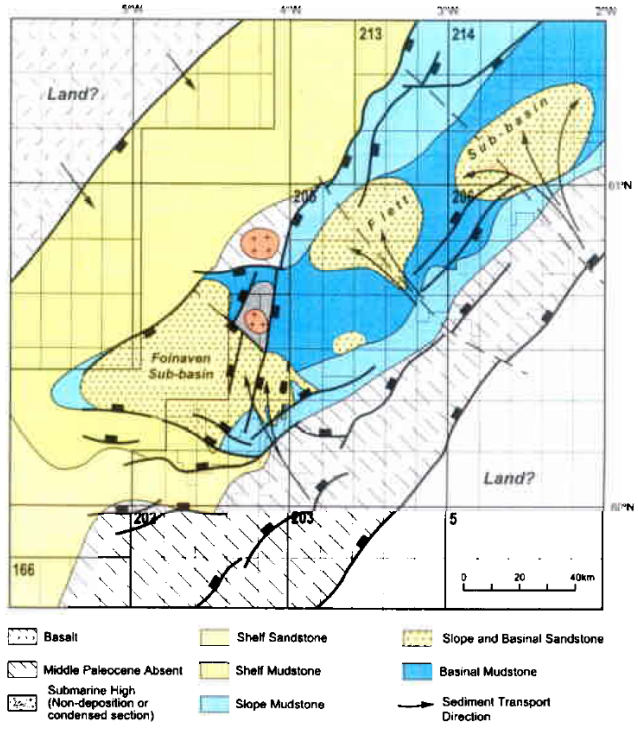
At a conceptual level, the geological model for Davaar is identical to that of Foinaven.

Foinaven provides a precedent that gives good visibility in terms of how Davaar could be developed in the case of a successful discovery. Therefore we are reasonably confident in our capital cost estimates for an exploration prospect.

exploration well. It is in water depths comparable to the Davaar prospect (on average circa 450m). It was the first deep water oil field to be developed on the Atlantic margin, being sanctioned in 1994. The field produced first oil in 1997 and Phase 1 (21 wells) was completed in 2000 which produced at a plateau production rate of circa 85,000 bbls/d. BP operates the field in partnership with Marathon, with BP's equity production typically being around two-thirds of total production (ownership varies by productive reservoir). The field is expected to produce around 415 million barrels of oil equivalent (more than twice the original estimate), consisting of 92% oil and 8% gas and the field is at depths such that all drilling must be undertaken with a semi-submersible rig. The development arrangement consists of wet wellheads (Christmas trees). Surface facilities consist of an anchored FPSO, Petrojarl Foinaven, which has a length of 240m and a storage capacity of 300,000 bbls. Production is currently enhanced by water injection. The field has been developed using the most sophisticated production methods, including 4D (time-lapse seismic), down hole flow control ("smart wells") and through tubing drilling. The entire 32 well development cost £655 million (source throughout: BP). It is interesting to note that the field was penetrated by a well in 1990, but the official discovery of the field occurred two years later when advanced seismic technology was applied to realise the significance of the field. According to E Lamers et al ("The Paleocene deepwater sandstone play West of Shetland", Petroleum Geology 1986, the Geological Society, London): "A combination of improved seismic data processing and BP's and Shell's quantitative modelling techniques imported from the Gulf of Mexico resulted in the identification of direct hydrocarbon indicators on the seismic data." Shell was a partner in the field at the time of its discovery. Like the Davaar prospect, Foinaven's reservoir consists of Vaila formation sands of Paleocene age.

- **Regional Geology:** The regional depositional environment of the Middle Paleocene is provided in the following figure. Throughout the Paleocene, the Foinaven and Flett sub-basins received more or less continous coarse sediment from the southeast with only rare volcanic detritus from the northwest. The deposits took the form of slope and basin-floor turbidites which form most of the reservoir targets in the area (source throughout: E Lamers et al. "The Paleocene deepwater sandstone play West of Shetland", Petroleum Geology 1986, the Geological Society, London).

Depositional Environment – Middle Paleocene



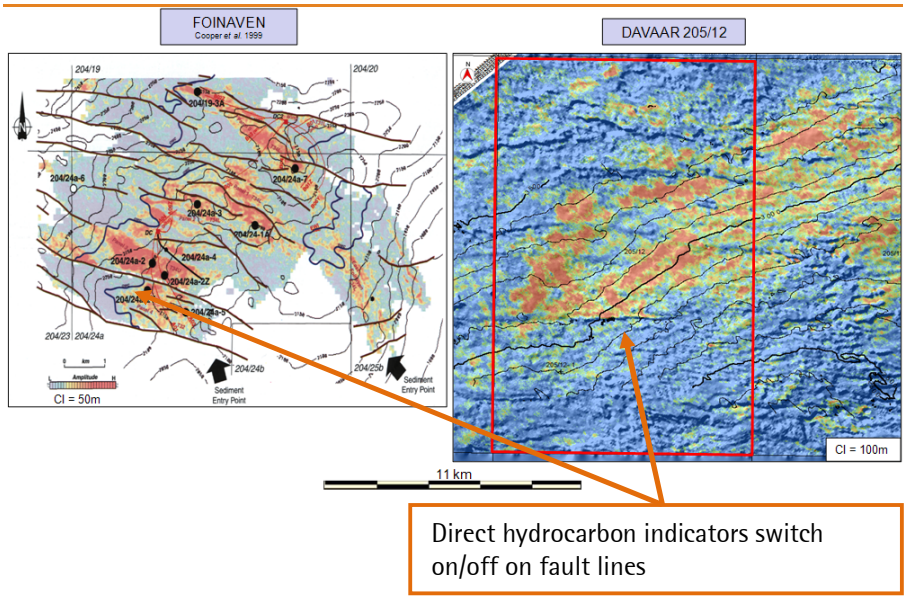
Source: E Lamers et al. "The Paleocene deepwater sandstone play West of Shetland", Petroleum Geology 1986, the Geological Society, London

We believe that the relevant petroleum system for Davaar is robust and that a successful discovery would find high quality oil that would not present particular engineering challenges.

- **Petroleum System**: The petroleum source-rock system West of Shetlands comprises two Jurassic source rocks which expel different types of hydrocarbons. The Middle Jurassic oil-prone source rocks generate a waxy oil. The Upper-Jurassic oil prone source rocks are Kimmeridge Clays, which produce a low wax crude oil. The oil from the Foinaven field has an 8% wax content, however the oil has a pour point of -15°C, thus the wax content does not impede production. The API density of the oil is 26.0° (source: BP). The relative contributions from each source rock determines the wax content of the crude oil in the region's productive reservoirs. Hydrocarbon generation and expulsion in the area is thought to have occurred on a large scale during the Late Cretaceous and Paleocene periods of rapid burial (source throughout: E Lamers et al. "The Paleocene deepwater sandstone play West of Shetland", Petroleum Geology 1986, the Geological Society, London).

- **Direct Hydrocarbon Indicators:** The sandstone reservoir structures in the area are largely stratigraphic and do not lend themselves to the use of conventional seismic imagery. Advanced quantitative techniques are therefore applied with a view to identifying hydrocarbons directly based on the fluid properties of hydrocarbons compared to the salt water brine that generally saturates porous rocks. The direct hydrocarbon indicator that supports the prospectivity of Davaar is a relative softening of the seismic amplitude signal in the area that is thought to be hydrocarbon bearing. Importantly, the Davaar anomaly is present only on the downthrown side of a main bounding fault for the reservoir as seen in the image below. If the anomaly was a lithological effect it could be expected to be present on both sides of the fault because the fault post-dates the deposition i.e. the same lithology (rocks) should be present on both sides of the fault. It is common for oil (and gas) fields to exist on one side of a fault with water on the other side, which is consistent with the indications provided by the amplitude anomaly.

Seismic Anomalies – Foinaven vs Davaar



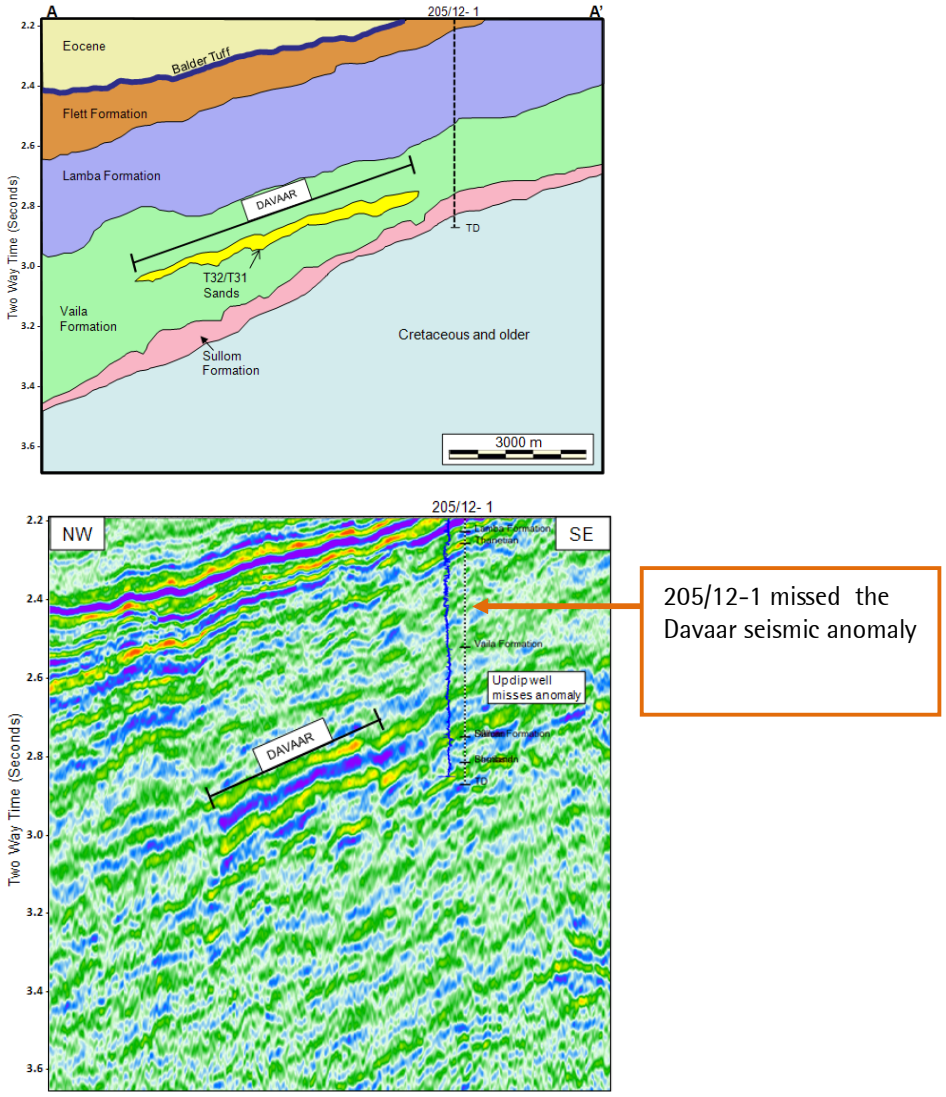
Source: Parkmead and Charles Stanley Securities

Davaar's direct hydrocarbon indicators are convincing because they conform with a credible geological model.

Parkmead's approach to risk analysis in the West of Shetlands is similar to that of the major oil companies that operate in the area such as BP. As such, before making a definitive decision to drill the Davaar prospect Parkmead will reprocess seismic data incorporating local rock data taken directly from nearby wells including the 205/12-1 well (details below). We expect this work will be completed in 2015. We believe that the characteristics of the direct hydrocarbon indicators are convincing and as such expect that further seismic analysis is much more likely than not to increase the chance of success. We therefore expect that when the seismic processing is complete we will be in a position to increase both our geological chance of success and our commercial chance of success, because Parkmead is likely to further is its commitment to drill the prospect at that time.

- **The 205/12-1 Well:** The only prior exploration well drilled in the block 205/12 was an exploration well drilled by Total in 1995. A cross section of the Davaar prospect shows that the 205/12-1 well was drilled up-dip of the Davaar anomaly (the well missed the anomaly). 205/12-1 was drilled at the same stratigraphic depth as the Davaar prospect (Vaila formation), but it is thought to have been drilled too far updip and beyond the pinchout edge of the Vaila reservoir sands.

205/12-1 Missed Davaar



Source: Parkmead and Charles Stanley Securities

- **Export Infrastructure:** Oil would be shipped to market by shuttle tanker. From a capital and a timing perspective it is important that there is already a gas pipeline, the West of Shetland Pipeline, that connects Foinaven and Schiehallion to Sullom Voe on the Shetland Islands (and from there to the UK and European pipeline network).
- **Tax:** Under the current tax regime in the UK, production from a successful discovery at Davaar would be taxed at a marginal rate of 62%, inclusive of the 32% supplementary charge. As the Davaar prospect is situated in relatively shallow water depths for the West of Shetlands, its development costs in the event of discovery will not trigger the £3 billion West of Shetland tax allowance.
- **Capital Expenditure:** Based on our analysis of the BP-operated Foinaven field, we expect that a successful discovery at Davaar will be developed with 16 wells (12 producers and 4 water injectors). We expect that the wells will each take 49 days to drill using a semi-submersible rig. We assume that the rig rate for the wells is $400,000/day (real 2014 costs) and the total gross cost per well will amount to $47.9 million (£29.0 million). In total we expect net drilling costs will amount to $257.0 million (£155.7 million), which includes an adjustment for inflation. We estimate that Parkmead's share of total capital expenditure to bring the field to

first oil will amount to $994.2 million (£602.5 million). Costs are attributable to: drilling (27%), engineering (4%), production facilities (43%), an FPSO retrofit (9%), pipelines (16%) and other items (1%). We estimate that a reasonable appraisal of the field would require circa five wells, inclusive of the discovery well. On this basis, we estimate that Parkmead's 30% share of the appraisal programme would amount to $77.3 million (£46.8 million)

We expect that the completion of ongoing seismic work will enable us to increase our chance of geological success for Davaar prior to the drilling of an eventual exploration well.

- **Geological Chance of Success:** Parkmead currently estimates that the Davaar prospect has about a one-in-five chance of success. We believe that Parkmead's initial estimate of the prospect's chance of success underestimates the probability of success. The company has applied a traditional risk evaluation. They have assumed that there is only an 80% chance that the source rock is effective, we believe that this risk is essentially nil. We also believe that the robust nature of the direct hydrocarbon indicators and nearby analogs (Foinaven in particular) reduce the risk further. We are particularly convinced by the existence of bright anomalies on the north/downthrown side of the prospect's main bounding fault. Based on this analysis, we are comfortable valuing the prospect on the basis of a one-in-four chance of success. Please consider that we applied a significantly higher chance of success (33.3%) to Pharos compared to the company's more conservative internal estimate (24%). That well made a successful gas discovery which adds to our comfort that Parkmead is being slightly too conservative in the assessment of its best prospects from an equity market or a valuation perspective.
- **Commercial Chance of Success:** We have applied a 50% chance of commercial success. We expect to increase our estimate of the commercial chance of success as the drilling of an exploration well takes definition.
- **Key Assumptions:** We assume a Brent crude oil price of $100/bbl, which we inflate by 2% p.a. We have valued the prospect using an after-tax discounted cash flow model and a 10% discount rate.

In the case of a successful discovery, we estimate Davaar would have a value of 339.9 p/share.

- **Valuation:** We estimate that the net value of Davaar to Parkmead, based on pre-drill estimates, and assuming that a successful discovery is made would amount to $520.5 million or 339.9 p/share. This values the oil from the field at $9.37/bbl.
- **Contribution to Target Price:** We have included 12.5% of the total success case value of Davaar in our target price, to reflect geological risk (25.0% chance of success) and commercial risk (50% chance of success). Therefore, we have included 42.5p/share in our target price to reflect the prospective value of Davaar.
- **Fundraise:** We have increased the number of shares outstanding to 87.4 million to reflect the issue of 15.7 million shares in January and have increased the company's cash balance to reflect that the company raised $66.0 million (£40.0 million) through the offering.
- **Increase to Target Price:** To reflect the effects of the fundraise and the contribution of Davaar to our target price, we are increasing our target price by 380.0p/share (from 374.0 p/share). A detailed valuation table is provided on pg. 8 of this note.

Asset, Valuation and Target Price Summary

Oil & Gas Assets	Type	Working Interest	Total Value Net to Company (NPV10) Total USD ($mn)	Total GBP (£mn)	Per Share (p/share)	Risked Value: Geological Chance of Success (%)	Commercial Chance of Success (%)	Market Valuation Factor (%)	Combined Valuation Factor (%)	Contribution to Target Price: Total ($mn)	per Share (p/share)	Valuation Estimates: Value $/boe ($/boe)	Total Future Production (mnboe; net)
UK Oil & Gas Assets													
Athena	Oil	30.0%	85.5	51.8	55.8	100%	100%	100%	100%	85.5	55.8	39.90	2.1
Perth Core	Oil	52.0%	155.3	94.1	101.4	100%	80%	100%	80%	124.2	81.1	7.22	21.5
Perth NW Terrace	Oil	52.0%	97.8	59.3	63.9	66%	80%	100%	53%	51.6	33.7	12.07	8.1
Perth NE Terrace	Oil	52.0%	84.2	51.0	55.0	50%	80%	100%	40%	33.7	22.0	12.20	6.9
Platypus	Gas	15.0%	16.8	10.2	11.0	100%	80%	100%	80%	13.4	8.8	6.51	2.6
Pharos	Gas	20.0%	40.1	24.3	26.2	66%	80%	100%	53%	21.2	13.8	6.91	5.8
Total UK Oil & Gas Assets			479.7	290.7	313.2					329.7	215.3	84.8	47.0
Netherlands Oil & Gas Assets													
Onshore Gas	Gas	15.0%	4.9	3.0	3.2	100%	100%	100%	100%	4.9	3.2	12.82	0.4
Geesbrug (2 wells)	Gas	15.0%	1.9	1.2	1.2	100%	50%	100%	50%	1.0	0.6	3.35	0.6
Ottoland	Oil & Gas	15.0%	0.6	0.4	0.4	100%	50%	100%	50%	0.3	0.2	2.25	0.3
Papekop	Oil & Gas	15.0%	11.0	6.6	7.2	100%	50%	100%	50%	5.5	3.6	15.01	0.7
Total Netherlands Oil & Gas Assets			18.4	11.1	12.0					11.6	7.6	9.37	2.0
Total Oil & Gas Assets			**498.1**	**301.9**	**325.2**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**341.3**	**222.9**	**10.17**	**49.0**
Balance Sheet and Other Adjustments													
Investment in Faroe Petroleum			8.0	4.9	5.2					8.0	5.2		
Aupec consulting business			30.0	12.5	13.4					30.0	13.4		
General & Admin Costs (PV10, four years, £3mn)			(14.1)	(8.6)	(9.2)					(14.1)	(9.2)		
Cash (30 June 2013)			20.3	12.3	13.3					20.3	13.3		
Cash assumed to be payable to EWE for 20% of Athena			(8.0)	(4.8)	(5.2)					(8.0)	(5.2)		
Cash assumed from option exercise			13.1	7.9	8.5					13.1	8.5		
Loans (30/6/2013)			(3.3)	(2.0)	(2.2)					(3.3)	(2.2)		
Cash from January 2014 fundraise			64.0	38.8	41.8					64.0	41.8		
Total			**110.0**	**60.9**	**65.6**					**110.0**	**65.6**		
Core NAV			**608.0**	**362.8**	**390.9**					**451.3**	**288.5**		
Lower Visibility Oil & Gas Assets													
UK Oil & Gas Assets													
Possum	Gas	15.0%	13.6	8.2	8.9	50%	80%	100%	40%	5.4	3.6	12.95	1.1
Skerryvore	Oil	30.5%	192.9	116.9	126.0	38%	80%	100%	30%	57.9	37.8	10.63	18.1
Davaar	Oil	30.0%	520.5	315.5	339.9	25%	50%	100%	12.5%	65.1	42.5	9.37	55.5
Athena 5th Well	Oil	10.0%	52.9	32.1	34.5	100%	50%	0%	0%	-	-	17.42	3.0
Blackadder	Gas	20.0%	42.3	25.6	27.6	33%	80%	100%	27%	11.3	7.4	7.17	5.9
Total UK Oil & Gas Assets			822.2	498.3	536.9					139.6	91.2	9.83	83.7
Netherlands Oil & Gas Assets													
Diever West	Gas	0.1	1.6	1.0	1.1	51%	50%	100%	26%	0.4	0.3	7.32	0.2
Total Netherlands Oil & Gas Assets			1.6	1.0	1.1					0.4	0.3	7.3	0.2
Total of Lower Visibility Assets			**823.8**	**499.3**	**537.9**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**140.1**	**91.4**	**17.1**	**83.9**
Net Asset Value and Target Price			**1,431.9**	**862.1**	**928.8**					**591.3**	**379.9**		

Key assumptions:

Brent price of $100/bbl escalated at 2% p.a.; UK gas price of 68p/therm ($10.71/mcf) escalated by 2% p.a.; Exchange rate of $1.65 = £1.00

Asset values are based on after-tax discounted cash flow models for each asset using a 10% discount rate (a standard NPV10 approach to oil & gas assets)

Financials

Balance sheet (£m)						
Year to June	**2011A**	**2012A**	**2013A**	**2014E**	**2015E**	**2016E**
Cash and equivalents	1.3	7.7	13.3	54.1	42.6	17.0
Trade receivables	1.7	3.3	4.0	5.0	6.0	7.0
Inventories	-	-	-	1.2	1.2	1.2
Other current assets	-	-	-	-	-	-
Investments	7.1	6.5	4.4	-	-	-
Long-term assets	2.3	5.5	31.7	64.0	147.2	252.7
Total assets	**12.3**	**22.9**	**53.4**	**124.3**	**197.0**	**277.9**
Trade payables	0.8	4.1	8.7	7.5	7.5	12.0
Other current liabilities	0.3	0.1	0.4	0.4	0.4	0.4
Debt	-	3.0	2.0	8.0	53.0	53.0
Long-term deferred taxes	0.0	0.0	1.6	1.6	1.6	1.6
Other long-term liabilities	2.2	3.5	3.3	4.9	4.9	4.9
Total liabilities	3.3	10.7	16.0	22.4	67.5	71.9
Equity	9.0	12.3	37.3	101.9	129.5	206.0
Liabilities and equity	**12.3**	**22.9**	**53.4**	**124.3**	**197.0**	**277.9**

Source: Company and Charles Stanley Securities

Income statement (£m)						
Revenue	**3.7**	**2.9**	**4.1**	**36.5**	**49.6**	**129.9**
Cash opex	(2.0)	(1.4)	(2.1)	(14.6)	(18.1)	(38.5)
G&A costs	(5.3)	(5.5)	(7.7)	(7.1)	(6.6)	(7.3)
EBITDA	**(3.6)**	**(4.0)**	**(5.6)**	**14.9**	**24.9**	**84.1**
Depreciation	-	(0.7)	(0.7)	(7.3)	(6.4)	(21.0)
Operating profit	(3.6)	**(4.7)**	**(6.3)**	**7.6**	**18.5**	**63.1**
Other	1.7	-	1.2	-	-	-
Financial expenses	0.0	(0.2)	(0.1)	(0.2)	(0.3)	(4.3)
Profit (loss) on investments	0.1	-	(0.0)	-	-	-
Income tax	(0.1)	0.0	(0.3)	(0.7)	(0.6)	(2.4)
Earnings	**(1.9)**	**(4.9)**	**(5.6)**	**6.7**	**17.7**	**56.5**
Minority interests	-	-	-	-	-	-
Earnings for shareholders	**(1.9)**	**(4.9)**	**(5.6)**	**6.7**	**17.7**	**56.5**

Source: Company and Charles Stanley Securities

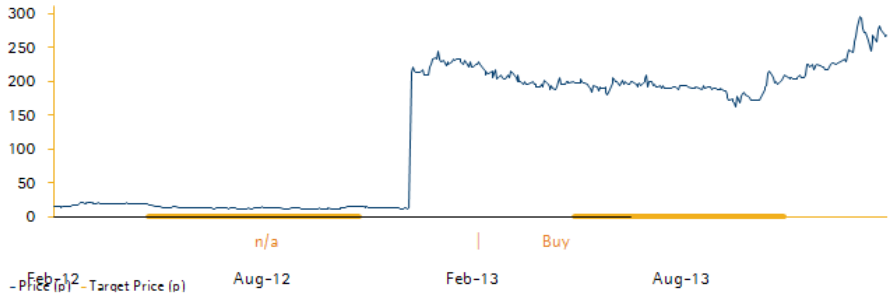
Cash flow statement (£m)						
Earnings	(1.9)	(4.9)	(5.6)	6.7	17.7	56.5
Depreciation	0.1	0.1	0.4	7.3	6.4	21.0
Other	0.4	3.9	3.5	-	-	-
Deferred tax	0.0	0.0	0.3	-	-	-
Cash flow from operations	**(1.3)**	**(1.0)**	**(1.4)**	**14.0**	**24.1**	**77.5**
Changes in working capital	0.1	(1.5)	(3.4)	(3.4)	(1.0)	3.4
Cash from operations	**(1.2)**	**(2.5)**	**(4.8)**	**10.6**	**23.1**	**80.9**
Disposals	2.1	0.0	0.7	4.4	-	-
Investments	(0.1)	(2.9)	(8.4)	(19.0)	(89.6)	(126.5)
Cash from investments	**1.9**	**(2.9)**	**(7.6)**	**(14.6)**	**(89.6)**	**(126.5)**
Cash from equity raised	0.3	8.8	15.6	38.8	10.0	20.0
Net cash from debt capital	(0.0)	3.0	2.5	6.0	45.0	-
Cash from financing	**0.3**	**11.8**	**18.1**	**44.8**	**55.0**	**20.0**
Net change in cash	**1.0**	**6.4**	**5.6**	**40.9**	**(11.5)**	**(25.6)**

Source: Company and Charles Stanley Securities

Important Disclosures

Recommendation and target price history

Share price performance



Charles Stanley Securities rating distribution					
Total Coverage	**Number**	**Percent**	**Banking Relationships**	**Number**	**Percent**
Buy	69	67.65	Buy	26	78.79
Add	8	7.84	Add	1	3.03
Hold	21	20.59	Hold	6	18.18
Reduce	2	1.96	Reduce	0	0.00
Sell	2	1.96	Sell	0	0.00

Charles Stanley Securities rating definitions – 12 month time scale			
Buy	+20% <	expected absolute	
Add	+10% <	expected absolute	< +20%
Hold	-10% <	expected absolute	< +10%
Reduce	-20% <	expected absolute	< -10%
Sell		expected absolute	< -20%

Charles Stanley Securities Contacts

Institutional Research		
Richard Hickinbotham (Head of Equity Research)	Industrials	020 7149 6035
Peter Ashworth	Smaller Companies	020 7149 6144
Samir Devani	Healthcare	020 7149 6259
Michael Donnelly	Support Services	020 7149 6225
William Game	Industrials	020 7149 6824
Kieron Hodgson	Commodities & Mining	020 7149 6939
Brendan Long	Oil & Gas	020 7149 6763
Peter McNally	Information Technology	020 7149 6624
Peter Smedley	Consumers	020 7149 6992
Andy Smith	Support Services	020 7149 6225

Institutional Sales	
Jonathan Dighe	020 7149 6352
Bob Pountney	020 7149 6860
Hugh Rich	020 7149 6294
Frank Watts	020 7149 6416
James Wood	020 7149 6074

Sales Trading	
Marc Downes	020 7033 4900
Paul Brotherhood	020 7033 4900
Chris Rylands	020 7033 4900
Paul Norman	020 7033 4900

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Registered office: 25 Luke Street, London EC2A 4AR Tel: 020 7739 8200 Fax: 020 7953 2822