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Stock Rating
Overweight

Industry View
Attractive

InterOil Corporation

October Drilling Catalysts & PNG Non-Approval Misunderstood

Investment conclusion: We continue to believe the risk/reward in IOC is compelling and we expect a corporate transformation to unfold over the next 6 months. IOC is currently drilling its Antelope-2 well and a series of preliminary results should be announced in October and November. Antelope-2 is an important well for IOC: it is the second well, in the second structure, underpinning its resource estimate. In our view, a successful well will continue to de-risk the resource at the critical time when potential partners are reviewing/valuing IOC's upstream assets and its LNG potential.

October/November Catalysts. We expect a series of drilling test results from IOC's Antelope-2 well in October-November with the first data point as early as 7 days (DST-1) and the full well test by early-to-mid November. A DST-1 that flows **7-18mmcf/d** and final flow test that exceed **100mmcf/d** would be positive results, in our view. We outline time periods and results from IOC's 3 prior successful wells to help evaluate preliminary results, as they are reported.

Misunderstood PNG non-approval. The Papua New Guinea (PNG) government has not yet approved IOC's proposed LNG facility which has become a source of investor concern. We believe PNG's delay in approving IOC's proposed LNG facility may be financing related; would not be a condition precedent to signing a JV partnership agreement; is a solvable issue; and we expect the issue will be resolved in the next 3-5 months.

Binary outcome highlights risks/rewards: Oil and gas exploration entails risks and well failure of Antelope-2 could delay or lower resource estimates which are the key variables in valuation for equity holders as well as potential LNG Partners.

Key Ratios and Statistics

Reuters: IOC.N Bloomberg: IOC US
Integrated Oil / United States of America

Price target	\$65.00
Shr price, close (Oct 5, 2009)	\$42.69
Mkt cap, curr (mm)	\$1,819
52-Week Range	\$43.00-8.90

Fiscal Year ending	12/08	12/09e	12/10e	12/11e
ModelWare EPS (\$)	(0.32)	0.10	0.15	0.15
Prior ModelWare EPS (\$)	-	-	-	-
P/E	NM	439.4	293.2	292.5
Consensus EPS (\$) §	(0.35)	0.26	0.21	0.15
Div yld (%)	0.0	0.0	0.0	0.0

Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework (please see explanation later in this note).
§ = Consensus data is provided by FactSet Estimates.
e = Morgan Stanley Research estimates

Quarterly ModelWare EPS

Quarter	2009e		2010e		2010e	
	2008	Prior	Current	Prior	Current	Current
Q1	(0.08)	-	0.07a	-	0.07	0.07
Q2	0.40	-	0.24a	-	0.10	0.10
Q3	0.22	-	(0.08)	-	0.00	0.00
Q4	(0.96)	-	(0.11)	-	(0.03)	(0.03)

e = Morgan Stanley Research estimates, a = Actual company reported data

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Investment Case

October-November Catalysts: Antelope-2

We expect drilling results on Antelope-2 as early as one week from now and extending into mid-November. IOC is currently drilling its Antelope-2 well in PNG. The drilling plan for Antelope-2 entails three primary objectives:

- (1) test at the top of the reservoir structure for hydrocarbons/flow (Drill Stem Test-1 "DST"-1);
- (2) a final flow test of entire reservoir, and
- (3) a test of an isolated zone at the bottom of the reservoir for liquids content and flow.

Based upon estimates of drilling and casing times, we expect to get results as follows:

- (1) DST-1 by **mid-October (as early as within 7 days)**,
- (2) a final flow test by **early November** (3+ weeks after DST-1), and
- (3) information regarding the liquids potential from the lower transitory zone by **mid-to- late November** (3+ weeks after full flow test).

In the lower transitory zone, IOC intends on horizontally drilling into the reservoir to test flow characteristics (permeability and porosity) as well as uniformity of this portion of the reservoir (seeking any pockets of liquids/higher porosity and information on the structure). IOC has horizontal drilling equipment on site that was not available for Antelope-1. We currently assume IOC has 75mmbbls of liquids (risked at 80%) which is modestly higher than 59.3mmbbls in GLJ's resource estimate (which was obtained before the full well test on Antelope-1 and, thus, is likely conservative).

We believe Antelope-1 will provide the most material comparison for early test results of Antelope-2.

- (1) We believe Antelope-1's DST-1 provides the most meaningful comparison for DST-1 yet, as Antelope-1 had one of the highest flow rates we know, any rate between Elk-2/Elk-4 and Antelope-1 would be a considered successful, in our view. Antelope-1's DST-1 flowed at 18.2 mmcfcd with no liquids, so **we believe a DST-1 flow rate between 7-18mmcfcd would be positive.** Antelope-2 DST-1 will be the first evidence of gas in this well because it is being drilled over-balanced (vs. underbalanced as in prior wells).
- (2) On the final flow test, Antelope-1 flowed at 382mmcfcd and 5,000bbls of liquids and we believe a final flow test of

Antelope-2 over 100mmcfcd and limited liquids would be positive.

Antelope-2 is an important well. We believe Antelope-2 is an important well for 3 reasons: (1) it is the second well in the Antelope structure and will inform the overall size and resource potential, (2) Antelope is a reef structure which is different from the older limestone reservoir in Elk and, if successful, will be more persuasive than Elk on a resource estimate. Matrix porosity issues overhang Elk (on whether Elk gas flowed from the limestone or the natural fractures in the limestone) and a successful Antelope-2 well (as defined above) will likely better support resource estimates; and (3) IOC is currently conducting a process for selling a portion of its upstream interests and any well/structure positive data is clearly an important element of valuation of IOC's proposition.

How does IOC release well data?

There are 3 ways IOC has historically disclosed well-related results: (1) press release (materiality threshold), (2) drilling reports (periodic, at different junctures), and (3) technical presentations (contemporaneously or after press release often containing additional data). We believe the 3 important data points on Antelope-2 will be press-released. We aggregated the data for all 4 wells in Exhibit 1 for comparison purposes of the test at the top of the structure (DST-1 in Antelope 2's case) and the full well test, the two most important results. All wells are different and Elk is a different structure than Antelope yet the rate of progression is notable as evidence of IOC's application of improved knowledge and understanding of the region, geology, and conditions. IOC conducted various DSTs in the prior wells and in various orders. For instance, some DST-1s were lower in the structure and the full well tests were conducted sooner in Antelope-1 than in the Elk wells. Also, over 16 DSTs were conducted in Antelope-1 due to the difficulty in isolating zones because of the high pressure and high permeability characteristics in the dolomitized portions of the reservoir. We would expect fewer in Antelope-2.

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Exhibit 1

Time Table for Well Results: Historical and Expected

Timeline	Elk-1	Elk-2	Elk-4	Antelope 1	Antelope 2	Comments
Date Spud Well	2/19/2006	2/12/2007	11/15/2007	10/15/2008	7/27/2009	
Date to Top of Structure (A=Announced, E=Expected)	5/15/2006 E	6/13/2007 E	3/31/2008 E	12/18/2008 A	9/17/2009 A	IOC guided Mid-Sept
Depth to Top of Structure (feet)	5,473.00	7023	7,116	5,729	6,007	
Days to Top of Structure Announcement	85	121	137	64	52	
Preliminary Comments	Experienced gas kicks	Experienced background and trip gas	Experienced gas kicks	Experienced gas kicks	Hit 345 ft higher than expected, overbalanced drilling = no kick	A Potentially larger reservoir vs. seismic interpretation
Total Number of DSTs Performed	2	12	4	16	3-5	Estimated
Top of Structure DST	Test top of structure	Test top of structure	Test top of structure	Test top of structure	DST-1 = Tests top of structure 10/12/2009	
Date of DST-1	6/24/2006	6/27/2007	5/7/2008	1/22/2009		E Estimated, Guided 90 days
Days to DST-1 Announcement	125	135	174	99	77	Potentially sooner than expected
Results: Gas Flow (mmcf/d)	18.1	Limited	7.2	18.2		} Flow rates between 7-18 mmcf/d would be positive, in our view
Results: Liquids Flow (bpd)	0	0	82	225		
Results: Size of Interval Tested (ft)	659	1,306	177	1,995		
Results: Depth (feet)(to bottom of test zone)	6,040	N/A	7,402	8,071		
Results: Surface flowing pressure (psi)	2,015	N/A	510	870		
Results: Choke (inch)	18/64	N/A	64/64	66/64		
Results: Calculated absolute open hole (AOF)(mmcf/d)	2,880	N/A	N/A	17,000		
Results: Shut-in surface pressure (psi)	3,165	3,332	3,050	3,030		
Days to Final Flow Test (5-7 inch tubing)				138	102	Assume 3.5 weeks to drill, case, and run test
Results: Gas Flow (mmcf/d)	102	N/A	105	382		} Flow rates exceeding 100mmcf/d would be positive, in our view. Any liquids is upside
Results: Liquids Flow (bpd)	510	N/A	1,890	5,000		
Results: Choke (inch)	4 1/4	N/A	1 2/5	3 1/5		
Results: Surface flowing pressure (psi)	1,990	N/A	1150-1450	1,740		
Results: Shut-in surface pressure (psi)	3,160	N/A	3,095	3,035		
DSTs Beyond 2 and Production Test	N/A	Drilled, cored & tested well for structural information	Successfully tested 2 deeper zones which indicated matrix flow and higher condensate yields	Attempted various tests yet difficult to isolate zone. Sidetracked bottom hole to test for liquids		Have horizontal drilling equipment that lacked in Antelope-1 to explore for liquids horizontally and laterally in the structure after final flow test

Source: Company data, Morgan Stanley Research

PNG Government Non-approval Misunderstood

Various government statements have been reported.

There have been conflicting reports regarding PNG's willingness or ability to approve IOC's LNG project and be involved in 2 LNG projects simultaneously. Most recently, the Minister for the Petroleum and Energy in PNG, Honorable William Duma, clarified some uncertainty stating: "PNG fully supports both the ExxonMobil and InterOil led LNG projects" and "[w]e will continue to negotiate with InterOil to move ahead with the second LNG plant in the country. The people of Papua New Guinea will not be denied the fiscal, employment and educational benefits associated with development of both the proposed LNG projects." Concerns remain as IOC's proposed project has not yet been approved by PNG.

Source of potential delay

In our view, the issue on the approval delay is likely four fold:

- (1) PNG may be concerned on how to potentially finance any investment in IOC's facility;
- (2) PNG may be incented to allow Oil Search to sell its interest in PNG LNG before approving IOC's project;
- (3) PNG may want PNG LNG to reach, final investment decision ("FID"), before it approves a second facility; and
- (4) PNG may believe approval of IOC's proposal is not yet ripe (i.e., they have time).

On the first point, development and construction of LNG facilities is costly, and PNG is estimated to need \$1.6BN to finance the capital investment associated with its 19.4% stake in PNG LNG. PNG may also need capital for IOC's facility if/when developed based on its opt-in interest (total project is estimated to cost \$6-8BN). For PNG LNG, this issue was solved through an arrangement with IPIC (International Petroleum Investment Company), of Abu Dhabi, whereby PNG received \$1.68BN from IPIC (as a concessional loan) and PNG (via IPBC) granted IPIC an exchangeable bond that is exchangeable into PNG's equity shares in Oil Search Limited (at A8.55 price, a 76% premium at time of execution). PNG owns 17.56% of Oil Search (as of 12/31/08) in connection with a 2002 merger with Orogen Minerals Ltd. In the financing transaction as we understand it, PNG is effectively selling its Oil Search shares at a strike in five years, assuming Oil Search shares exceed the strike, to fund its investment in PNG LNG.

On the second issue and related to the exchangeable note, PNG may be incented to wait for Oil Search to sell its 3% interest in PNG LNG before it approves IOC's facility (as a shareholder). Oil Search is currently attempting to sell an

additional 3% of its interest in PNG LNG to Abu Dhabi to help fund its equity capex investment in the facility.

On the third issue, XOM is expected to FID PNG LNG by year-end and, thus, the issue is solved over time.

On the fourth issue, we don't believe approval of IOC's facility is a condition precedent to a partnership agreement (as PNG might). An agreement can, and likely will, contain many conditions, PNG approval being one. Antelope-2 results and a partnership offer could occur before the PNG approval is ripe.

Any PNG financing issue is solvable

In our view, the key element of any delay may be financial and financial issues are solvable. Another party (another state interest) could carry PNG with a loan or PNG could own a lower interest in an LNG facility and derive its value in the upstream which it owns a 20.5% interest (22.5% with locals). We would contend that monetization of the upstream interest has much higher value and return than an interest in the LNG facility. PNG could follow IOC's lead and sell more or the LNG interest (or opt into less) and capture value on the upstream and all other collateral benefits when the LNG facility is operating (such as taxes, jobs and ancillary benefits). We expect the PNG financing issue is not the gating issue for IOC: signing the partnership agreement is. If a potential partner has to carry PNG's interest, it could impact (lower) the sale price, and as we assume a 40% discount to recent comparables, we believe we have captured that risk.

Ultimately interests are aligned

PNG owns 20.5% of IOC's upstream and that value will not be monetized until there is an LNG facility. Further, IOC's proposed project would be the second largest infrastructure project in PNG's history and have all the positive collateral and tax impact associated therewith (as well documented in the PNG LNG project).

Valuation and Risks

We have a \$65 price target, based on an \$85/bbl long-term oil price, 14% S-curve slope for LNG pricing, two LNG trains with a combined 6.5 mmtpa capacity (smaller than 8mmtpa company estimates), and \$8.25 billion of total project capex (15% excess of IOC estimates). We assume condensate stripping start-up in 2012 and LNG start-up in 2014. We assume that IOC completes a sell-down of 24% upstream interest and 58% LNG Plant interest for a price of \$1.2 billion (including a carry on the remaining \$530 million in equity capex net to IOC post-sell-down). Cash flow is discounted at a WACC-based 12.4%.

Risks include: Asset interest sale fails to materialize; Purchase price in sell down disappoints; Antelope-2 well results disappoint; Liquidity shortage and/or equity dilution; Cost overruns and project delays.

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Total	2,343		665		

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Industry Coverage: Integrated Oil

Company (Ticker)	Rating (as of)	Price (10/05/2009)
Evan Calio		
Chevron Corporation (CVX.N)	O (07/14/2009)	\$69.39
ConocoPhillips (COP.N)	E (07/14/2009)	\$47.86
Exxon Mobil Corporation (XOM.N)	E (07/14/2009)	\$67.58
Hess Corporation (HES.N)	E (07/14/2009)	\$53.67
InterOil Corporation (IOC.N)	O (09/18/2009)	\$42.69
Marathon Oil Corporation (MRO.N)	U (07/14/2009)	\$30.93
Murphy Oil Corporation (MUR.N)	E (07/14/2009)	\$57.56

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