Morgan Stanley

MORGAN STANLEY RESEARCH
NORTH AMERICA

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December 1, 2009

Stock Rating
Overweight

Industry View
Attractive

InterOil Corporation

Another Well, Another Record; Raising PT to $80

What's Changed	
Price Target	**$73.00 to $80.00**

Another Well, Another Record: We were in Papua New Guinea today, along with industry reps, potential investors and government officials, where InterOil's long anticipated Antelope-2 well test exceeded already high expectations. Moments before management presented the Governor of PNG's Gulf Province with a certificate recognizing the world record flow rate from Antelope-1 (382 mmcf/d), IOC broke its own record, flowing Antelope-2 at a staggering 705 mmcf/d and 11.2 kb/d of condensate. For frame of reference, this represents almost 70% of the estimated 1.0 bcf/d of feed gas that the entire two-train LNG facility will require at its peak. In our view, results continue to exceed the expectations of supporters and challenge the credibility of doubters, further bolstering resource estimates and equally important, confidence in well deliverability. We are raising our estimate for the sale price of IOC's project interest from $0.74/mcf to $0.90/mcf on higher resource confidence, raising our target price from $73 to $80 and reiterate our Overweight rating.

Key Takeaways from our time in PNG include the following: 1) Year-end resource estimate should rise significantly from both GLJ's 3.8 Tcfe and Knowledge Reservoir's 6.7 Tcfe estimates, with an update likely arriving by mid-February, 2) Rapid pressure build-up following well shut-in, even at these record rates, offers further encouragement on both resource size and productivity, 3) Buyer interest remains strong in both Upstream, LNG and condensate projects, with the mid-Dec condensate DST potentially serving as a catalyst for clarity on a partner in the liquids stripping facility, 4) Future exploration should be robust, with multiple nearby targets under current consideration and strong external interest in participation, 5) Strong vocal support by the Governor of the local Gulf Province signaled important political support *(continued on p. 2)*.

Key Ratios and Statistics

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

Price target	**$80.00**
Shr price, close (Nov 30, 2009)	$55.90
Mkt cap, curr (mm)	$2,382
52-Week Range	$58.00-10.20

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**	**575.4**	**383.9**	**382.9**
Consensus EPS ($)§	**(0.35)**	**0.35**	**0.32**	**0.15**
Div yld (%)	0.0	0.0	0.0	0.0

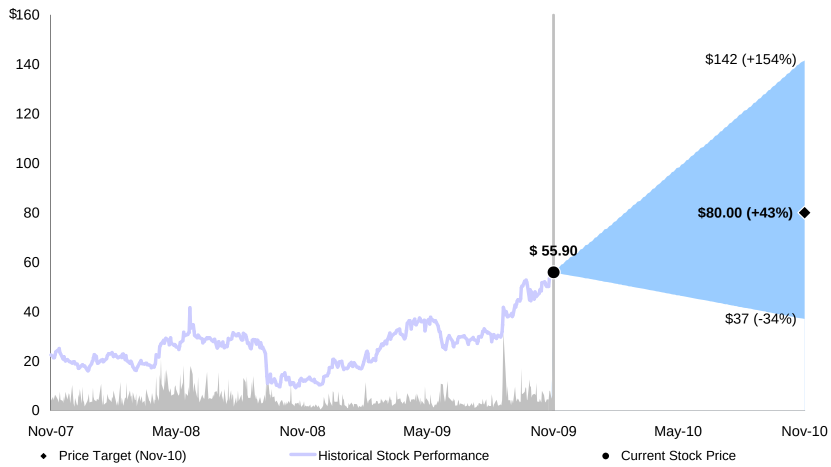
Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework (please see explanation later in this note).
§ = Consensus data is provided by FactSet Estimates.
e = Morgan Stanley Research estimates

Another Well, Another Record *(cont'd)*

Next Steps: 1) Mid-December DST #2 targeting the condensate-rich zone to isolate and establish the condensate ratio. This offers material upside to current condensate estimates, and needed clarity for the proper sizing of (and investment in) the anticipated liquids stripping facility; 2) Completion of vertical drilling through the potential oil leg by year end (and possible DST). Both of these events offer significant upside to the current share price (we attribute zero value for potential oil in our $80 target price) and could serve as the gateway to the first steps in IOC's interest sell-down.

InterOil Corp. (IOC, $56, Overweight, Price Target $80)

Risk-Reward View: Strong Risk/Reward Skew



Price Target $80	Derived from our base case.
Bull Case $142 Assumes $85 oil price (perpetuity)	**Exploration Upside; Higher liquids in Antelope** Improving resource estimate and liquid stripping economics,220MMbbls of liquids; $3.5 billion sale price of IOC's interest and $6 per share for exploration upside
Base Case $80 Assumes $85 oil price (perpetuity)	**Joint Venture Partnership is Signed** Assumes 120MMbbls of liquids (liquids stripping financed on unlevered basis), $1.2 billion sale price of IOC's interest. Upstream NAV risked at 80% chance of success on LNG project development, with shares targeted to trade at an additional 20% discount to risked NAV.
Bear Case $37 Assumes $75 oil price	**No Joint Venture Signed** Assumes IOC is unable to enter a LNG development JV in $75 oil price environment, IOC exploration resource and undeveloped acreage is worth $21/sh and gas is worth $12/sh with the refining at $5/sh at a 20% discount to risked NAV.

Source: Morgan Stanley Research
The probability we assign to a successful LNG project in our base case is only illustrative. It does not forecast a precise series of events and does not account for all possible outcomes but instead illustrates our sense of the relative plausibility of the outcome, based on current industry dynamics.

Why Overweight?

- Strong value proposition as market overlooks and discounts resource and potential monetization.
- We expect IOC to enter a partnership in next 6 months to develop LNG facility/ monetize its natural gas and associated liquids.
- Catalyst-loaded story over the next 12-months.
- Largest exploration land position in PNG with over a decade of drilling experience.
- Niche refining exposure levered to substantial economic growth forecasted in PNG.

Potential Catalysts/Key Value Drivers

- **Antelope-2 DST** liquid rich gas zone due mid-December
- **Antelope-2** horizontal drilling (oil potential) due mid-December
- **GLJ/Knowledge Resource** update due in January 2010.
- **Liquid stripping** venture due early 2010
- **Antelope-3** results expected first quarter 2010
- **LNG Partnership/upstream** sell down expected in 1H 2010

Where We Could Be Wrong

- Exploration failure. IOC is proving its resource base and any exploration failure will likely delay development and, as historically, materially impact share price.
- Failure to enter LNG JV. IOC is unlikely to be able to finance LNG development and its continued exploration program w/o partners.
- PNG risks. 100% of IOC's operating assets are located in PNG.
- Failure to enter JV before potential 1H10 liquidity shortage forces additional capital raise.

Exhibit 1

InterOil Income Statement (2008-2011E)

Segment Earnings				
E&P	**2.15**	**(10.35)**	**(11.10)**	**(11.10)**
Refining	4.72	23.03	26.96	26.85
Liquefaction	(7.91)	(8.43)	(8.22)	(8.38)
Total Midstream	**(3.20)**	**14.59**	**18.73**	**18.47**
Downstream	**(1.21)**	**2.82**	**0.66**	**1.20**
Corporate and adjustments	**(9.55)**	**(3.14)**	**(1.88)**	**(2.15)**
Specials and non continuing business	0.00	0.00	0.00	0.00
Clean Post Tax Net Income	**(11.80)**	**3.92**	**6.41**	**6.43**
Net income to shareholders	**(11.80)**	**3.92**	**6.41**	**6.43**
Shares (m)	36.70	40.40	44.04	44.04
Reported EPS	(0.32)	0.10	0.15	0.15
Clean EPS	**(0.32)**	**0.10**	**0.15**	**0.15**
Sales and operating revenues	915.58	712.38	1,045.94	1,368.79
Interest	0.93	6.74	13.06	13.26
Other	3.22	3.17	3.27	3.31
Revenue	**919.73**	**722.29**	**1,062.27**	**1,385.36**
Cost of sales and operating expenses	888.62	628.54	949.71	1,271.81
Administrative and general expenses	42.75	50.83	63.35	63.97
Derivative losses/(gains)	(24.04)	(0.93)	0.00	0.00
Exploration costs, excluding exploration impairment	1.00	1.00	1.13	1.13
Exploration impairment	0.11	0.00	0.00	0.00
Interest Expense	23.97	22.23	27.24	27.24
Depreciation and amortization	14.14	14.33	14.32	14.37
Gain on LNG shareholder agreement	0.00	0.00	0.00	0.00
Gain on sale of oil and gas properties	(11.24)	(1.09)	0.00	0.00
Foreign exchange (gain)/loss	(3.88)	1.11	0.00	0.00
Accretion expense	0.00	0.00	0.00	0.00
Total cost and Expense	**931.44**	**716.01**	**1,055.75**	**1,378.52**
Profit before Income Tax	(11.71)	6.28	6.52	6.83
Income taxes (recoveries)				
Current and future	(0.08)	(2.35)	(0.10)	(0.40)
Tax Rate	0.7%	-37.5%	-1.5%	-5.9%
Income/(loss) before non controlling interest	(11.80)	3.93	6.42	6.43
Non-controlling interest	(0.00)	(0.00)	(0.00)	(0.00)
Net earnings	(11.80)	3.92	6.41	6.43
Other comprehensive income				
Cumulative foreign currency translation adjustment	0.00	0.00	0.00	0.00
Hedge of net investment, net of tax	0.00	0.00	0.00	0.00
Derivatives designated as cash flow hedges, net of tax	0.00	0.00	0.00	0.00
Comprehensive income	(11.80)	3.92	6.41	6.43
Special items	0.00	0.00	0.00	0.00
Net earning Reported	(11.80)	3.92	6.41	6.43
Basic EPS	(0.35)	0.10	0.15	0.15
Diluted EPS - Recurring	(0.32)	0.10	0.15	0.15
Diluted EPS	(0.32)	0.10	0.15	0.15

Source: Company data, Morgan Stanley Research

Exhibit 2

InterOil Statement of Cash Flows (2008-2011E)

Operating activities				
Net income	(11.80)	3.92	6.41	6.43
Adjustments for non-cash and non-operating transactions				
Non-controlling interest	0.00	0.00	0.00	0.00
Depreciation and amortization	14.14	14.33	14.32	14.37
Future income tax asset	(0.20)	1.01	0.00	0.00
Fair value adjustment on IPL PNG Ltd. Acquisition	0.00	0.00	0.00	0.00
(Gain) / Loss on sale of plant and equipment	(0.02)	0.00	0.00	0.00
Gain on sale of exploration assets	(11.24)	(1.09)	0.00	0.00
Amortization of discount on debentures liability	1.92	1.21	0.00	0.00
Amortization of deferred financing costs	0.26	0.11	0.00	0.00
Gain on unsettled hedge contracts	0.85	(0.21)	0.00	0.00
Timing difference between derivatives recognised and settle	(17.03)	15.07	0.00	0.00
Stock compensation expense	5.74	3.32	0.00	0.00
Inventory revaluation	8.38	0.00	0.00	0.00
Non-cash interest on secured loan facility	2.19	0.00	0.00	0.00
Non-cash interest settlement on preference shares	0.37	0.00	0.00	0.00
Non-cash interest settlement on debentures	2.62	2.35	0.00	0.00
Oil and gas properties expensed	1.10	0.25	0.00	0.00
Loss/(gain) on proportionate consolidation of LNG project	(0.81)	0.72	0.00	0.00
Unrealized foreign exchange gain	(3.73)	(3.90)	0.00	0.00
Other	0.00	0.00	0.00	0.00
Preference share transaction costs	0.00	0.00	0.00	0.00
Change in operating working capital				
Decrease/(increase) in trade receivables	18.68	(43.46)	35.45	(24.92)
(Decrease)/increase in unrealised hedge gains	0.90	6.27	0.00	0.00
Decrease/(increase) in other assets and prepaid expenses	0.59	0.18	(0.65)	(1.37)
(Increase)/decrease in inventories	(3.19)	1.21	22.93	(31.15)
Increase/(decrease) in accounts payable, accrued liabilities	5.85	81.73	26.85	27.28
Cash flow - operating activities	**15.59**	**83.04**	**105.32**	**(9.36)**
Investing activities				
Expenditure on oil and gas properties	(63.89)	(43.68)	0.00	0.00
Proceeds from IPI cash calls	18.32	5.58	0.00	0.00
Expenditure on plant and equipment	(5.17)	(4.86)	0.00	0.00
Proceeds received on sale of assets	0.31	0.00	0.00	0.00
Proceeds received on sale of exploration assets	6.50	0.00	0.00	0.00
Acquisition of subsidiary	0.00	0.00	0.00	0.00
(Increase)/decrease in restricted cash held as security on borı	(3.90)	4.92	0.00	0.00
(Decrease)/increase in accounts payable and accrued liabilitie	0.44	(5.89)	0.00	0.00
Other	0.00	0.00	0.00	0.00
Allocation of oil and gas properties expenditure applied agains	0.00	0.00	0.00	0.00
Cash flow - investing activities	**(47.39)**	**(43.93)**	**0.00**	**0.00**
Financing activities				
Proceed /Repayments of secured loan	(9.00)	(4.50)	0.00	0.00
Borrowings / Repayments of bridging facility, net of transactioı	(70.00)	0.00	0.00	0.00
Proceeds from PNG LNG cash call	9.45	0.00	0.00	0.00
Repayment of deferred financing fees	0.00	0.00	0.00	0.00
Proceeds from Clarion Finanz for Elk option agreement	5.50	3.58	0.00	0.00
Proceeds from Petromin for Elk participation agreement	4.00	4.44	0.00	0.00
(Repayments of)/proceeds from working capital facility	2.29	(64.83)	0.00	0.00
Proceeds from issue of common shares/conversion of debt, n	(0.10)	83.91	0.00	0.00
Proceeds from issue of debentures, net of transaction costs	94.78	0.00	0.00	0.00
Proceeds from preference shares, net of transaction costs	0.00	0.00	0.00	0.00
Other	0.00	0.00	0.00	0.00
Proceeds from conversion of warrants	0.00	0.00	0.00	0.00
Cash flow - financing activities	**36.91**	**22.59**	**0.00**	**0.00**
Foreign exchange gain/(loss) / Adjustment for restatement	0.00	0.00	0.00	0.00
Increase in cash and cash equivalents	5.11	61.69	105.32	(9.36)
Beginning cash	43.86	48.97	110.66	215.98
Ending cash	**48.97**	**110.66**	**215.98**	**206.63**

Source: Company data, Morgan Stanley Research

Exhibit 3

InterOil Balance Sheet (2008-2011E)

Assets				
Current Assets				
Cash and Cash equivalents	48.97	110.66	215.98	206.63
Cash restricted	25.99	14.52	14.52	14.52
Trade / other receivables	42.89	85.53	50.08	75.00
Commodity derivative contracts	31.34	0.00	0.00	0.00
Other assets	0.17	0.70	0.70	0.70
Inventories	83.04	85.53	62.60	93.75
Prepaid Expenses	4.49	3.78	4.42	5.79
Total Current Assets	236.88	300.72	348.30	396.39
Non-current				
Cash restricted	0.29	6.84	6.84	6.84
Deferred financing cost	0.00	0.00	0.00	0.00
Goodwill	0.00	5.76	5.76	5.76
PP&E, Net	223.59	214.12	199.80	185.43
Oil and gas properties	128.01	157.88	157.88	157.88
Other assets	0.00	0.00	0.00	0.00
Future income tax benefit	3.07	2.06	2.06	2.06
Total Assets	591.84	687.38	720.65	754.36
Liabilities				
Current liabilities				
Accounts payable and accrued liabilities	78.15	154.94	181.78	209.06
Commodity derivative contracts	0.00	0.00	0.00	0.00
Working capital facility	68.79	3.96	3.96	3.96
Deferred hedge gain	0.00	0.00	0.00	0.00
Current portion of secured loan	9.00	9.00	9.00	9.00
Current portion of indirect participation interest	0.54	0.54	0.54	0.54
Other	0.00	0.00	0.00	0.00
Total Current Liabilities	156.48	168.44	195.29	222.57
Accrued financing costs	0.00	0.00	0.00	0.00
Secured loan	52.37	47.98	47.98	47.98
8% subordinated debenture liability	65.04	0.00	0.00	0.00
Preference share liability	0.00	0.00	0.00	0.00
Deferred gain on contributions to LNG project	17.50	13.08	13.08	13.08
Indirect participation interest	72.48	70.05	70.05	70.05
Indirect participation interest - PNGDV	0.84	0.84	0.84	0.84
Other	0.00	0.00	0.00	0.00
Total Long Term Liabilities	208.22	131.95	131.95	131.95
Non controlling interest	0.01	0.01	0.01	0.02
Stockholders' Equity				
Share capital	373.90	550.08	550.08	550.08
Preference shares	0.00	0.00	0.00	0.00
8% subordinated debentures	10.84	0.00	0.00	0.00
Contributed surplus	15.62	17.36	17.36	17.36
Warrants	2.12	2.12	2.12	2.12
Accumulated Other Comprehensive Income	27.70	16.55	16.55	16.55
Conversion options	17.14	17.14	17.14	17.14
Accumulated deficit	(220.19)	(216.26)	(209.85)	(203.42)
Total Shareholder Equity	227.13	386.99	393.40	399.83
Total liabilities and Stockholders' Equity	591.84	687.38	720.65	754.36

Source: Company data, Morgan Stanley Research

MORGAN STANLEY ModelWare

Morgan Stanley ModelWare is a proprietary analytic framework that helps clients uncover value, adjusting for distortions and ambiguities created by local accounting regulations. For example, ModelWare EPS adjusts for one-time events, capitalizes operating leases (where their use is significant), and converts inventory from LIFO costing to a FIFO basis. ModelWare also emphasizes the separation of operating performance of a company from its financing for a more complete view of how a company generates earnings.

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(as of November 30, 2009)

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	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**915**	**38%**	**284**	**41%**	**31%**
Equal-weight/Hold	**1077**	**45%**	**312**	**45%**	**29%**
Not-Rated/Hold	**25**	**1%**	**2**	**0%**	**8%**
Underweight/Sell	**384**	**16%**	**89**	**13%**	**23%**
Total	**2,401**		**687**		

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Overweight (O). The stock's total return is expected to exceed the average total return of the analyst's industry (or industry team's) coverage universe, on a risk-adjusted basis, over the next 12-18 months.
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Unless otherwise specified, the time frame for price targets included in Morgan Stanley Research is 12 to 18 months.

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Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.
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Industry Coverage:Integrated Oil

Company (Ticker)	Rating (as of)	Price (11/30/2009)
Evan Calio		
Chevron Corporation (CVX.N)	O (07/14/2009)	$78.04
ConocoPhillips (COP.N)	E (07/14/2009)	$51.77
Exxon Mobil Corporation (XOM.N)	E (07/14/2009)	$75.07
Hess Corporation (HES.N)	O (11/20/2009)	$57.96
InterOil Corporation (IOC.N)	O (09/18/2009)	$55.9
Marathon Oil Corporation (MRO.N)	U (07/14/2009)	$32.62
Murphy Oil Corporation (MUR.N)	E (07/14/2009)	$56.39

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