Morgan Stanley

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NORTH AMERICA

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Stock Rating
Overweight

Industry View
Attractive

InterOil Corporation

Pieces Fall-ing into Place

We believe IOC will outperform this Fall as IOC approaches finalization for its LNG development by year-end, enters gas off-take agreements, and commences the first high impact potential exploration well since company-maker Antelope.

Finalization of resource development and the return of high impact exploration will begin to de-risk our $225/share NAV. We believe much of IOC's stock price volatility since January 2010 can be attributed to: (1) delay and change in IOC's natural gas and condensate development plans, (2) skepticism regarding IOC's monetization decisions, and (3) lack of exploration catalysts. The stock's volatility has been amplified by market volatility, early-stage development variation, and the often-polarizing nature of this stock. We believe these elements will be largely addressed in 2H11 and IOC will breakout of its recent trading range that has been established since discovery of Antelope that established IOC's resource.

Expect project's value to become de-risked. We believe IOC's choices of floating (FLNG) and modular mid-sized plants to liquefy its gas and the choice of partners in FLEX LNG and EWC will de-risk as these applications become more main-stream, gas off-takes are signed, and partner Mitsui reaches final investment decision, a key milestone (FID). As larger scale plants continue to witness cost inflation, we expect both modular mid-sized LNG and FLNG, with material cost advantages, will gain industry traction. FID in late 2011 by Mitsui and likely expansion of their role commensurate with a larger CSP plant, will materially improve IOC's project credibility and valuation. Mitsui involvement in 8 LNG projects globally and hands-on project due diligence since 2009 is more meaningful than Wall Street's or a competitor's assessment.

Exploration matters: IOC discovered 9.36Tcfe of gas equivalent resource through the drill-bit, which helped drive the stock from the low $30s to mid-$80s in less than 4 months. IOC will spud its next high-impact potential target, Triceretops-2, in 3Q11 with results by year-end. Success could meaningfully add to our NAV.

Key Ratios and Statistics

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

Price target	**$135.00**
Shr price, close (Jul 22, 2011)	$65.04
Mkt cap, curr (mm)	$3,109
52-Week Range	$81.98-47.29

Fiscal Year ending	12/10	12/11e	12/12e	12/13e
ModelWare EPS ($)	**(1.03)**	**0.36**	**0.28**	**(0.40)**
Prior ModelWare EPS ($)	**-**	**-**	**-**	**-**
P/E	**NM**	**183.1**	**229.2**	**NM**
Consensus EPS ($)§	**(1.03)**	**0.44**	**0.56**	**0.87**
Div yld (%)	0.0	0.0	0.0	0.0

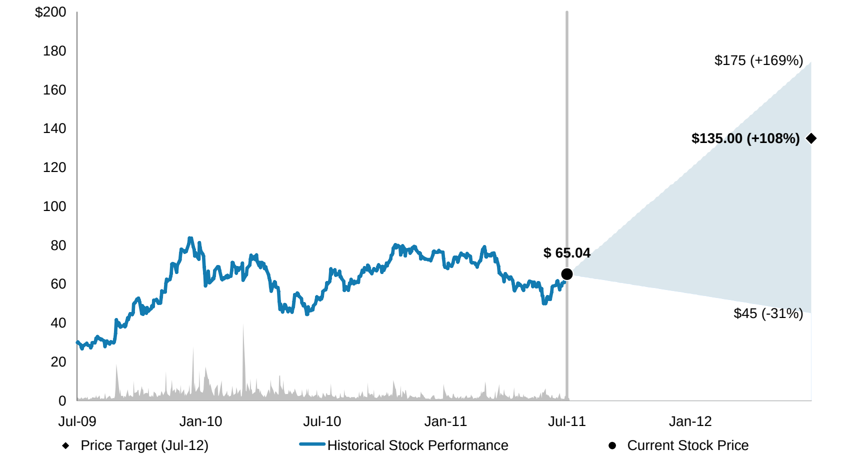
Unless otherwise noted, all metrics are based on Morgan Stanley ModelWare framework (please see explanation later in this note).
§ = Consensus data is provided by FactSet Estimates.
e = Morgan Stanley Research estimates

Recent Reports

Title	Date
InterOil Corporation: Floating LNG Deal Signed Evan Calio / Ben Hur / Ryan Todd / Marko Lazarevic	Apr 12, 2011
InterOil Corporation: Quick Comment: Same Destination, Different Route Evan Calio / Ryan Todd / Ben Hur / Marko Lazarevic	Mar 24, 2011
InterOil Corporation: Forward Progress: More to Come in 1H2011 Evan Calio / Ben Hur / Ryan Todd / Marko Lazarevic	Feb 2, 2011
InterOil Corporation: LNG Deal Drives Higher NAV; More Catalysts Coming Evan Calio / Ryan Todd / Ben Hur / Marko Lazarevic	Sep 30, 2010
InterOil Corporation: Mitsui Partnership Prices Elk/Antelope Resource Evan Calio / Ryan Todd / Ben Hur	Aug 4, 2010

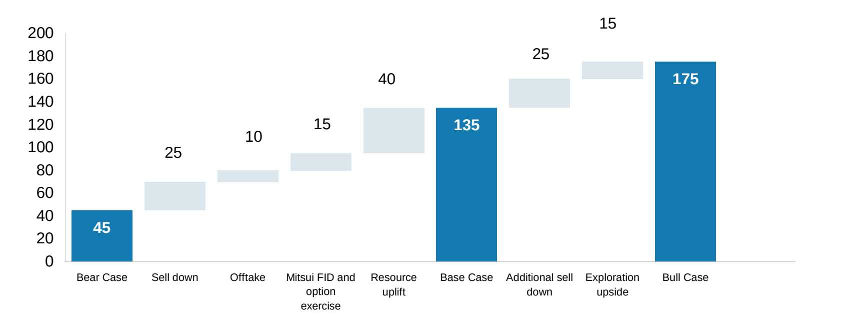
InterOil Corp. (IOC, $65, Overweight, Price Target $135)

Risk-Reward View: Positive Risk/Reward Skew



Price Target $135	Derived from our base case.
Bull Case $175 Assumes $85 oil price (perpetuity)	**Exploration Upside; new prospect - Triceratops** Full field development by 2017, **+**15Tcfe of resource at 2011YE; second phase of LNG and CSP trains announced; $6 per share for exploration, Assumes a 5% sell-down at $2 per mcfe. And, 35% discount to NAV.
Base Case $135 Assumes $85 oil price (perpetuity)	**Joint Venture Partnerships are Signed** Assumes a 5% sell-down at $2 per mcfe, Mitsui, Flex and EWC reach FID, Mitsui exercises 2x2.5% options, mid-point of GLJ resource range. And 45% discount to full field NAV (8mmtpa LNG, 1.7mtpa FLNG, CSPs).
Bear Case $45 Assumes $75 oil price	**Delay in FID, Resource Estimate Lower** Assumes no FID in 2011, no sell-down, a $75 oil price and low end of GLJ resource estimate, IOC exploration resource and stranded gas is valued at $40/sh and refinery $5/sh.

Bear to Bull



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?

- Trading at over a 70% discount to our NAV (NAV omits any value for exploration acreage) one of the widest discounts in energy. Project execution should close the discount to NAV with FID in 2H11 the next major milestone.
- Potential EBITDA generation of $1.2Bn in 2015 with plateau EBITDA (15+ year plateau) of ~+$2.5Bn per annum 2017+ on flat $85 oil price.
- One of the largest exploration land positions in PNG, one of the fastest emerging LNG hubs with attractive royalty regime. IOC has +40 indentified prospects, several with reefal indication, on its 3.9MM acres with over a decade of exploration experience in PNG.

Potential Catalysts/Key Value Drivers

- Signing HOAs for natural gas off-take(s) for gas production with oil-linkage. 2H11.
- FID of condensate facility with partner, Mitsui. 2H11. Expansion of Mitsui relationship and potential upstream options in connection with larger CSP (900mmcf/d vs. 400mmcf/d).
- FID of 3mmtpa land based LNG facility with partner, EWC. 2H11.
- FID of 2mmtpa FLNG with partner, FlexLNG and Samsung. 2H11.
- Spud the first exploration well since company-maker Antelope in 2H11 with results by YE. The well, Triceratops-2 has preliminary pre-drill resource estimate of filed of 4.6Tcfe “most likely.”
- Potential upstream sell-downs, (likely post-FID in 2012).

Where We Could Be Wrong

- **Continued delays in achieving LNG Project start-up.** IOC has limited cash flow. A failure to execute agreements on the various elements, condensate stripping, FLNG, and land based modular LNG is a risk.
- **Exploration failure.** IOC is proving its resource base and any exploration failure is a risk.
- **PNG risks**. 100% of IOC’s operating assets are located in PNG, an unexpected change in the political climate could have adverse effects for IOC.

Pieces Fall-ing into Place to Drive 2H11 Outperformance

Long and winding road: We believe much of IOC's stock price volatility since January 2010 can be attributed: (1) delay and change in IOC's natural gas and condensate development plans, (2) skepticism regarding the IOC's monetization decisions, and (3) lack of exploration catalysts. The stock's volatility has been amplified by market volatility, typical early-stage development variation, and the often-polarizing nature of this stock. We believe these elements will be largely addressed in 2H11 and IOC will breakout of its recent trading range that has been established since discovery of Antelope that established IOC's resource. *See* Exhibit 1.

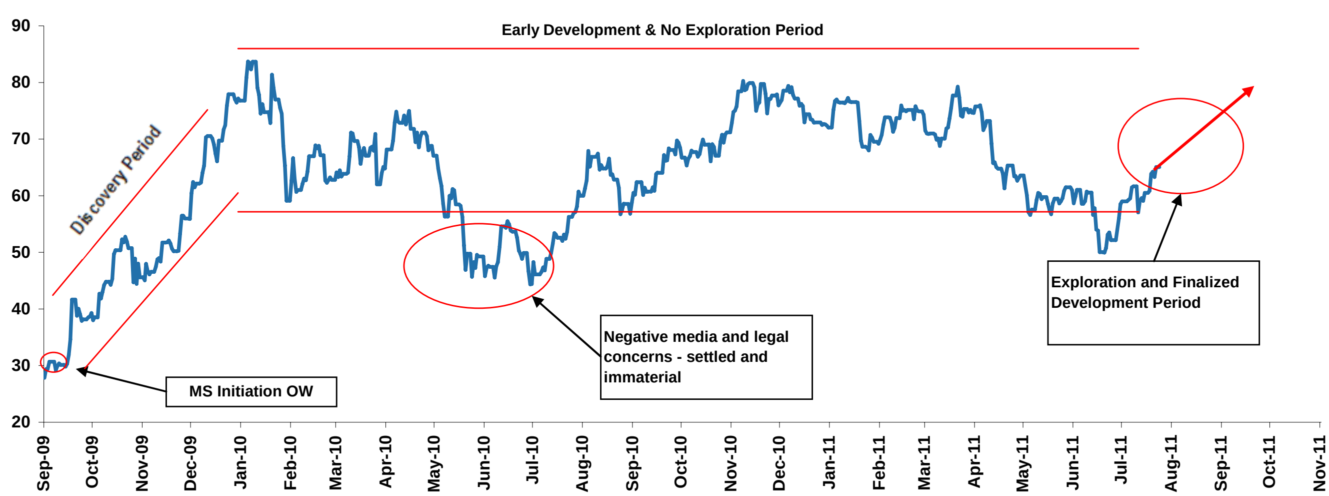
Mitsui's participation matters. Mitsui is one of the largest companies in Japan, involved in 8 LNG projects globally and is the epitome of a highly sophisticated partner. Mitsui entered the LNG liquefaction business in the 1970s when it acquired a 15% stake in the 5.5 mmtpa Abu Dhabi LNG Project. The company subsequently participated in the North West Shelf LNG Project in Australia (8.3%), the Qatargas 1 Project (7.5%), the Oman LNG Project (2.8%), the Tangguh LNG Project in Indonesia (2.3%), and the Qatargas 3 Project (1.5%). Mitsui's web-site description of its LNG business devotes almost 1/3 of the discussion to a single project in which it owns an 8.5% stake, the Equatorial Guinea LNG Project. This was MRO's project facilitated by Henry Aldorf, former President of Marathon International, and current President of Pacific LNG – IOC's partner. Since signing the JV, Mitsui has established an office in Singapore, with a dedicated project team, and conducted significant field and project due diligence. In January 2010, the Japan Ministry of Economy and Trade endorsed compact motor driven LNG plants in PNG (what IOC will develop with EWC). This is an important determination that allows Japanese consumers to enter into off-take on this type of LNG facility. We believe Mitsui reaching FID on the project is more meaningful than Wall Street's or a competitor's assessment of IOC's project in our view.

First agreement. Mitsui signed a preliminary works joint venture with IOC in April of 2010. Under this agreement, IOC and Mitsui jointly agreed to perform preliminary works and front-end engineering and design (FEED) for a 400mmcfd condensate stripping plant with anticipated yield of 9,000bbls of condensate a day with the gas re-injected into the reservoir. IOC and Mitsui financed FEED jointly (50/50) and if FID isn't reached IOC must refund Mitsui's capex.

Second agreement. On August 4, 2010, the relationship was expanded and IOC and Mitsui formed a JV to construct a 400mmcfd condensate plant whereby Mitsui would fully fund the plant's construction estimated at $550MM and when the two parties reached FID, Mitsui would get two options: (1) the option to convert the CSP into 2.5% of the Elk and Antelope field and LNG plant, and (2) an option to buy 2.5% of the Elk and Antelope field at the greater of $550MM or at the same price paid in a sell-down to a third party.

Exhibit 1

Long and Winding Road: About to Turn Higher



Source: Company data, Morgan Stanley Research

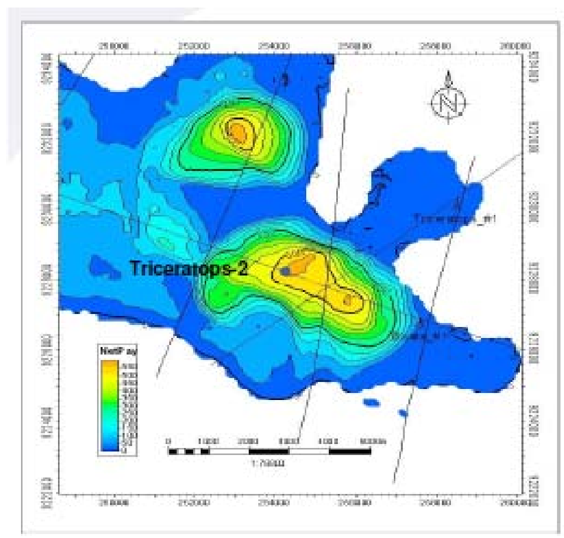
Likely third Mitsui agreement into FID. The upstream gas monetization method changed since IOC and Mitsui formed their JV. Rather than develop a traditional LNG facility to stream in 2016 and build the CSP earlier for 2014 start-up and re-inject the gas allowing for earlier cash flows associated with 9kbpd of condensate (oil) production, IOC has accelerated its LNG plans and increased capacity from 2/3 to 5tpa. This has impacts the IOC/Mitsui plant in two ways: (1) the size will likely be increased to handle 5tpa (from 2/3tpa) of gas which is ~900mmcf/d (vs. 400mmcfd), and (2) the gas is no longer re-injected, it with go to the 2 LNG plants (one onshore, one offshore). Since this facility will be larger and more costly, we would expect the Mitsui options to increase in size.

Exploration maters – Triceratops-2. IOC discovered 9.36Tcfe of gas equivalent resource through the drill-bit which helped drive the stock from the low $30s to mid-$80 in less than 4 months. IOC will commence drilling its next high-impact potential target Triceratops-2 in the Bwata field in 3Q11 with results expected by year-end. On preliminary third party assessment (Knowledge Reservoir), Bwata resource estimate is 4.595 TCFE of gas in place and appears to be as similar reefal build-up to Antelope (high at 7.1Tcfe and low at .877Tcfe). There was a well drilled in Bwata in 1959 by Shell (Bwata-1) which flowed gas and proved the reservoir is gas charged. There was a Triceratops-1 well drilled by IOC in 2005 that had oil and gas shows yet proved non-commercial and was plugged and abandoned. Triceratops-1 was drilled on one line of seismic drilled Puri limestone. Exploration risks exists yet success could meaningfully add to our $225/share NAV.

What's next? Forecasting the timing of events for IOC and its project has been challenging as the project scope, complexity and monetization path has changed and certain events have taken longer than originally forecasted. However, there is a significant "prize" at stake that is much more important than the path. We believe that we are within 6 months of having a final and committed LNG project that will begin to generate significant cash flows in 2014. There are four parties that need to be in a position to reach FID, one of the most significant project milestones: IOC, EWC, FlexLNG and Mitsui. Each of the four parties has clear responsibilities and we expect the three project FIDs: the CSP (Mitsui), land-based LNG plant (EWC) and the FLNG vessel (FlexLNG/Samsung) will have simultaneous FIDs as they are physically integrated. The company guided to FID by year-end 2011. We see the recent approval by the Board on June 21, 2011 to expend $100MM for condensate and processed gas line pipe, infrastructure and other long-lead items as tacit acknowledgement that FID is close. IOC had been conservative with its $232MM cash position with limited exploration and spending and, in our view, this spending approval represents a marked and incremental change. We expect some gas off-take agreements before FID and any upstream interest sell-down likely post project FID will command a higher price per mcfe.

Exhibit 2

Triceratops-2: IOC's Next Exploration Catalyst



Source: Company data, Morgan Stanley Research

Primary risks: (1) project delays and failure to reach FID by year-end per Street expectations, (2) single country risk with 100% of company assets in Papua New Guinea, (3) pre-production, development stage E&P company subject to volatility.

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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Not-Rated/Hold	**117**	**4%**	**19**	**2%**	**16%**
Underweight/Sell	**389**	**14%**	**96**	**10%**	**25%**
Total	**2,787**		**950**		

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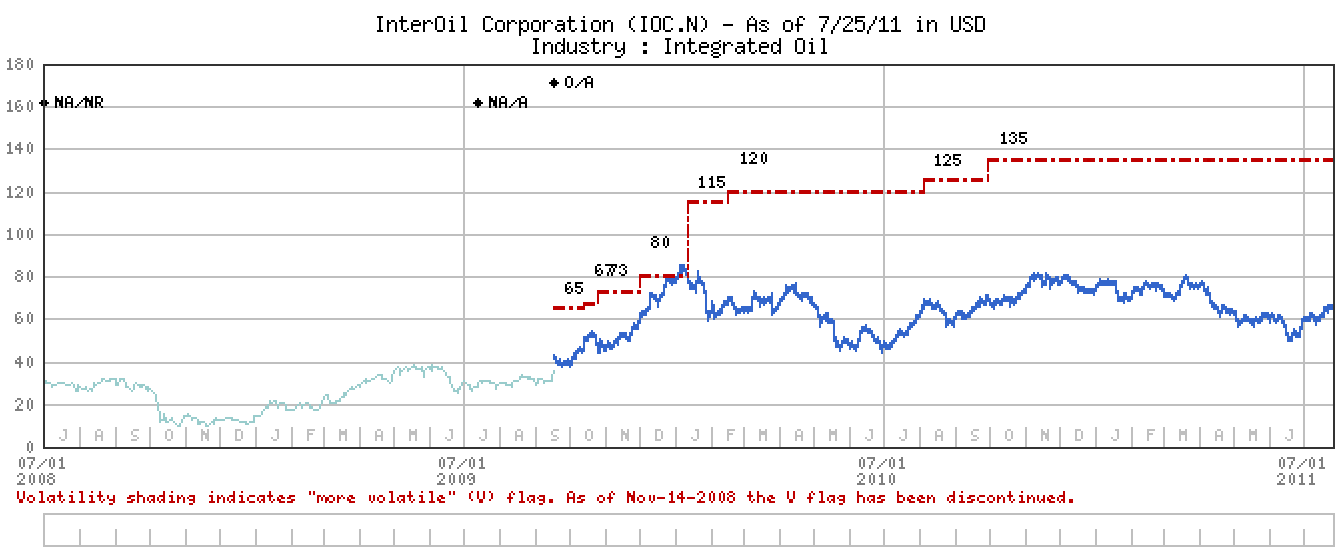
Stock Price, Price Target and Rating History (See Rating Definitions)



Stock Rating History: 7/1/08 : NA/NR; 7/14/09 : NA/A; 9/18/09 : O/A

Price Target History: 9/18/09 : 65; 10/14/09 : 67; 10/26/09 : 73; 12/1/09 : 80; 1/11/10 : 115; 2/16/10 : 120; 8/4/10 : 125; 9/30/10 : 135

Source: Morgan Stanley Research   Date Format : MM/DD/YY   Price Target   No Price Target Assigned (NA)
Stock Price (Not Covered by Current Analyst)   Stock Price (Covered by Current Analyst)
Stock and Industry Ratings (abbreviations below) appear as ◆ Stock Rating/Industry View
Stock Ratings: Overweight (O) Equal-weight (E) Underweight (U) Not-Rated (NR) More Volatile (V) No Rating Available (NA)
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Industry Coverage:Integrated Oil

Company (Ticker)	Rating (as of)	Price* (07/22/2011)
Evan Calio		
Chevron Corporation (CVX.N)	O (07/14/2009)	$108.97
Cobalt International Energy Inc (CIE.N)	O (12/02/2010)	$14.78
ConocoPhillips (COP.N)	U (10/01/2010)	$75.26
Exxon Mobil Corporation (XOM.N)	E (07/14/2009)	$85.22
Hess Corporation (HES.N)	O (05/06/2011)	$74.37
InterOil Corporation (IOC.N)	O (09/18/2009)	$65.04
Marathon Oil Corporation (MRO.N)	E (07/08/2011)	$32.01
Murphy Oil Corporation (MUR.N)	O (07/23/2010)	$69.71
Occidental Petroleum (OXY.N)	E (01/25/2011)	$107.88

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* Historical prices are not split adjusted.