RAB Special Situations Company Limited

Key Facts

AIM quoted
Ticker: RSS.L

Company Information

Shares in issue: 64,665,000*
Denomination: GBP
Admission date: 31 May 2005
Year end: 31 December

**Voting shares in issue, excludes shares held in treasury*

Share Price (as at 15/08/12)

26.50 p

Manager

RAB Capital

Administrator & Company Secretary

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Investment Commentary

In July 2012 the NAV of the RAB Special Situations Company (the "Company") returned -10.7% bringing the year to date NAV performance to -2.0%; for the last 6 months the Company returned -8.6% and -7.5% over the last 12 months. In July 2012, the RAB Special Situations Fund declined -11.3% ($ Class). This compares with the Bloomberg World Mining Index, which was down -2.7%. For the year the Fund was down -1.7%, compared to -8.9% for the Bloomberg World Mining Index, -16.7% for the GDX and -4.1% for the SXPP. This was a particularly negative month for us as Borders & Southern ("Borders") had to abandon a drill hole before hitting its target. The Fund lost some money on Borders, but the main effect was a loss of confidence in Falkland Oil & Gas ("FOGL"), which has since recovered in August. More detail on FOGL is given below.

July was a relatively quiet month as far as the markets were concerned, with the main news flow yet again coming out of Europe. At the Global Investment Conference in London on July 26, European Central Bank President Mario Draghi excited investors by saying: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." The markets were happily surprised because Draghi's remarks suggested that the ECB's governing council – which includes six members of the Executive Board and the governors of the 17 euro zone central banks – would vote to restart the central bank's program of buying government bonds of debt-challenged euro zone members like Spain and Italy. Draghi's comments were no doubt also a surprise to the German Central Bank, with the Bundesbank reiterating its position on Friday that bond purchases were against the spirit of the ECB's statutes. However markets seemed to ignore this and were therefore slightly disappointed when Draghi announced a week later that there would be no immediate action by the ECB, with the responses in the follow-up Q&A session focusing more on price stability rather than growth.

The US took a similar stance, with the Federal Open Market Committee ("FOMC") stating that they would "closely monitor" economic and financial developments and provide additional assistance only "as needed" rather than actually do anything now. After the FOMC's announcement, Labor Department data indicated that employment in the US increased by 163,000 payrolls in July, significantly more than the 100,000 forecast. The increase, helped by a pickup at automakers and health-care providers, followed a revised 64,000 June advance. This data is reasonably consistent with moderate growth, but the jobless rate, based on a separate survey of households, climbed to 8.3%, and has been over 8% since February 2009, so there is still work to be done. *(Continued on next page)*

Portfolio - Top 5 Holdings

Top 5 Holdings		Gross Assets (%)
1	Falkland Oil & Gas	30.6
2	Goviex Uranium	5.7
3	African Minerals	4.5
4	Royal Nickel	4.2
5	Beximco Pharma	3.9
	Top 5 holdings represent	**48.9**

Sector Split

	Sector	(%)
1	Oil & Gas	45.7
2	Ind. Base Metals	17.0
3	Coal/Uranium	10.3
4	Gold & P. Metal	12.7
5	Biotech	4.2
6	Agriculture	4.2
7	Technology	1.4
8	Consumer	1.5
9	Other	1.3
10	Clean Tech/Energy	1.4
11	Real Estate	1.0
		100.7

Investment Commentary *(Cont'd)*

During July, the Fund was relatively inactive in the market, with the manager deciding to clear a couple of the smaller, non-core positions in order to free up cash, but otherwise the only significant market activity that the Fund participated in was to purchase additional shares in Royal Nickel.

The main contributors to the Fund's performance were Wildhorse Energy, Madagascar Oil, FOGL and Borders. Wildhorse Energy saw a positive reaction to its announcement of an agreement with the Hungarian Government to work towards the implementation of underground coal gasification ("UCG") technology in Hungary. To progress this, the company will work with the Geological Institute of Hungary and the University of Miskolc to formalise the legislative and regulatory framework to facilitate the development of UCG projects in the country. Management also highlighted that the bankable feasibility study is underway and they are holding initial discussions with potential strategic partners to fund its completion and the construction of the project.

Nickel: The recent correction to $6.90/lb has brought nickel prices down to the 70th percentile of the cash cost curve, below what is viewed as sustainable cost support levels at about the 90th percentile of the curve. Meanwhile, input cost inflation and a weak US dollar continue to put upward pressure on operating costs. At current nickel prices, producers with costs at the 40th percentile or above are losing money on a full cost basis. The historical inventory and price relationship, based in part on the cost to produce nickel pig iron in blast furnaces, suggests the nickel fundamental price support of approximately $9/lb. As a result, further downside risk should be limited.

We believe the medium to long term risk/reward in nickel is attractive at current prices. With Indonesia recently cracking down on exports of raw materials, medium term risks to laterite nickel ore supply have increased significantly. Indonesian laterite ores have contributed to c.50% of the growth in Chinese recoverable nickel imports since 2007. As such, developments in Indonesia and their impact on the Chinese market in particular will need to be watched closely over the coming months. In the scenario where nickel exports from Indonesia decline to 2010 levels in H2 2012 – broadly in line with government statements to date – we are likely to see a slow but significant tightening in the ore market over the next 6-12 months.

The long term outlook for nickel is positive, underpinned by stainless steel demand driven by economic growth and urbanisation rates in emerging economies. It is worth noting that as an economy such as China's develops, demand moves from more basic materials like carbon steel to stainless steels and ultimately into specialty alloys that require a lot of nickel, and this will drive non-stainless nickel consumption in China. China has been the main driver of global nickel demand growth for the past 10 years (with trend growth of +21.9% and +23.1% for the last 5 and 10 years respectively) and remains the key to our positive outlook for nickel with consensus forecast growth of +9.7% in 2012, reaccelerating to 19.3% in 2013 and 2014. At 0.4kg per capita, China's current nickel consumption is still less than half of that of the industrial economies of Western Europe and Japan. Estimates suggest that at Japanese and German per capita consumption levels, Chinese nickel demand could increase by 1 million tonnes per annum by 2020. Going forward increased nickel mine supply is expected to come from a small number of large projects, and based on the current set of projects under construction, this will only provide for 500,000 tonnes by 2020. The effect of technological failure or delay at any one of these projects could easily exacerbate the overall supply/demand balance in the long term.

Royal Nickel gives the Fund exposure to a truly world class nickel project.

Focus on FOGL

In light of the spudding of the Loligo well on 3rd August, we felt it would be useful to provide a more detailed update on the recent events in relation to the largest position in the Fund, Falkland Oil and Gas, and the significant catalysts occurring in the coming months.

The drilling campaign in the South Falklands Basin began on 31st January with the announcement by Borders and Southern that they had commenced drilling of the Darwin East prospect. It is worth highlighting at this point that while they hold some adjacent acreage, Borders and FOGL have no cross shareholding at the corporate level or in any of their assets, even though the share prices have sometimes moved together on sentiment. Due to some issues with the rig this well took significantly longer than predicted but the result, a gas condensate discovery, was announced on 23rd April. The market responded negatively to the news of gas but importantly it confirmed "a working source rock, good quality reservoir and competent seals" in the basin. We anticipate the results of the laboratory tests on the samples taken from the well by the end of August, crucially these will confirm the condensate proportion and thus significantly impact commerciality.

Darwin was followed by the Stebbing well which was unfortunately plugged and abandoned in mid-July without reaching the lower target. While gas shows were seen in the upper target it consisted of thin bedded siltstones and claystones and was considered unlikely to be commercial. However as drilling continued to the main lower target the pressure conditions necessitated the use of additional casing strings which eventually led to the decision that progress could not be continued without jeopardising well integrity. This news led to a 75% fall in the price of Borders within a few days and saw FOGL fall by 22% despite its lack of a direct interest in the acreage and its independent targets.

At the end of July the rig was assigned to FOGL for its two well campaign. The first to be drilled is the Loligo Tertiary channel play, with a 4.7bn boe resource potential, which spudded on 3rd August. When addressing concerns over the pressure issues experienced by Borders, FOGL CEO, Tim Bushell, has highlighted that the geological setting is entirely different with the stratigraphic nature of Loligo being more geologically benign than the foldbelt targeted at Stebbing. It is worth noting that should the results of Loligo be encouraging there is further prospectivity in the form of the geologically similar Nimrod target with its 1.5bn boe potential. The current intention is for the second well in the campaign to be the Scotia prospect, targeting a potential resource of 1.1bn boe in a mid-Cretaceous fan play. The reasoning behind selecting Scotia is that this will test an entirely different play type, one which has seen recent success offshore West Africa and French Guiana. Thus once the Leiv Eriksson rig leaves the Falkland Islands, in combination with Borders, four separate play types will have been tested (Foldbelt, Springhill, Tertiary channel and mid-Cretaceous fan). If all proceeds according to plan then we would expect to see Scotia spud in mid-October.

On the corporate front FOGL has also been busy agreeing two separate farm-in deals with large, respected industry partners:

26th June – Edison S.p.A., whose controlling shareholder is EDF (who in turn is majority owned by the French state), exercised an option which they had purchased for $3m in March in order to take a 25% interest in the northern licences and 12.5% of the southern licences (in light of the Darwin well results FOGL elected to reduce this from 25%). In consideration FOGL will receive a $40m fee as well as Edison contributing its pro-rata portion of back costs and the 2012 drilling programme which is estimated at $50m.

6th August – Noble Energy, a leading US independent E&P company, farmed in to take a 35% interest in the Northern and Southern acreage, excluding the area around Loligo and Nimrod. By way of consideration Noble will pay $25m in cash, 60% of two firm wells (including Scotia) and 45% of a discretionary third well. FOGL estimates this represents a commitment on Noble's part to spend between $180m - $230m over three years.

The results of this activity over the past few months should not be underestimated, in our view they represent a material improvement in FOGL's situation for a number of reasons:

- Should both of the wells drilled in 2012 come in on budget it is estimated that the company will have approximately $212m in cash. On a per share basis this would equate to ~42p thus providing a level of underpinning to the share price even if the two wells provide no encouragement.
- The result of sharing the costs of these wells, as well as the cash payments made to FOGL, is that management estimates they will now be fully funded not only through the 2012 campaign but also for two large 3D seismic surveys and three further wells. To this end, management are apparently already looking into contracting a seismic vessel for a programme this year and rig availability for a potential drilling campaign in H2 2014.
- Both Edison (~50k boe production per day and reserves of 360 million boe) and Noble (~73k boe production per day, 1.2bn boe in reserves), with their exploration experience in deepwater Gulf of Mexico, West Africa and the Eastern Mediterranean, bring both a depth of technical expertise and third party industry validation. It is worth noting as well that both groups have sufficient financial standing that should an accelerated or expanded work programme be desirable this will not be hampered by FOGL's partners inability to fund their portion.
- A final point is the potential ramifications on the political situation regarding the increasingly aggressive statements by Argentina's President Christina Kirchner. While these have always been met by a staunch UK government defence based on both historical facts and the right of self determination we now see the involvement of an Italian firm controlled by EDF (of whom the French state owns 84%) and a significant US firm. Whilst we clearly cannot be sure of the discussions that have taken place it would appear reasonable that the respective national governments of these companies would have been consulted to some degree. This would only seem to bolster the position of the Falkland Islanders who seek simply to determine their own government. To this end they have announced their intention to hold a referendum in the first half of 2013 in the hope that the result will be respected under the right to self determination as enunciated in the UN Charter.

Thus, whilst one should always be aware of the fact that this is frontier exploration with all of the significant risks that it entails, if we compare the current situation of FOGL to that at the beginning of the year, the Darwin well (funded by Borders) has provided encouragement in relation to the hydrocarbon system in the Southern basin, the Loligo well has been spudded targeting a potential resource of 4.7bn boe and two partners with significant, complimentary technical expertise have farmed into the acreage. In addition, the deals struck have left the company in a cash position that should provide an element of downside protection as well as the flexibility not have to seek further funding at depressed levels in the event of poor or ambiguous well results and to aggressively pursue 3D seismic and further wells if the results provide encouragement.

Conclusion

At the time of writing the Fund has recovered nearly all the losses of July as the market has renewed confidence in FOGL, as at the 9th of August, the Fund is up an estimated +9.3% ($ Class). We share that confidence and anticipate the first newsflow in early September. And across the portfolio many of our investments are continuing to develop their assets despite this not being reflected in valuations by the market, which remains bearish. We look forward to an exciting last four months of the year and thank our investors for remaining invested with us.

Philip Richards and Team

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