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Canadian Spirit Resources (SPI – TSX)

Recommendation: Buy

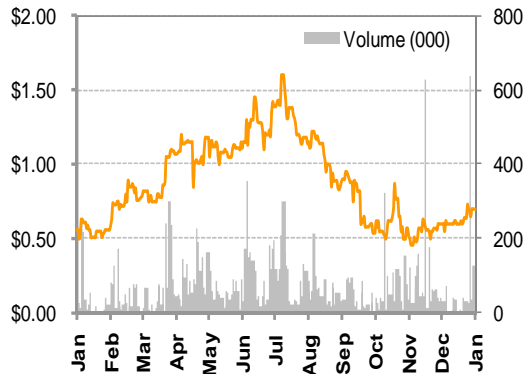
Industry activity validates both shallow and deep gas

Target Price: \$1.50

Company Update	Shares O/S (000)	48,675
Target Price	\$1.50	FD Shares (000) 57,899
Current Price	\$0.70	Insider Holdings 3%
Potential Return	114%	Market Cap. (\$000) \$34,073
52 Wk High	\$1.60	Work. Cap.(\$000) <u>\$12,411</u>
52 Wk Low	\$0.35	EV (\$000) <u>\$21,662</u>

Summary

- Recent activity by competitors in the Farrell Creek area of Northeast B.C. validate what Canadian Spirit Resources is doing, both in the shallow Gething formation and the deeper Montney formation.
- South of Farrell Creek, Canada Energy Partners (CE-V) and Geomet (GMET - NASDAQ) have tied their first wells in to the Spectra Energy pipeline, which runs right through the property, and are now producing coal bed methane from the Gething. Canadian Spirit's own pilot project is expected to be on production by the end of March.
- North of Canadian Spirit's land at Farrell Creek, Talisman Energy is planning a full-scale, multi-billion development of Montney gas. Talisman has drilled one very prolific vertical well and is now drilling its first horizontal well, and is sufficiently encouraged by its early results to commit to a ten-year development program with first gas later this year.
- Canadian Spirit has farmed its shallow rights out to Shell Canada and its deep rights out to privately owned Canbriam Energy in return for capital commitments of \$50 million and \$29 million respectively. It has a potential 400 bcf of net gas reserves in the Gething and potentially that much again in the Montney.
- Our low case estimate of the net present value of CSRI's Gething reserves alone is \$2.65. That could be much higher with a higher recovery rate and more productive wells, and any success in the Montney would be incremental.



Source: Bloomberg

Price Assumptions	2007a	2008e	2009e
WTI Crude Oil (US\$/bbl)	\$72.36	\$99.73	\$62.50
NYMEX gas (US\$/mcf)	\$6.65	\$7.72	\$6.98
USD/CAD	\$0.931	\$0.943	\$0.835

Production	2007a	2008e	2009e
Crude oil & Liquids (bbls/d)	-	-	-
Natural Gas (mcf/d)	-	-	300
Total Production (boe/d)	-	-	50
Production/MM Basic shares	n/a	n/a	n/a
Oil Weighting	n/a	n/a	n/a
Growth	n/a	n/a	n/a

Financial	2007a	2008e	2009e
Net Income (\$000)	(\$876)	(\$1,097)	\$151
Cash Flow (\$000)	(\$1,015)	(\$895)	\$258
CFPS (\$/basic share)	(\$0.02)	(\$0.02)	\$0.01

Valuation	2007a	2008e	2009e
P/CF (Basic)	n/a	n/a	n/a
EV/DACF	n/a	n/a	n/a
EV/BOED	n/a	n/a	n/a
D/CF	n/a	n/a	n/a

Company Profile:

Canadian Spirit Resources is a junior producer with a focus on unconventional gas in Northeast B.C.

All figures in Canadian dollars unless otherwise noted.

Near-term Activity

There are several inflection points that could help propel CSRI's share price higher:

- Shell is now constructing a gathering system that will allow it to tie-in seven Gething wells at an expected 1 mmcf/d (net 25% to CSRI) by the end of March. It won't generate a meaningful amount of cash flow but after seven years of exploration and development, first production will be symbolic for Canadian Spirit.
- Tying in the first seven wells will satisfy Shell's Phase 1 commitment to Canadian Spirit but it could elect to proceed to a second phase as early as the third quarter. That would entail another \$50 million in capital spending and pooling of Shell's large land position with CSRI's large land position.
- Canbriam has drilled two Montney tests on CSRI's 'East Block' at a cost of about \$10 million. It expects to continue drilling on the 'West Block' after break-up — probably late June or July — and may emulate Talisman's technical approach. Success in either of those wells would be good news for Canadian Spirit.



Farrell Creek Refresher

Canadian Spirit owns 50 sections of shallow rights at Farrell Creek. Its focus has been on the shallow Moosebar Gates and Gething formations where Sproule Associates recognizes a combined 1.8 trillion cubic feet of natural gas resources. CSRI has drilled and tested several vertical wells on its property but does not yet have them on production. It is now building a gas gathering system and preparing to tie-in to the Spectra operated trunk line which runs right through the block. Because of the tight nature of the reservoir rock - a combination of sands, shales and coals - vertical wells are expected to produce only 100 - 500 mcf/d.

CSRI also owns 45 sections of deep rights which are prospective in the Halfway, Montney and Debolt formations and of course there has been an enormous amount of Montney activity elsewhere in B.C. in the past twelve months, plus some very large prices paid for land acquisition. The Montney is especially attractive because there is a potential 100 bcf of gas in place per section, trapped in shales, but it is much more expensive to drill.

For more detail on this area, please see our report (Shale Gas Pioneer Attracting Serious Partners) dated July 17, 2008.

Last July CSRI entered into a \$50 million joint venture agreement with Shell Canada to develop the Gething formation. As part of that commitment, Shell purchased another 95 sections of shallow rights surrounding CSRI's existing acreage. It has since drilled several more wells on the property and now has the option to proceed with a second phase of the joint venture which would require it to spend another \$50 million and pool its land with the CSRI acreage, leaving CSRI with a 25% working interest in a combined 145 sections of land.

CSRI had previously entered into a \$29 million joint venture with a private company called Canbriam Energy to evaluate the potential of the Montney. Canbriam is also involved with Northpoint Energy on land just north of Farrell Creek and has entered into a similar transaction with Gastem in the St. Lawrence Lowlands of Quebec. Last summer Canbriam drilled two wells on CSRI's 'East Block' in order to preserve title to the lands, and will drill two more on the 'West Block' later this year. Upon completion of its commitment, Canbriam will have earned a 65% interest in the deep rights, leaving CSRI with 35%. Canbriam can elect to spend additional capital to increase its working interest to 70%.

Recent Developments

- Canada Energy Partners has also been developing shallow gas in the Gething formation on a large block south of CSRI's Farrell Creek acreage. They recently tied their first wells in to the Spectra mainline. CEP's 50% partner is a U.S. company called Geomet which specializes in coal bed methane so it is taking a slightly different approach, completing their wells only in the coals and consequently producing at very low initial rates.
- On December 10, 2008 representatives of Talisman Energy met with the citizens of Hudson Hope, B.C. to outline their plan to spend \$7.5 billion at Farrell Creek, just north of the town, over a period of ten years. Talisman has drilled what may be the best vertical Montney well yet drilled in B.C. at 4 mmcf/d, and has now licensed three horizontal wells to be drilled from the same location. Talisman's acreage is immediately north and east of Canadian Spirit's large block of land. Although CSRI has drilled only two Montney wells on its own acreage, with somewhat disappointing results, Talisman's success and its commitment to the project are independent validation of the potential of the Montney in the area.
- The Province of British Columbia collected \$2.7 billion in land sale revenue last year, driven largely by the scramble to secure acreage that is prospective for natural gas in the Montney. Industry paid as much as \$33,500/hectare for several large blocks at Saturn or Ground-birch in May and July. In November an anonymous purchaser — believed to be Talisman Energy — paid \$106 million for four licenses in the Farrell Creek and Altares areas, immediately north and east of Talisman's discovery well.
- Canada Energy Partners has farmed out its deep rights to Crew Energy and West Energy.

Financial

Having entered into the two joint venture agreements, Canadian Spirit has no significant capital requirements in the near future. It has no debt and approximately \$11.6 million (or \$0.24/share) in cash in the bank. It also has \$47 million in tax pools available to shelter future income.

Although we expect Canadian Spirit to have first production and cash flow in 2009, normal valuation measures such as price / cash flow do not really apply. The attraction is the large natural gas resource so a better measure is net asset value. In our July, 2008 report we calculated a net asset value of \$4.32/share assuming that Shell undertook a full-scale development program in 2009 but Shell is moving at a steady, methodical pace so we may have been optimistic about the pace of development.

Our original \$3.00 target price for Canadian Spirit was based on some assumptions about recovery rates and well productivity— both unknowns at this point. We subsequently reduced our target to \$1.50 just reflecting current market conditions, but we believe the long-term value is much higher. New modeling, based on GLJ's January 1st price deck, suggests that the net present value of the Gething reserves alone could range from \$2.65/share (10% recovery factor & 100 mcf/d) to \$12.25 (40% recovery factor & 500 mcf/d).

The Montney could add significantly more value, but we would consider that to be a bonus.

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Return Rating	Rating Description	Distribution
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