Energy

# Canadian Spirit Resources Inc. (SPI-V, $1.38)

**Recommendation: Strong Buy**

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WELLINGTON WEST Capital Markets Inc.

*April 7, 2011*

***All values in C$ unless otherwise noted.***

| | |
|---|---|
| Current Price (intra-day) | $1.38 |
| Target Price (12-Month) | $2.25 |
| Target Return | 63% |

***Changes***

| | Old | New |
|---|---|---|
| Production boe/d '11E | 671 | Unch. |
| CFPS (FD) '11E | $0.00 | Unch. |
| Production boe/d '12E | 1,750 | Unch. |
| CFPS (FD) '12E | $0.09 | Unch. |
| Recommendation | Strong Buy | Unch. |
| Target Price | $2.25 | Unch. |

***Company Profile***

Canadian Spirit (SPI) is a Calgary-based junior natural gas company with extensive Montney & Gething rights in the Farrell Creek area of N.E. British Columbia. An updated independent valuation by Sproule Unconventional Limited estimates SPI's Farrell Creek lands (29.4 sections at year-end 2010) contain TPIIP of 5.0 Tcf to 10.9 Tcf in the Montney alone. In total, SPI owns interest in ~34.4 net sections (48% WI) including 53 sections (16.5 net) in the Canbriam JV.

## *Resource Update Increases Farrell Creek TPIIP by 40% YoY From 3.6 Tcf to 5.0 Tcf; Strong Buy*

- **TPIIP* increased by 40% YoY to 5 Tcf in Upper Montney alone**
  Sproule's updated TPIIP of 5.0 Tcf (v. 3.6 Tcf prior), based on a 6% porosity cut-off, doubles to 10.9 Tcf including L. Montney at 3% cut off .

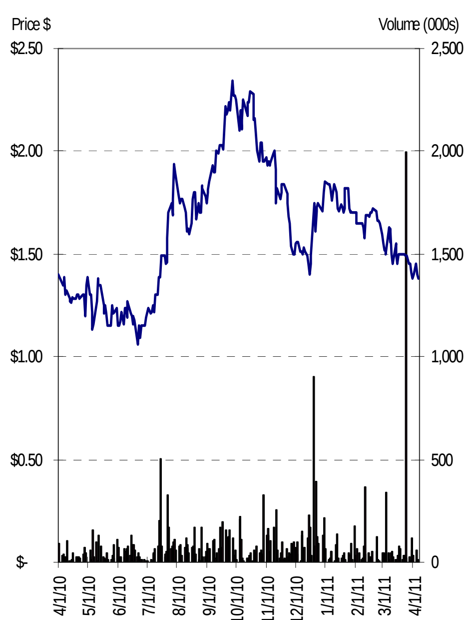
- **Recoverable resource estimate substantiates our 25% recovery factor**
  Best estimate (P50) recovery factor of ~23% yields 408 Bcf from Upper Montney alone; applying 25% R.F. to low-end of TPIIP implies 645 Bcf.

- **Reserve report expected by May 2011**
  Contributing to reserves will be 3 Montney hztl wells (1 Upper & 2 Lower),which came on-stream in early Q1; we model EUR of 7 Bcf/well.

- **Montney development supports $2.25 target at $4/mcf gas pricing**
  Farrell Creek Montney project yields $NPV_{10\%}$ of $2.20/sh based on $4.16/mcf AECO; which jumps to +$5.50/share at $5/mcf gas pricing.

** Total Petroleum Initially in Place – using a 3% porosity cut-off Sproule more than doubles the TPIIP to 10.9 Tcf, which includes Lower Montney potential.*

### Price Chart




Source: Thomson One

### Financial Summary

| | | | |
|---|---|---|---|
| Shares O/S (M) | 75.3 | 52-Week Trading Range | $1.06 - $2.34 |
| Market Capitalization (M) | $104 | Average Weekly Volume | 382,478 |
| Net Debt - 2011E (M) | $3 | Market Float (M) | $102 |
| Enterprise Value (M) | $107 | NAV/Share - 2011E | $0.91 |

| **Forecasts** | **2009** | **2010E** | **2011E** | **2012E** |
|---|---|---|---|---|
| Production (BOE/d) | - | - | 671 | 1,750 |
| % Gas | - | - | 100% | 100% |
| Oil Price (US$/bbl - WTI) | $61.99 | $79.46 | $88.00 | $89.00 |
| Gas Price ($/mcf - wellhead) | $3.99 | $4.39 | $4.37 | $4.98 |
| Revenues (M) | $0 | $0 | $6 | $19 |
| Cash Flow (M) | ($2) | ($2) | $1 | $8 |
| Debt/CF | 5.9x | 13.1x | 5.2x | 3.5x |
| CFPS (FD, incl. cap. G&A) | ($0.04) | ($0.04) | ($0.00) | $0.09 |
| EPS (FD) | ($0.04) | ($0.03) | ($0.04) | ($0.04) |

| **Valuation** | **2010E** | **2011E** | **2012E** |
|---|---|---|---|
| EV/DACF | n/m | n/m | 18.6x |
| EV/BOE/d (per unit production) | n/m | $158,933 | $60,924 |
| EV/BOE (per unit proven reserves) | $58.02 | $16.65 | $8.65 |
| P/E | n/m | n/m | n/m |
| Target EV/DACF | n/m | n/m | 28.0x |

Source: WWCM, Company Reports

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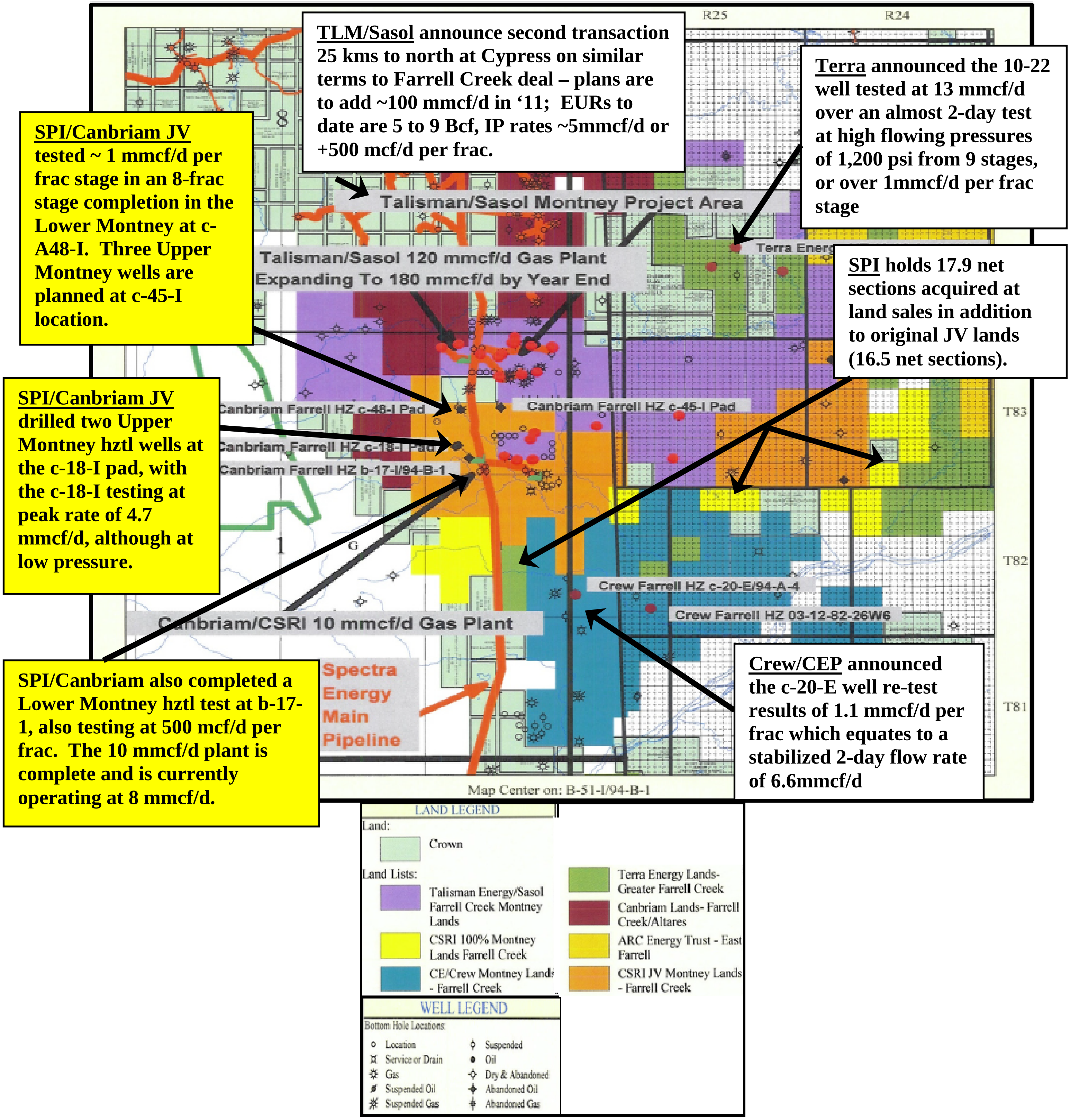
**Exhibit 1: SPI's Lands are Close to Infrastructure (JV has Secured 50 mmcf/d Firm Transportation Capacity on Spectra's Main-line) & are Immediately Adjacent to Talisman/Sasol's Farrell Creek Acreage**

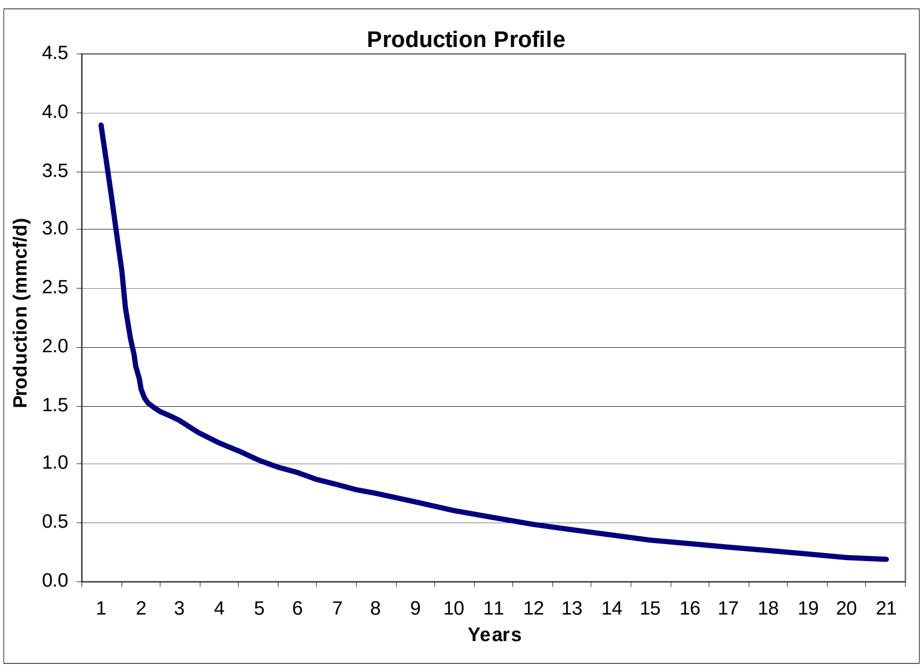



Source: Company Reports, WWCM

### Exhibit 2: Talisman (TLM-T) Re-confirms Type-well of 7 Bcf in Recent Corporate presentation Update, Driving an IRR of 23% at $4.16/mcf AECO

**Farrell Creek - Economics of Montney Type Horizontal Gas Wells**

| | | Type Well | Conversion boe @ 6:1 |
|---|---|---|---|
| ***Well Parameters:*** | | | |
| Well Cost - Drill, Complete & Tie-in ($mm)* | | **$7.5** | |
| Initial Production Rate (mmcf/d) | | **6.0** | 1000 |
| Reserves per spacing unit (Bcf) | | **7.0** | 1.16 |
| Reserve Life Index (years) - 1st year exit production | | 9.1 | |
| ***Financial Parameters:*** | AECO | Wellhead | |
| Wellhead Price (CDN $/mcfe) - + 5% AECO heat content | **$4.16** | **$4.37** | $26.21 |
| Royalty Rate (%) | | **10.4%** | |
| OpX & Transpo Expense ($/mcf) - CSI's 10 mmcf/d plant | | **$1.15** | $6.90 |
| G&A Expense ($/mcf) | | **$0.15** | $0.90 |
| Leverage ($/mcf) | | **$0.00** | |
| Initial Leverage (% of cost) | | 0% | |
| Interest Rate (%) | | **6%** | |
| Tax Rate (%) | | **31%** | |
| PV Discount Rate | | **10%** | |
| ***Result:*** | | | |
| Finding and Development Costs ($/mcf) | | $1.08 | **$6.46** |
| 1st Year Production Add Costs ($/mcf) | | $1,852 | $11,111 |
| Recycle Ratio | | 2.9x | |
| P/I Ratio | | 1.5x | |
| NPV Per Well | | **$3.6** | |
| **Internal Rate of Return (IRR)** | | **23.5%** | |




**Internal Rate of Return (IRR) Sensitivities**

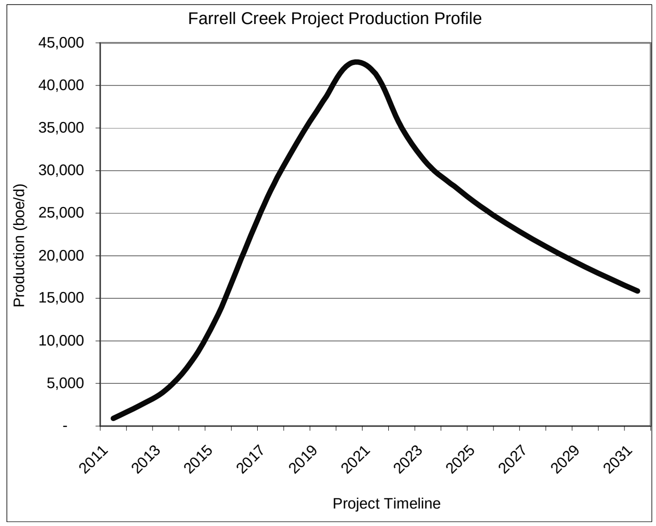
| IRR | | Gas Price (CDN $/mcf) | | | |
|---|---|---|---|---|---|
| | | **$3.50** | **$4.37** | **$6.00** | **$8.00** |
| **Well** | **$6.0** | 19% | 35% | 71% | 117% |
| **Cost** | **$7.5** | 11% | 24% | 50% | 86% |
| **($mm)** | **$8.0** | 9% | 21% | 45% | 78% |
| | **$9.0** | 7% | 16% | 37% | 66% |

Source: Company Reports, WWCM

## Exhibit 3: Project Model With Less Aggressive CapX Program Near-term Yields Project IRR of ~15% at $4.16/mcf AECO

### Farrell Creek - Potential Economics of Long-term Development

| | Type Well | Conversion boe @ 6:1 |
|---|---|---|
| ***Well Parameters:*** | | |
| Well Cost - Drill, Complete & Tie-in ($mm) | $7.5 | |
| Initial Production Rate (mmcf/d) | 6.0 | 1000 |
| Reserves (Bcf) | 1,028 | 171 |
| Reserve Life Index (years) - Life of Project Average | 7.7 | |
| Average Success Rate | **100%** | |
| ***Financial Parameters:*** | | |
| Wellhead Price (CDN $/boe) - + 5% AECO heat content | $4.37 | $26.21 |
| Royalty Rate (%) | 10.4% | |
| OpX & Transpo Expense ($/mcf) - own 10 mmcf/d plant | $1.15 | $6.90 |
| G&A Expense ($/mcf) | $0.15 | $0.90 |
| Leverage ($/mcf) | $0.00 | $0.00 |
| Interest Rate (%) | 6% | |
| Tax Rate (%) | 31% | |
| PV Discount Rate | 10% | |
| ***Result:*** | | |
| F&D Costs ($/mcf) - Life of Project | $2.00 | $12.02 |
| Recycle Ratio | 1.3x | |
| **NPV per share** | **$2.20** | |
| **Internal Rate of Return (IRR)** | **15.3%** | |




### Development Scenario

| Year | Net Wells | Start Prod. | Decline Rate | Ending Prod. | Average Production mmcf/d | boe/d | Revenues | Royalties | OpX | G&A | Cash Flow | Capital* | Unlevered Cash Flow | PV CF |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2010 | and prior | | | | | | | | Estimated Net Sunk Capital => | | | *35* | $(35) | |
| 2011 | **2.8** | - | n/a | 11 | 5 | 900 | $9 | $1 | $2 | $0 | $5 | $21 | $(15) | $(13) |
| 2012 | **3.8** | 10.8 | 46% | 18 | 14 | 2387 | $23 | $2 | $6 | $1 | $14 | $29 | $(15) | $(11) |
| 2013 | **6.5** | 17.8 | 42% | 33 | 25 | 4235 | $41 | $4 | $11 | $1 | $24 | $51 | $(26) | $(18) |
| 2014 | **11.3** | 33.0 | 41% | 59 | 46 | 7671 | $73 | $8 | $19 | $3 | $44 | $90 | $(46) | $(28) |
| 2015 | **17.8** | 59.1 | 41% | 98 | 79 | 13119 | $125 | $13 | $33 | $4 | $75 | $144 | $(69) | $(39) |
| 2016 | **24.6** | 98.3 | 40% | 148 | 123 | 20545 | $197 | $20 | $52 | $7 | $118 | $204 | $(86) | $(44) |
| 2017 | **24.6** | 148.2 | 38% | 184 | 166 | 27670 | $265 | $27 | $70 | $9 | $158 | $208 | $(49) | $(23) |
| 2018 | **24.6** | 183.8 | 35% | 215 | 199 | 33218 | $318 | $33 | $84 | $11 | $190 | $212 | $(22) | $(9) |
| 2019 | **24.6** | 214.8 | 33% | 243 | 229 | 38107 | $365 | $38 | $96 | $13 | $218 | $216 | $2 | $1 |
| 2020 | **24.6** | 242.5 | 31% | 268 | 255 | 42529 | $407 | $42 | $107 | $14 | $244 | $220 | $23 | $8 |
| 2021 | **6.0** | 267.8 | 25% | 229 | 248 | 41366 | $396 | $41 | $104 | $14 | $237 | $55 | $182 | $58 |
| 2022 | **0.0** | 228.6 | 16% | 192 | 210 | 35059 | $335 | $35 | $88 | $12 | $201 | $- | $201 | $58 |
| 2023 | **0.0** | 192.1 | 8% | 177 | 184 | 30725 | $294 | $30 | $77 | $10 | $176 | $- | $176 | $46 |
| 2024 | **0.0** | 176.6 | 9% | 161 | 169 | 28161 | $269 | $28 | $71 | $9 | $161 | $- | $161 | $39 |
| 2025 | **0.0** | 161.4 | 8% | 148 | 155 | 25820 | $247 | $26 | $65 | $8 | $148 | $- | $148 | $32 |
| 2026 | **0.0** | 148.5 | 8% | 137 | 143 | 23785 | $228 | $24 | $60 | $8 | $136 | $- | $136 | $27 |
| 2027 | **0.0** | 137.0 | 8% | 126 | 132 | 21945 | $210 | $22 | $55 | $7 | $126 | $- | $126 | $23 |
| 2028 | **0.0** | 126.4 | 8% | 117 | 122 | 20253 | $194 | $20 | $51 | $7 | $116 | $- | $116 | $19 |
| 2029 | **0.0** | 116.6 | 8% | 108 | 112 | 18690 | $179 | $19 | $47 | $6 | $107 | $- | $107 | $16 |
| 2030 | **0.0** | 107.6 | 8% | 99 | 103 | 17249 | $165 | $17 | $43 | $6 | $99 | $- | $99 | $13 |
| 2031 | **0.0** | 99.3 | 8% | 91 | 95 | 15862 | $152 | $16 | $40 | $5 | $91 | $- | $91 | $11 |
| **Wells** | **171** | | | **Cum reserves** | **1028** | | $4,489 | $466 | $1,182 | $154 | $2,687 | $1,484 | $1,239 | $165 |
| | | | | | **Bcf** | | | | | | **Calculated unleveraged IRR ==>** | | **15.3%** | |

**** Capital costs escalated at 2% per annum***

Source: Company Reports, WWCM

## Exhibit 4: We Model Farrell Creek Montney Potential of ~645 Bcf at 6% Cut-off & 25% RF

**Canadian Spirit Resources - Farrell Creek Montney Potential**

| | 6% cut-off | 3% cut-off |
|---|---|---|
| **Sproule Estimated Potential Resource (Bcf, gross)*** | **5,024** | **10,904** |
| Number of Sections in Sproule Report | 67 | 67 |
| **TPIIP per Section (Bcf)** | **75** | **163** |
| Net TPIIP - SPI/Canbriam Block - net 16.5 sections | 1,238 | 2,690 |
| Net TPIIP - New Lands - net ~17.9 sections^ | 1,343 | 2,918 |
| **Total Net TPIIP** | **2,580** | **5,607** |
| Assumed Recovery Factor | 25% | 25% |
| **Implied Net Recoverable Resource Potential (Bcf)** | **645** | **1,402** |
| Net Recoverable Resource/Section (Bcf) | 19 | 41 |
| Recoverable per well @ 6 wells/Section (Bcf) | 3.1 | 6.8 |

**** Sproule reported as at Dec. 31, 2010 covers 29.4 of SPI's 34.4 net sections held***

Source: Company Reports, WWCM

## Exhibit 5: Applying "Industry-Norm" Valuation Parameters for Risked Resource Implies $1.59/sh - $3.17/sh.

**Canadia Spirit Resources - Risked Potential Take-out Value of Farrell Creek Asset**

| | | |
|---|---|---|
| **Sproule Estimated Net Resource Potential (Bcf - TPIIP)** | 1,238 | - at 6% cut-off in Upper Montney |
| Assume Similar Potential on 50% of New Lands (Bcf) | 671 | - at 50% cos of 77 Bcf/section on 18 net sections |
| Recoverable Assuming 25% Recovery Factor (Bcf) | **477** | |

| **Valuation matrix:** | **SPI/Canbriam Block** | | **New Lands** | |
|---|---|---|---|---|
| | **@ $0.25/mcf** (TPIIP, R.F.) | **@ $0.50/mcf** (delineated) | **@ $0.25/mcf** (TPIIP, R.F.) | **@ $0.50/mcf** (delineated) |
| Potential valuation ($mm) | **77** | 155 | **42** | 84 |
| **Per Share (proforma 75.3mm shs o/s)** | **$1.03** | $2.06 | **$0.56** | $1.12 |
| **Total of Both Blocks ($/share)** | | | **$1.59** | **$3.17** |

Source: Company Reports, WWCM

## Exhibit 6: Production/share Gains Positioned to Ramp-up in 2011/2012E

| **Production** | **2009** | **2010E** | **2011E** | **2012E** |
|---|---|---|---|---|
| Crude Oil & SPls (bbl/d) | 0 | 0 | 0 | 0 |
| Natural Gas (mmcf/d) | 0 | 0 | 4 | 11 |
| BOE/d (@ 6:1 conversion rate) | 0 | 0 | 671 | 1,750 |
| **YoY Per Share Growth** | **n/m** | **n/m** | **n/m** | **161%** |
| **Reserves** | | | | |
| 2P reserves (mmBOE) | 0.0 | 3.7 | 13.1 | 25.6 |
| Proven reserves (mmBOE) | 0.0 | 1.8 | 6.4 | 12.3 |
| Proven RLI (years)* | n/m | n/m | 15.0 | 14.5 |
| **Implied all-in F&D Costs** | **$0.00** | **$10.34** | **$5.19** | **$4.72** |
| **Flow of Funds** | | | | |
| Cash Flow ($mm) | -$2 | -$2 | $1 | $8 |
| Capex ($mm) | $1 | $19 | $25 | $31 |
| Net Debt ($mm) | -$9 | -$22 | $3 | $26 |
| **Debt/CF ratio (x)** | ***5.9*** | ***13.1*** | ***5.2*** | ***3.5*** |
| **Financial Data Per BOE** | | | | |
| Operating & Transpo Costs ($/BOE) | $0.00 | $0.00 | $10.00 | $9.00 |
| G&A Costs ($/BOE) | $0.00 | $0.00 | $14.50 | $5.87 |
| **Cash Flow Netbacks ($/BOE)** | **n/m** | **n/m** | **$2.18** | **$11.86** |
| **Proven Recycle Ratio** | **n/m** | **n/m** | **0.4** | **2.5** |

*RLI based on year-end reserves and fourth quarter production

Source: Company Reports, WWCM

## Exhibit 7: Despite '12E Revenue Growth, Firmer Gas Prices Are Needed

| | 2009 | 2010E | 2011E | 2012E |
|---|---|---|---|---|
| **Operating Income** | | | | |
| Oil and natural gas revenues | 0.0 | 0.0 | 6.4 | 19.1 |
| Royalties, net of credits | 0.0 | (0.0) | (0.7) | (2.5) |
| Other | 0.0 | 0.1 | 0.1 | 0.1 |
| | 0.0 | 0.1 | 5.8 | 16.7 |
| **Expenses** | | | | |
| Operating and processing | 0.0 | 0.0 | 2.4 | 5.7 |
| General and administrative | 1.6 | 1.8 | 2.8 | 3.0 |
| Depletion and depreciation | 0.0 | 0.0 | 4.9 | 11.5 |
| Interest on long-term debt | 0.0 | 0.0 | 0.0 | 0.4 |
| Provision for site restoration | 0.0 | 0.0 | 0.0 | 0.0 |
| Other | 0.0 | 0.0 | 0.0 | 0.0 |
| Other - non-cash | 0.4 | 0.6 | 0.2 | 0.2 |
| | 2.1 | 2.4 | 10.3 | 20.8 |
| **Income Before Income Taxes** | **(2.0)** | **(2.2)** | **(4.6)** | **(4.1)** |
| Capital taxes | 0.0 | 0.0 | 0.0 | 0.0 |
| Current taxes | 0.0 | 0.0 | 0.0 | 0.0 |
| Future taxes | 0.0 | (0.7) | (1.4) | (1.3) |
| **Net Income** | **(2.0)** | **(1.6)** | **(3.1)** | **(2.8)** |
| Dividends on ordinary shares | 0.0 | 0.0 | 0.0 | 0.0 |
| **Net Income to Common** | **(2.0)** | **(1.6)** | **(3.1)** | **(2.8)** |
| Retained earnings, beginning of period | (18.1) | (20.1) | (21.7) | (24.8) |
| Common shares repurchased | 0.0 | 0.0 | 0.0 | 0.0 |
| Adjustment for taxes | 0.0 | 0.0 | 0.0 | 0.0 |
| Retained earnings (deficit), end of period | (20.1) | (21.7) | (24.8) | (27.7) |
| **Earnings per Common Share** | **($0.04)** | **($0.03)** | **($0.04)** | **($0.04)** |
| **Earnings per Fully Diluted Common Share** | **($0.04)** | **($0.03)** | **($0.04)** | **($0.04)** |

Source: Company Reports, WWCM

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|---|---|---|
| Canadian Spirit Resources Inc. | SPI-V | 1,2,3 |

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