

# Canadian Spirit Resources Inc. (SPI-V, \$1.35)

**Recommendation: Strong Buy**

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All values in C\$ unless otherwise noted.

Current Price	\$1.35
Target Price (12-Month)	\$2.25
Target Return	67%

## Changes

	Old	New
Production boe/d '11E	453	Unch.
CFPS (FD) '11E	\$0.00	Unch.
Production boe/d '12E	1,021	Unch.
CFPS (FD) '12E	\$0.05	Unch.
Recommendation	Strong Buy	Unch.
Target Price	\$2.25	Unch.

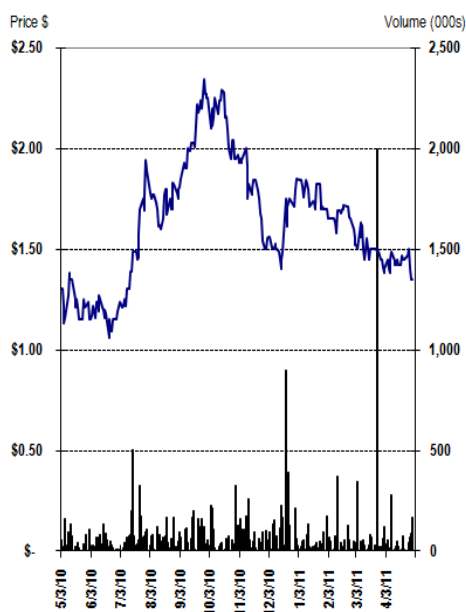
## Company Profile

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 ~40 net sections (~52% WI) including 16.5 net sections within the Canbriam JV.

## Additional Montney Lands at Farrell Creek Adds Estimated 99 Bcf to Potential Resource

- SPI acquires additional Montney/Doig rights at Farrell Creek**  
 The acquisition of 5.3 net sections contiguous to existing lands increases SPI's total Farrell Creek lands by 15% to just under 40 net sections.
- Unrisked resource potential likely to expand accordingly**  
 With broad ariel extent of these resource trends, we expect SPI's recoverable resource potential will increase similarly to over 1.1 Tcf net.
- Balance sheet remains healthy – proceeding with frac program H2/11**  
 SPI to fund \$17mm CapX program with available cash on hand (current working capital is \$17.9mm) and cash flow; three frac jobs starting in Q3.
- 10-year Montney project development supports our \$2.25 target**  
 At \$4.16 AECO, Farrell Creek Montney project yields NPV<sub>10%</sub> of \$2.17/sh over 10 years, which jumps to +\$5.50/sh at \$5/mcf gas pricing.

## Price Chart



Source: Thomson One

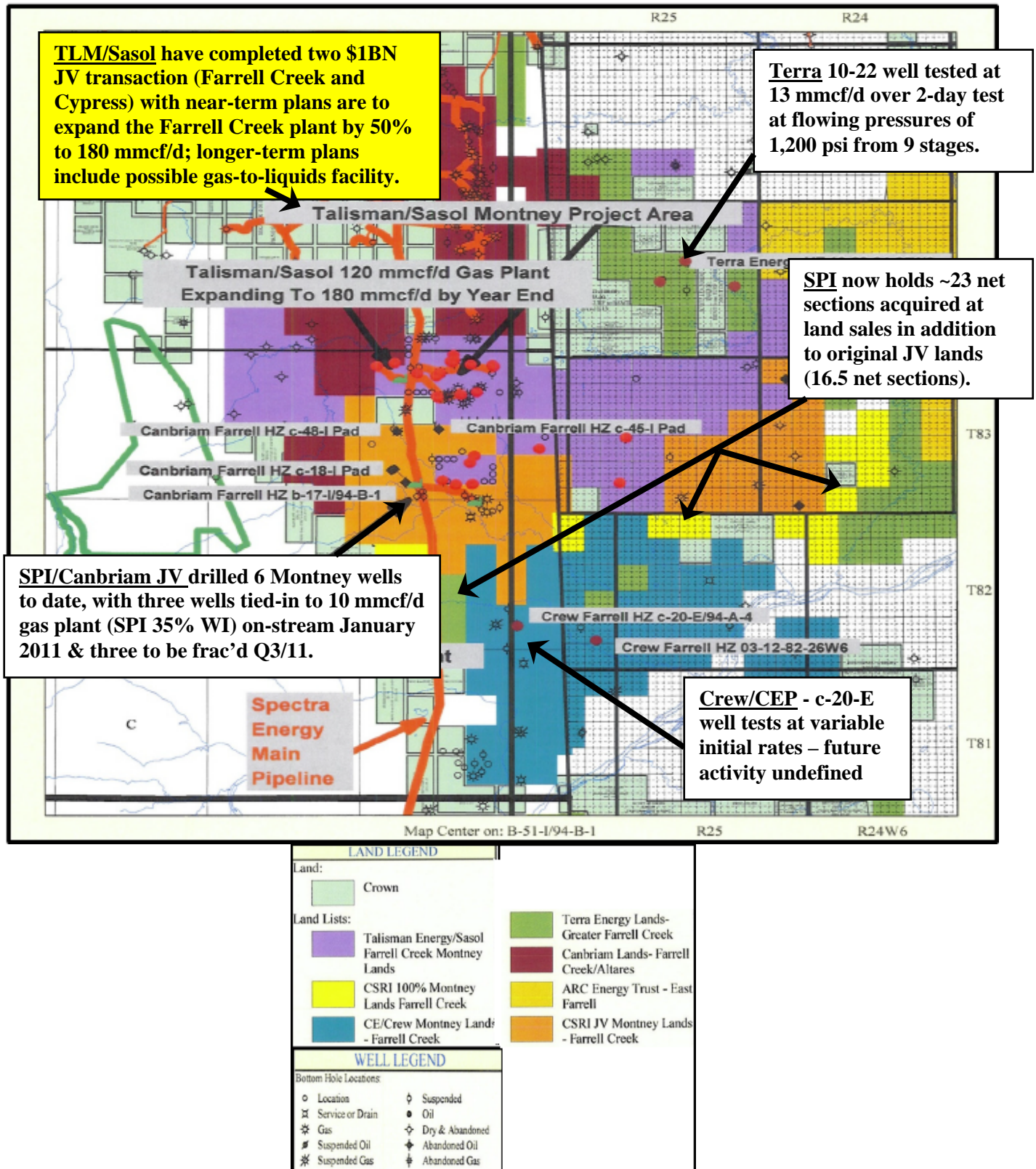
## Financial Summary

Shares O/S (M)	74.6	52-Week Trading Range	\$1.06 - \$2.34	
Market Capitalization (M)	\$104	Average Weekly Volume	385,340	
Net Debt - 2011E (M)	-\$5	Market Float (M)	\$102	
Enterprise Value (M)	\$100	NAV/Share - 2011E	\$0.70	
<b>Forecasts</b>	<b>2009</b>	<b>2010</b>	<b>2011E</b>	<b>2012E</b>
Production (BOE/d)	-	-	453	1,021
% Gas	-	-	100%	100%
Oil Price (US\$/bbl - WTI)	\$61.99	\$79.46	\$88.00	\$89.00
Gas Price (\$/mcf - wellhead)	\$3.99	\$3.99	\$4.37	\$4.98
Revenues (M)	\$0	\$0	\$4	\$11
Cash Flow (M)	(\$2)	(\$2)	\$1	\$5
Debt/CF	5.9x	13.3x	(5.8x)	3.3x
CFPS (FD, incl. cap. G&A)	(\$0.04)	(\$0.03)	\$0.00	\$0.05
EPS (FD)	(\$0.04)	(\$0.02)	(\$0.02)	(\$0.02)
<b>Valuation</b>		<b>2010</b>	<b>2011E</b>	<b>2012E</b>
EV/DACF		n/m	n/m	28.5x
EV/BOE/d (per unit production)		n/m	\$219,499	\$97,505
EV/BOE (per unit proven reserves)		n/m	\$43.57	\$16.06
P/E		n/m	n/m	n/m
Target EV/DACF		n/m	n/m	43.6x

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**

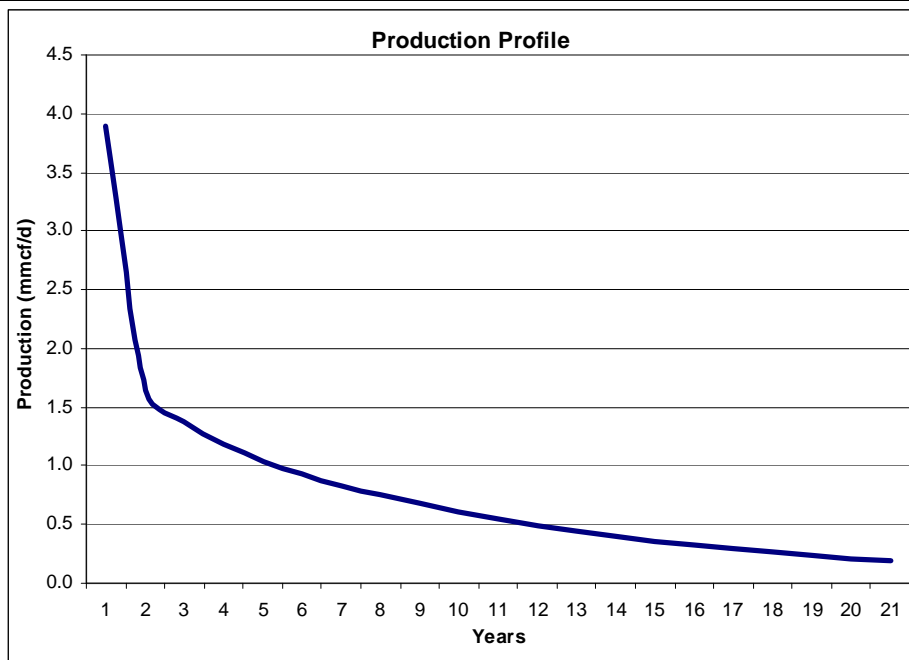


Source: Company Reports, WWCM

**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	
<b>Well Parameters:</b>			
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		
<b>Financial Parameters:</b>			
	<u>AECO</u>	<u>Wellhead</u>	
Wellhead Price (CDN \$/mcf) - + 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%	
<b>Result:</b>			
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	
<b>Internal Rate of Return (IRR)</b>		<b>23.5%</b>	



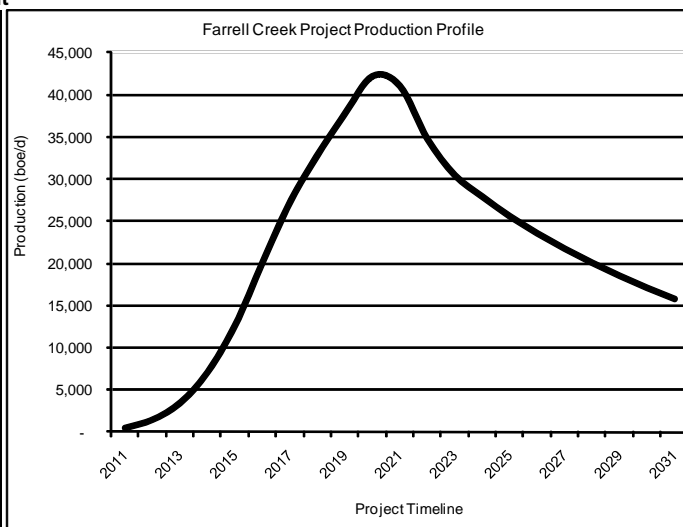
<b>Internal Rate of Return (IRR) Sensitivities</b>					
<u>IRR</u>	<u>Gas Price (CDN \$/mcf)</u>				
		\$3.50	\$4.37	\$6.00	\$8.00
<b>Well</b>	\$6.0	19%	35%	71%	117%
<b>Cost</b>	\$7.5	11%	24%	50%	86%
<b>(\$mm)</b>	\$8.0	9%	21%	45%	78%
	\$9.0	7%	16%	37%	66%

Source: Company Reports, WWCW

**Exhibit 3: Project Model With Less Aggressive CapX Program in 2011 Yields Project IRR of ~15% at \$4.16/mcf AEEO and NAVPS of \$2.17/share – NAVPS Climbs to \$5.50/share at AEEO \$5/mcf gas prices**

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

	Type Well	Conversion boe @ 6:1
<b>Well Parameters:</b>		
Well Cost - Drill, Complete & Tie-in (\$mm)	\$7.5	
Initial Production Rate (mmcf/d)	6.0	1000
Reserves (Bcf)	1,013	169
Reserve Life Index (years) - Life of Project Average	7.7	
Average Success Rate	<b>100%</b>	
<b>Financial Parameters:</b>		
Wellhead Price (CDN \$/boe) - + 5% AEEO 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%	
<b>Result:</b>		
F&D Costs (\$/mcf) - Life of Project	\$2.01	\$12.07
Recycle Ratio	1.3x	
<b>NPV per share</b>	<b>\$2.17</b>	
<b>Internal Rate of Return (IRR)</b>	<b>15.3%</b>	



**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												
2011	1.4	-	n/a	6	3 486	\$5	\$0	\$1	\$0	\$3	\$11	\$(8)	\$(6)
2012	2.5	5.8	42%	12	9 1484	\$14	\$1	\$4	\$0	\$8	\$19	\$(10)	\$(8)
2013	6.5	12.0	42%	29	21 3454	\$33	\$3	\$9	\$1	\$20	\$51	\$(31)	\$(21)
2014	11.3	29.5	42%	56	43 7136	\$68	\$7	\$18	\$2	\$41	\$90	\$(49)	\$(30)
2015	17.8	56.2	41%	96	76 12663	\$121	\$13	\$32	\$4	\$73	\$144	\$(72)	\$(40)
2016	24.6	95.8	40%	146	121 20142	\$193	\$20	\$51	\$7	\$115	\$204	\$(88)	\$(45)
2017	24.6	145.9	38%	182	164 27305	\$261	\$27	\$69	\$9	\$156	\$208	\$(51)	\$(24)
2018	24.6	181.7	35%	213	197 32882	\$315	\$33	\$83	\$11	\$188	\$212	\$(24)	\$(10)
2019	24.6	212.8	33%	241	227 37797	\$362	\$38	\$95	\$12	\$216	\$216	\$0	\$0
2020	24.6	240.7	31%	266	253 42243	\$404	\$42	\$106	\$14	\$242	\$220	\$21	\$8
2021	6.0	266.2	25%	227	247 41102	\$393	\$41	\$104	\$14	\$235	\$55	\$181	\$58
2022	0.0	227.0	16%	191	209 34817	\$333	\$35	\$88	\$11	\$199	\$-	\$199	\$58
2023	0.0	190.8	8%	175	183 30502	\$292	\$30	\$77	\$10	\$175	\$-	\$175	\$46
2024	0.0	175.3	9%	160	168 27953	\$267	\$28	\$70	\$9	\$160	\$-	\$160	\$38
2025	0.0	160.2	8%	147	154 25628	\$245	\$25	\$65	\$8	\$147	\$-	\$147	\$32
2026	0.0	147.4	8%	136	142 23608	\$226	\$23	\$59	\$8	\$135	\$-	\$135	\$27
2027	0.0	135.9	8%	125	131 21782	\$208	\$22	\$55	\$7	\$125	\$-	\$125	\$22
2028	0.0	125.4	8%	116	121 20102	\$192	\$20	\$51	\$7	\$115	\$-	\$115	\$19
2029	0.0	115.8	8%	107	111 18551	\$177	\$18	\$47	\$6	\$106	\$-	\$106	\$16
2030	0.0	106.8	8%	99	103 17121	\$164	\$17	\$43	\$6	\$98	\$-	\$98	\$13
2031	0.0	98.6	8%	91	95 15800	\$151	\$16	\$40	\$5	\$90	\$-	\$90	\$11
<b>Wells</b>	<b>168</b>			<b>Cum reserves</b>	<b>1013</b>								
				<b>Bcf</b>		<b>\$4,425</b>	<b>\$459</b>	<b>\$1,165</b>	<b>\$152</b>	<b>\$2,649</b>	<b>\$1,464</b>	<b>\$1,220</b>	<b>\$162</b>
												<b>Calculated unleveraged IRR ==&gt;</b>	<b>15.3%</b>

\* Capital costs escalated at 2% per annum

Source: Company Reports, WWC

**Exhibit 4: Production/share Gains Positioned to Ramp-up in 2012E**

<b>Production</b>	<b>2009</b>	<b>2010</b>	<b>2011E</b>	<b>2012E</b>
Crude Oil & SPLs (bbl/d)	0	0	0	0
Natural Gas (mmcf/d)	0	0	3	6
BOE/d (@ 6:1 conversion rate)	0	0	453	1,021
<b>YoY Per Share Growth</b>	<b>n/m</b>	<b>n/m</b>	<b>n/m</b>	<b>125%</b>
<b>Reserves</b>				
2P reserves (mmBOE)	0.0	0.0	4.8	13.0
Proven reserves (mmBOE)	0.0	0.0	2.3	6.2
Proven RLI (years)*	n/m	n/m	10.7	14.6
<b>Implied all-in F&amp;D Costs</b>	<b>\$0.00</b>	<b>\$0.00</b>	<b>\$11.20</b>	<b>\$8.07</b>
<b>Flow of Funds</b>				
Cash Flow (\$mm)	-\$2	-\$2	\$1	\$5
Capex (\$mm)	\$1	\$20	\$17	\$26
Net Debt (\$mm)	-\$9	-\$21	-\$5	\$16
<b>Debt/CF ratio (x)</b>	<b>5.9</b>	<b>13.3</b>	<b>- 5.8</b>	<b>3.3</b>
<b>Financial Data Per BOE</b>				
Operating & Transpo Costs (\$/BOE)	\$0.00	\$0.00	\$6.50	\$6.00
G&A Costs (\$/BOE)	\$0.00	\$0.00	\$21.45	\$10.06
<b>Cash Flow Netbacks (\$/BOE)</b>	<b>n/m</b>	<b>n/m</b>	<b>\$5.14</b>	<b>\$12.99</b>
<b>Proven Recycle Ratio</b>	<b>n/m</b>	<b>n/m</b>	<b>0.5</b>	<b>1.6</b>

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

Source: Company Reports, WWCM

**Exhibit 5: Despite '12E Revenue Growth, Firmer Gas Prices Are Needed**

	<b>2009</b>	<b>2010</b>	<b>2011E</b>	<b>2012E</b>
<b>Operating Income</b>				
Oil and natural gas revenues	0.0	0.1	4.3	11.1
Royalties, net of credits	0.0	0.0	(0.2)	(1.1)
Other	0.0	0.0	0.6	0.3
	0.0	0.1	4.7	10.3
<b>Expenses</b>				
Operating and processing	0.0	0.0	1.1	2.2
General and administrative	1.6	1.7	2.8	3.0
Depletion and depreciation	0.0	0.0	3.3	6.5
Interest on long-term debt	0.0	0.0	0.0	0.3
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	2.3	7.4	12.2
<b>Income Before Income Taxes</b>	<b>(2.0)</b>	<b>(2.2)</b>	<b>(2.7)</b>	<b>(1.9)</b>
Capital taxes	0.0	0.0	0.0	0.0
Current taxes	0.0	0.0	0.0	0.0
Future taxes	0.0	(1.0)	(0.8)	(0.6)
<b>Net Income</b>	<b>(2.0)</b>	<b>(1.2)</b>	<b>(1.8)</b>	<b>(1.3)</b>
Dividends on ordinary shares	0.0	0.0	0.0	0.0
<b>Net Income to Common</b>	<b>(2.0)</b>	<b>(1.2)</b>	<b>(1.8)</b>	<b>(1.3)</b>
Retained earnings, beginning of period	(18.1)	(20.1)	(21.3)	(23.2)
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)	(21.3)	(23.2)	(24.5)
<b>Earnings per Common Share</b>	<b>(\$0.04)</b>	<b>(\$0.02)</b>	<b>(\$0.02)</b>	<b>(\$0.02)</b>
<b>Earnings per Fully Diluted Common Share</b>	<b>(\$0.04)</b>	<b>(\$0.02)</b>	<b>(\$0.02)</b>	<b>(\$0.02)</b>

Source: Company Reports, WWCM

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