

## Candax Energy Inc.

CAX : TSX : C\$0.94

**SPECULATIVE BUY**

**Target: C\$1.12 ↑**

**Terry Peters** 1.416.869.6597

terry.peters@canaccordadams.com

**Asad Rawra CA, CPA** 1.416.869.7397

asad.rawra@canaccordadams.com

### COMPANY STATISTICS:

52-week Range:	\$0.39-1.08
Avg. Daily Vol. (000):	337
Market Capitalization (M):	\$158.7
Shares Out. (M) basic:	168.9
Shares Out. (M) fd:	168.9

### EARNINGS SUMMARY:

FYE Dec	2005A	2006A	2007E	2008E
Equivalent				
Production (boe/d):	1,357	560	1,482	4,386
EPS:	(0.02)	(0.00)	(0.01)	0.04
Operating EPS:	(0.01)	(0.01)	(0.01)	0.04
P/Operating EPS:	(64.5x)	(83.3x)	(154.2x)	25.9x
CFPS:	0.05	0.03	0.08	0.27
P/CF:	18.2x	30.7x	12.2x	3.5x

### SHARE PRICE PERFORMANCE:



### COMPANY SUMMARY:

Candax Energy Inc. is an international energy company involved in oil and gas exploration and production and power generation. Candax has operations in Tunisia and looks to expand into the Middle East and other parts of North Africa. With an experienced, international oil and gas knowledgeable management team inclusive of Michael Wood, President and CEO, John Clarke, Executive Vice President and Chris Hopkins, CFO; Candax is primed for growth.

All amounts in C\$ unless otherwise noted.

### Energy -- Oil and Gas, Exploration and Production

## MINOR PRODUCTION DELAYS, BUT DRILLING FINALLY STARTS AT EL BIBANE

### Event

Candax Energy announced on Tuesday, July 31 that it commenced drilling of the first El Bibane well, EBB-4, with production start-up expected during the first week of October. Upon completion of EBB-4, the West Titania jack-up rig will re-complete EBB-3RE2 by drilling a horizontal well, and then move to its final location to drill EBB-5, a gas re-injection well. While the commencement of drilling at El Bibane (Candax 73.8%) is "music to our ears", production start-up from EBB-4 has been delayed. We had expected first production from El-Bibane to start during mid-August, which will now begin almost two months later, during October.

### Impact

Neutral. As a result of the delay at El Bibane, we now anticipate no production from the field in Q3/07 and expect production to start mid-October. We have lowered our 2007E CFPS (fd) and operating EPS (fd) from \$0.11 and \$0.00 to \$0.08 to (\$0.01), respectively. For 2008E, we have increased both CFPS (fd) and operating EPS (fd) by \$0.03 to \$0.27 and \$0.04, respectively. Our estimate for 2007 production has decreased from 1,961 boe/d to 1,482 boe/d.

### Action

We are maintaining our SPECULATIVE BUY rating, but are raising our target price from C\$1.00 to C\$1.12 on the back of higher expected cash flow in 2008.

### Valuation

Our target price of C\$1.12 represents 4.2 times our forecast 2008 cash flow and 4.0 times on a debt-adjusted basis. Candax remains net debt-free with forecast working capital of \$20.4 million at year-end.

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## ALMOST, BUT NOT QUITE THERE YET

After a series of disappointments from the company, the commencement of drilling at El Bibane is a step in the right direction. Candax announced that it has started drilling EBB-4, the first well in the three-well development program, utilizing the West Titania jack-up drilling rig. The well will take approximately 40 days to drill and an additional two weeks to tie-in the pipeline to the well, with first oil and gas production to start during October.

After drilling the EBB-4 well, the West Titania drilling rig will move on to EBB-3RE2, the second well, to re-complete the existing well by drilling a new, horizontal production well. The well is expected to be completed in 30 days, after which the rig will move on to its final location to drill EBB-5. The EBB-5 well will be used as a gas re-injection well with first gas injection to commence in December. Production from the El Bibane field is expected to be fully stabilized at this time.

We had expected first production from El Bibane during mid-August; however, due to delays in drilling start-up, actual commencement of production has also been pushed forward by almost two months. As such, the timing of inventory liftings, or sales, has also shifted, with a decrease in the number of liftings during Q3 and Q4/07 and an increase in liftings and sales during 2008.

As a result of the production delay at El Bibane and a shift in the timing of product sales, we have revised our estimates for H2/07 and 2008. Our estimate for 2007 production has decreased from 1,961 boe/d to 1,482 boe/d. We have lowered both 2007E CFPS (fd) and operating EPS (fd) from \$0.11 and \$0.00 to \$0.08 and (\$0.01), respectively. For 2008E, we have increased both CFPS (fd) and operating EPS (fd) by \$0.03 to \$0.27 and \$0.04, respectively. See Figure 1 for a summary of Candax's operating and financial results and forecast.

**Figure 1: Financial and operating results and forecast**

(\$ thousand)	Q1/07	Q2/07E	Q3/07E	Q4/07E	2007E	2007E	2008E	2008E
					Old	New	Old	New
Net Income	(877)	(712)	3,303	(2,744)	414	(1,030)	2,580	6,258
<b>Reported EPS (FD)</b>	<b>-\$0.01</b>	<b>\$0.00</b>	<b>\$0.02</b>	<b>-\$0.02</b>	<b>\$0.00</b>	<b>-\$0.01</b>	<b>\$0.01</b>	<b>\$0.04</b>
<b>Operating EPS (FD)</b>	<b>-\$0.01</b>	<b>\$0.00</b>	<b>\$0.02</b>	<b>-\$0.02</b>	<b>\$0.00</b>	<b>-\$0.01</b>	<b>\$0.01</b>	<b>\$0.04</b>
Cash Flow	369	1,145	6,054	5,486	18,335	13,053	41,658	46,410
<b>CFPS (FD)</b>	<b>\$0.00</b>	<b>\$0.01</b>	<b>\$0.04</b>	<b>\$0.03</b>	<b>\$0.11</b>	<b>\$0.08</b>	<b>\$0.24</b>	<b>\$0.27</b>
Net Capital Spending	(2,120)	(10,000)	(8,000)	(9,280)	(29,400)	(29,400)	(30,000)	(30,000)
Net Debt/(cash) incl. Working capital	(31,995)	(23,139)	(21,193)	(17,399)	(22,680)	(17,399)	(34,338)	(33,809)
Liquids (b/d)	420	822	1,173	2,959	1,711	1,344	3,553	3,553
Gas (mmcf/d)	0	0	0	3	2	1	5	5
<b>Equivalent (boe/d)</b>	<b>420</b>	<b>822</b>	<b>1,173</b>	<b>3,515</b>	<b>1,961</b>	<b>1,482</b>	<b>4,386</b>	<b>4,386</b>

Note: Actual timing of the oil inventory liftings may vary from our expectations and may have an impact on cash flow.

Source: Company reports, Canaccord Adams estimates

### Near-term exploration prospects

The Chaal-1 well has been abandoned for over a year now. In mid-2006, the well was drilled to 4,500 metres and 90 metres of net pay was interpreted within a gross 400-metre hydrocarbon column. The well flowed high-quality gas; however, the tests were impaired because of damage to the well bore due to high mud weights, and testing was suspended after a leak in the coiled tubing was found. At the present, there is an ongoing technical

review with the other partners with the potential to drill a high angled side-track well in late 2007. A letter of intent for a rig contract has been signed for Q4/07 subject to detailed well planning and design by the partners. We expect an update on the status of the technical review and plans for drilling at Chaal possibly along with the Q2/07 earnings release on August 13, 2007.

The Ryder Scott Reserve report, dated December 31, 2006, presents gross unrisks estimates for gas in place (GIP) and contingent resources at the Chaal prospect (Candax 60%). See Figure 2 for a summary of the low-, medium-, and high-case scenarios for GIP and contingent resources at Chaal. Based on the medium-case scenario of 544 Bcf of contingent resources, assuming a 20% chance of success, and an arbitrary nominal value of \$3.00/boe, we approximate a potential exploration upside of \$0.22 per fully diluted share.

**Figure 2: Chaal Permit – Gross GIP & Contingent Resources**

	Low	Medium	High
Gas in place (Bcf)	150	1,088	1,708
Contingent resources (Bcf)	75	544	854

Source: Company reports

Secondly, Candax has exposure to additional exploration upside through two large Triassic structures below the Ezzaouia and El Bibane fields. Based on the company's internal estimate, the exploration potential of these prospects is quite significant, with unrisks estimates of gross GIP greater than 3 Tcf. Candax plans to drill the onshore Ezzaouia structure first and, if successful drill the offshore El Bibane structure. The company is currently looking for a rig to drill the deep Ezzaouia Triassic prospect and discussions are ongoing with the Tunisian government regarding ETAP's level of participation in the well. A decision from the government is expected before year-end.

Candax has a 2 Tcf gross GIP estimate for the Triassic structure at Ezzaouia (Candax 31.4%) and assuming that the company drills this structure first, we have estimated a value for potential exploration upside from Ezzaouia. If we assume a recovery factor of 70% on the gross GIP and a 20% chance of success with a nominal value of \$3.00/boe, the Triassic has a risks potential of \$0.26 per share, or \$0.13 per share if Dana Gas exercises its 50% back-in right.

While the exploration prospects at Chaal and Ezzaouia potentially provide a combined \$0.35 per fully diluted share of exploration upside, we have not included any of this upside as part of our current Candax base asset valuation. We believe the company first needs to firm up its drilling plans, partners' participation, and enter into a rig contract. In the interim, as Candax continues to reinvest cash into cash producing assets at El Bibane and Ezzaouia, we believe the company will be valued more on conventional cash flow multiples. Our target price for Candax is based on 4.0 times debt-adjusted operating cash flow and Candax's base NAV (\$0.81) underpins its share valuation. Significant upside potential to its NAV remains from reserve upgrades at Ezzaouia and the potential for success at either Chaal or in the deep Triassic.

**Summary and conclusion**

With well workovers at Ezzaouia and incremental production from El Bibane, the second half of 2007 and beyond should bring with it a steady stream of higher cash flows for Candax. Most of the incremental cash flow is consistent with higher production and multiple inventory liftings planned during H2/07 and beyond. We believe that the Candax story is still about converting cash to cash flows with significant cash flow growth in 2008. We recently shifted our target price emphasis from a net asset value focus to a multiple of cash flow. See our *Flash Update* of June 7, 2007 for more information. This year is aimed at accelerating and maximizing the value of Candax's oil and gas assets through a workover and in-fill program at Ezzaouia and a redevelopment of the El Bibane field, the results of which are expected to generate both higher production and cash flow. The early results from Ezzaouia are positive and while risk remains, we anticipate the El Bibane field production should commence in Q4/07.

Even though production at El Bibane has been delayed, the mobilization of the jack-up rig and actual start-up of drilling at the field has been viewed positively by Candax's shareholders. This is reflected in the company's share price which closed at \$0.94, trading at 3.5 times our 2008 CFPS forecast. We are maintaining our SPECULATIVE BUY rating and increasing our target price from C\$1.00 to C\$1.12. Our target price represents 4.2 times our forecast 2008 cash flow and 4.0 times on a debt-adjusted basis.

**Investment risks**

In addition to operating risks inherent in oil and gas exploration and production activities, oil and natural gas price realizations and production may be lower or higher than our forecast. Collectively, these risks could impact the company's valuation and our forecasts.

Candax acquired producing assets that are mature with a relatively short reserve life and a high water cut. There is no guarantee that all future volumes of production will occur in sufficient quantities to make existing fields commercial. Two major fields (El Bibane and Ezzaouia) currently represent greater than 95% of the proved value of Candax. Should either of these fields experience a production-related problem for a prolonged period of time, there could be a material impact on our financial and valuation estimates. Unless new discoveries or assets are acquired, future cash flows from existing assets will decline substantially, which may impact the future valuation of Candax. All producing and potential properties are presently located in Tunisia. Although currently seen as a relatively stable government, the company's operations, financial results, and valuation could be adversely affected by events beyond its control taken by the current or future governments with respect to policy changes regarding taxation, regulation, and other business environment changes.

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**Site Visit:** An analyst has visited the issuers’ material operations in Tunisia and corporate headquarters in Toronto. No payment or reimbursement was received from the issuers for the related travel costs.

**Price Chart:\***



Date	Analyst Rating	Target Price
1) 09/22/05	TP Speculative Buy	1.50
2) 09/26/05	TP Speculative Buy	0.83
3) 04/04/06	TP Speculative Buy	1.33
4) 10/04/06	TP Speculative Buy	0.88
5) 03/06/07	TP Speculative Buy	0.78
6) 04/09/07	TP Speculative Buy	0.81
7) 06/07/07	TP Speculative Buy	1.00

\* Price charts assume event 1 indicates initiation of coverage or the beginning of the measurement period.

**Distribution of Ratings:**  
Global Stock Ratings  
(as of 29 June 2007)

Rating	Coverage Universe		IB Clients	
	#	%	#	%
Buy	302	55.6%	42.4%	
Speculative Buy	68	12.5%	69.1%	
Hold	147	27.1%	36.7%	
Sell	26	4.8%	11.5%	
	543	100.0%		

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Candax Energy Inc.	1A, 2, 3, 7, 11 (John Zaozirny)

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