



Candax Energy Inc – (CAX: TSX C\$0.55)

Results Reported As Expected – Drilling Rig Finally Mobilized

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Stock Rating: Speculative BUY

Target Price: \$1.15 (previously \$1.18)

C\$000	F2005A	F2006E	F2007E
Yr end Dec. 31			
Oil and Liquids (bbls/d)	493	624	2,300
Natural Gas (mcf/d)	1,095	0	4,200
BOE/D (boe/d 6:1)	675	624	3,000
CFPS, f.d.	\$0.05	\$0.04	\$0.22
Net Debt (MM)	(\$11.4)	(\$35.4)	(\$23.7)
Enterprise Value (MM)	\$71	\$57	\$69
EV/BOE/D	\$104,614	\$92,109	\$23,072
Projected Return			109.1%
Shares O/S Basic (MM)			168.9
Shares O/S F.D. (MM)			180.4
Market Cap. (MM)			\$92.9
NAV (\$/f.d. share), end-2006			\$1.15
P/NAVPS			0.5

Candax Energy (CAX-T) announced its Q3 financial results yesterday, which were broadly in line with our expectations. Production for the quarter averaged 519 b/d compared to our expectation for 555 b/d, while sales were also close to expectations (for 300 b/d) at 278 b/d. Since production at El Bibane remains shut in and production volumes are low, export sales liftings are highly irregular, which is the reason for the difference between production and sales.

With regard to the outlook for operations, and in particular the redevelopment of the El Bibane field, which will be crucial to (re-)establishing significant production, CAX reports that the main drilling barge to be used for the redevelopment of the El Bibane field sailed (from Montenegro) on Nov. 9th and is expected to arrive in Tunisia by Nov. 19.

Source: MGI Securities & Company Reports

Developments

The reported loss for the quarter of \$2.9mm (\$0.01 per f.d. share) was substantially more than our expectations for \$1.3mm (also \$0.01 per f.d. share) despite significantly lower than expected operating and general expenses. The main reason for this was a large tax expense of \$1.4mm (which occurs at irregular intervals) that we did not anticipate before year-end. This also resulted in a negative cash flow of \$1.1mm (\$0.01 per f.d. share) compared to our expectations for negative cash flow of \$0.3mm (\$0.001 per f.d. share).

The company also reported that its 50% owned SEEB subsidiary (which operates the onshore gas power plant in Tunisia) received notification that additional business interruption insurance proceeds of US\$0.8mm (CAX's share US\$0.4mm) would be paid to the joint venture.

Comments

Overall, the Q3 financials have had no visible impact on our valuation of CAX. As long as production is negligible due to El Bibane remaining shut-in, the company is essentially unprofitable, but this could be dramatically changed early next year if redevelopment of El Bibane is successful. We are therefore more focused on progress on that project than on ongoing production operations.

Nonetheless, we are positively surprised by the extent to which CAX was able to control operating costs (as well as general and admin expenses) during Q3. We also welcome the confirmation of business interruption insurance to offset CAX's debt obligations related to the SEEB power plant. On the other hand, capital expenditures were considerably higher than expected, although we assume this is mainly due to earlier timing than assumed for some expenses related to preparation for redevelopment of El Bibane.

The shifting schedule for redevelopment of El Bibane continues to cause disappointment, however. Although the latest adjustment to our start-up timing assumption is only minimal (changed from Dec. 2006 to Jan. 2007), we remain wary that company production guidance (on which rely quite heavily) allows virtually no room for further delays.

In addition to updating our model for Q3 financials, we have therefore made minor adjustments to production forecasts for our discounted cash flow valuation of risked resources and reserves. As already mentioned we have adjusted our assumptions for start-up timing of the redevelopment at El Bibane, which reduces our end-year reserves valuation of that asset by \$0.02 per f.d. share. In addition, we have assumed a lower chance of success for our upside valuation of the Chaal discovery (20% chance of success versus 25% previously assumed), reducing that asset's valuation by \$0.01 per f.d. share. This latter adjustment is not due to any downgrading of that discovery's potential, but due to recognition and risking of possible delays in regard to CAX's expected reappraisal of that discovery. We also consider delays possible in regard to implementation of the Ezzaouia EOR project, although we have not adjusted our valuation of that field. Even though there are no technical reasons why the individual projects should impact each other, management will inevitably have limited time to focus on the next project until the current one is complete.

As a consequence of the dragging El Bibane project, we also expect management to be less focused on further business development activities (although we remain assured that the company is continuing to pursue new opportunities and still expect any eventual deals to be value-creating).

Table 1: Updated Risked NAV Calculation Results

	Risked Resource Estimates (end 2006 Forecast)		
	Resource Estimate	PV10	NAV/share (f.d)
	<i>mmboe</i>	<i>C\$mm</i>	<i>C\$/share</i>
Chaal	10.2	57.9	0.32
El Bibane	4.5	74.1	0.41
Other Acquired Assets	1.5	31.7	0.18
Total	16.2	163.7	0.91
Options Proceeds		8.9	0.05
		172.7	0.96
Net Debt		(35.4)	(0.20)
NAV Estimate		208.0	1.15
f.d. shares (mm)			180.4

Source: MGI Securities Inc.

Recommendation

We are reiterating our BUY recommendation for Candax Energy with a slightly reduced target price of \$1.15 (previously \$1.18). Our target price is based on 1.0x our estimate of risked expected NAV. We note that our valuation remains cautious in valuing longer-term potential, but we believe this to be appropriate until CAX has positive operational news to report.

We are particularly encouraged by the (long overdue) news of the drilling barge sailing for assembly at El Bibane, as this is a necessary step towards the key news item that we anticipate will drive share price recovery, namely successful restart of production at El Bibane. Assuming there are no more extraordinary delays, we continue to expect a sharp increase in production in Q1/07, which will make CAX attractive on short term metrics as well as on long-term discounted cash flow valuation (upon which our target price is based). Using our current assumptions of cash flow of \$39.5mm (\$0.22 per f.d. share), which is below company guidance of \$42mm, the company is currently trading at an assumed EV/DACF multiple of only 1.6, which highlights the potential for improved valuation should cash flow be close to expectations in 2007.

Despite our slight reduction in target price we believe that Candax Energy represents a worthwhile investment (at current market prices), but continue to rate the stock as speculative due to the high level of operational risk that remains. Our target price represents a potential return of 109.1% from the recent closing price of \$0.55.

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3. The analyst has visited the issuers London (UK) and Tunis (Tunisia) offices. No payment or reimbursement was received from the issuer for the associated travel costs.

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