

Candax Energy Inc. (CAX-T; \$0.70)

Recommendation: Market Perform

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WELLINGTON WEST
Capital Markets Inc.

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All values in C\$ unless otherwise noted.

Current Price	\$0.70
Target Price (12-Month)	\$1.00
Implied Capital Gain	43%

Changes

	Old	New
EPS 2006E	\$0.05	\$0.04
DACF/sh FD 2006E	\$0.11	\$0.08
EPS 2007E	\$0.13	\$0.16
DACF/sh FD 2007E	\$0.25	unchanged
Recommendation	Market Perform	unchanged
Target Price	\$1.20	\$1.00

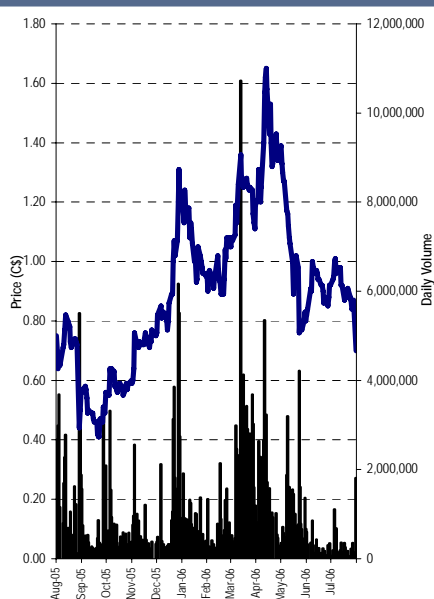
Company Profile

Candax Energy Inc. is a Canadian junior E&P with both producing and exploration assets in Tunisia. Candax began trading on the TSX on August 29th 2005 under the symbol CAX. The company is expected to be producing more than 2,000 boepd by year-end 2006 from the re-instatement of the El Bibane Field now expected in December.

Failure to achieve commercial rates at Chaal likely to increase pressure on '06 acquisition

- Candax has reported it has suspended operations at Chaal-1**
 A leak between the annulus and tubing has prevented safe testing of the fractured, high pressured carbonates from the rigless coiled-tubing unit.
- We have reduced chance of recovery to 20%, expect '07 re-entry**
 Inability to obtain a commercial rate from 90 m of net pay in a zone of booked probable reserves is a concern that may impact reserve value.
- El Bibane now expected to begin production in December**
 We have removed Q4 oil production from El Bibane from our forecasts and expect first oil in late December with full production by end Q1 2007.
- Reduce target to \$1.00 from \$1.20, maintain Market Perform rec.**
 Operational challenges have capped Candax with underlying value backed by \$0.99/share in risked NPV and \$0.25/sh in 2007E DACF.

Price Chart



Source: PCQuote

Financial Summary

Shares O/S (M FD)	181.2	52-Week Trading Range	\$0.39-\$1.73
Market Capitalization (M)	\$127	Average Weekly Volume	5,315,702
Net Debt - 2005E (M)	-\$44	Market Float (M)	\$85
Enterprise Value (M)	\$83	Risked Portfolio NPV/share (FD)	\$0.99
Forecasts	2005	2006E	2007E
Production (boe/d)	815	965	3,407
% gas	57%	8%	26%
Wtd Ave Realized Price (\$/boe)	\$65.61	\$58.03	\$51.86
CapEx (M)	\$48.1	\$28.7	\$50.1
Oil and Gas Revenue (M)	\$12.9	\$20.4	\$64.5
Total Revenue (M)	\$13.9	\$24.7	\$70.8
Debt Adjusted Cash Flow (M)	\$7.4	\$13.6	\$42.4
Shares Outstanding (M)	77.1	170.0	170.0
DACFPS (FD)	\$0.04	\$0.08	\$0.25
EPS (FD)	(\$0.01)	\$0.04	\$0.16
Valuation	2005	2006E	2007E
EV/DACF	15.6x	6.7x	2.0x
EV/BOE/d (per unit production)	\$101,956	\$86,088	\$24,378
P/E	(60.9x)	17.2x	4.5x

Source: Company reports, Wellington West Capital Markets Inc.

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Investment Summary and Outlook

Since late 2004 Candax has shown the ability to leverage relationships and gain access to quality assets under favourable terms while minimizing their capital at risk. Unfortunately, a series of operational incidents have marred this story since September 2005. Production from El Bibane has been shut-in but is expected to build to >2000 bopd by Q1 2007. A key onshore exploration well at Chaal found thicker than anticipated gas pay, but was unable to test gas at a commercial rate. We expect that Candax will seize opportunities for low-risk growth throughout the region with further acquisitions and farm-in agreements.

Operational miscues plague Tunisian activities

Chaal suspended due to leak in casing preventing safe perforation and testing

Candax has reported that operations on the Chaal-1 appraisal well have been suspended. Previously the company had revealed that the well had discovered a gas column of 450 m, with approximately 90 m of net pay. Very high sub-surface pressures forced Candax to replace a 10,000 psi BOP with a 15,000 psi stack. When testing began in June it revealed the presence of formation damage, delivering sweet, non-acidic gas at sub-commercial rates from two zones.

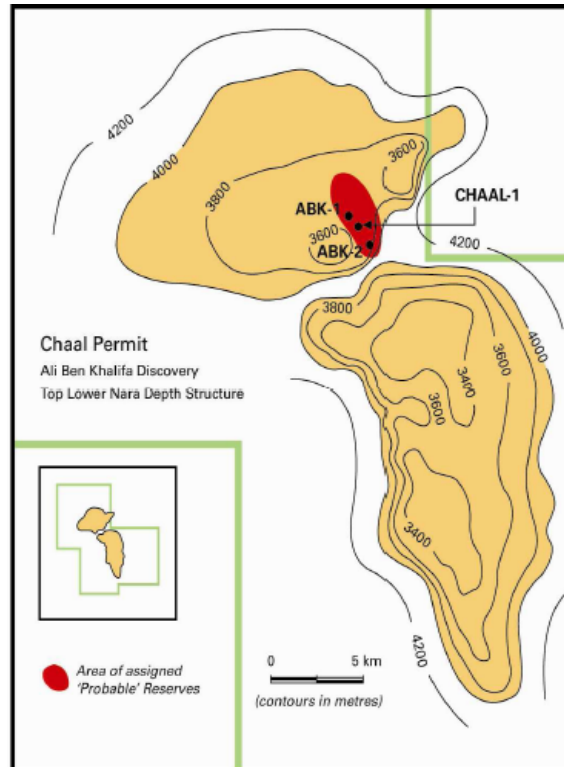
On June 20th Candax announced that the well would be cased as a producer. A coiled-tubing unit was brought in to continue with further testing and evaluation. Unfortunately, during an acid injectivity test the team observed a sudden loss of annulus pressure. After further study it was concluded that the cause of this loss was a leak between the annulus and the tubing. However, as the rig had been released in July Candax did not have the ability to immediately remove the faulty casing and therefore suspended the well.

Although the Chaal partnership has been encouraged by the initial log results from the well, future activity remains at question. Previous announcements had suggested Candax would review alternative strategies to tackle this difficult reservoir. Specifically they have noted underbalanced drilling and multi-lateral completions. The challenges of drilling an HP/HT fractured carbonate are substantial and Candax are likely to seek expertise beyond North Africa. We do not anticipate any further activity on this location until mid-2007. Further, as Mitsubishi has fulfilled their financial commitments on the farm-in expenditures of the first well, we expect additional activity will likely be apportioned on a working interest basis despite a contractual provision for a further promote.

We currently attribute 750 Bcf of gross resources to the Chaal structure but have reduced our chance of recovery to 20% from 30%. We had previously expressed some mild consternation at the location of the initial well as it is already within a region of booked probable reserves. Therefore, in the event of a success no new reserves would be added excepting those associated with thicker pay. Value could be created by moving these reserves in to proven, however,

after being unable to recover gas at commercial rates, a portion of these booked resources must be considered at risk.

Exhibit 1: Chaal Well Location and Prospect Structural Map



Source: Company Reports

El Bibane: Delays likely defer Q4 cash flow, first production expected Q1 2007

Light oil production from El Bibane has been shut-in since late-August 2005 due to a lack of natural lift. Production from El Bibane was focused on a single horizontal well, El Bibane 3, which at the time of the shut-in was producing 530 bopd and 3.7 mmcf/d. An attempt to restart production artificially with the injection of nitrogen failed and the field has lain dormant since. Through Q4 2005 Candax designed a plan to maximize recovery from the field with the installation of gas lift, two new horizontal producers, and a gas disposal well.

Due to significant delays in the delivery of the offshore rig and platforms production is now expected to restart as late as January 2007. Candax has hired a Tunisian contractor, Pireco for two engineering redevelopment projects. This work includes the fabrication of two new platforms, the installation of a separator and upgrades to onshore facilities to handle higher production volumes. We now anticipate the rig will be mobilized in September. First production is likely 3 months after this with full production of >2000 bopd expected in late Q1.

We have reduced Q4 2006 cash flow to remove the impact of El Bibane, and have refined our 2007 estimates. We anticipate Candax will see a full year of cash flow from El Bibane and estimate net rates of 2000 bopd with a further 5

mmcf/d of gas. The natural gas is sold to the SEEB power plant at an estimated US\$0.40/mcf with oil production receiving world prices. We have assumed production from the existing assets declines by approximately 10% through 2007 adding an average of 500 bopd. 2007E DACF is estimated at \$42.5 mm with operating netbacks of \$46 to \$49/bbl against an estimated US\$63/bbl Brent crude.

Corporate transaction considered more likely after operational challenges

We estimate Candax currently holds \$59 million in cash against \$14 million in long-term debt. As we indicated in our Scenarios piece (February 6th, 2006) in the event of failure at Chaal we suspect the pressure to make-up lost ground will increase the likelihood of an acquisition. We are aware that Candax has been actively pursuing acquisitions ranging from \$10 million to \$1 billion in value throughout North Africa and the Middle East. We anticipate a notable acquisition before year-end and focus our expectations on light oil from Egypt or gas in Oman. Both of these locations have a number of deals under discussion and fit the core competencies of this team.

Valuation and Summary Recommendation

We have reduced our target materially to \$1.00 from \$1.20 and maintained our Market Perform recommendation. We are not comfortable recommending this stock at this time as they have yet to prove their operational abilities and trade at only a modest, and arguably deserved, discount to net asset value. We understand that the majority of the problems encountered to date are the responsibility of contractors, however, Candax suffer accountability for their stewardship. That being said, there is fundamental downside support at the current level both in terms of near-term cash flow and reserves.

We estimate Candax will generate \$0.25/share in debt adjusted cash flow in 2007 on the back of light oil production from El Bibane. Despite the recent track record of their contractors we maintain confidence in the technical ability of this team and have been impressed with the thorough development planning to maximize recovery from the El Bibane field. Our target price represents a modest four times 07E DACF and is supported by a risked NPV/share of \$0.99.

Exhibit 2: Net Asset Valuation Table

Valuation Matrix	Forecast	Target Multiple	Value	Weighting	Weighted Value
Risked NPV/share	\$ 0.99	1.0	\$ 0.99	60%	\$ 0.60
2007 DACF Multiple	\$ 0.25	5.0	\$ 1.25	10%	\$ 0.12
Asset EMV/share	\$ 1.01	1.0	\$ 1.01	20%	\$ 0.20
EV/BOE - 2004 Acquisition Value	\$ 0.76	1.0	\$ 0.76	10%	\$ 0.08
12 month target price					\$ 1.00

Source: Company reports, Wellington West Capital Markets Inc.

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Candax Energy Inc.	CAX-T	-

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