

Candax Energy Inc. – (CAX:TSX, \$0.68)

Chaal Operations Suspended – Still Waiting for Good News

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Stock Rating: Speculative Buy

Target Price: \$1.18 (from \$1.30)

C\$000 Yr end Dec. 31	F05A	F06E	F07E
Oil and Liquids (bbl/d)	493	637	2,512
Natural Gas (mcf/d)	1,095	625	4,600
BOE/d (boe/d 6:1)	675	741	3,279
CFPS, f.d.	\$0.05	\$0.04	\$0.23
Net Debt (mm)	(\$11.4)	(\$34.2)	(\$23.0)
Enterprise Value (mm)	\$71	\$81	\$92
EV to BOE/D	\$104,614	\$108,910	\$28,009
Projected Return			73.5%
Shares Outstanding (basic) (mm)			168.9
Shares Outstanding (f.d.) (mm)			180.4
Market Capitalization			\$114.8
NAVPS (\$/f.d. share), end 2006 Forecast			\$1.18
P/NAVPS			0.6

Candax has announced that it has suspended operations at the Chaal-1 well in Tunisia without being able to perform additional flow tests. The development of a leak between the annulus and the tubing means that perforating, acidizing and testing operations on the well could not be safely undertaken.

As a result of this disappointing news, we are changing our assumptions for Chaal for our expected monetary value calculations (risked discounted cash flow). The initial development of Chaal is now not expected to come onstream until 2009 (we previously assumed 2008), and a similar delay has been incorporated in the larger potential long-term development of the field.

We are reducing our target price to \$1.18 per share from \$1.30. We are maintaining our Speculative BUY recommendation.

Source: Company Reports & MGI Securities Inc.

Developments

Chaal Operations Suspended

Candax has announced that it has suspended operations at the Chaal-1 well in Tunisia without being able to perform additional flow tests. The most recent program was designed to use a coiled-tubing unit and acid squeeze to repair formation damage caused by heavy mud used during drilling. Unfortunately, a leak appears to have developed between the well annulus and the tubing following an initial injectivity test, such that CAX would have to pull and repair the completion before being able to continue with any further preparations for testing. Since there is no longer a drilling rig available this is now not possible. Further operations at Chaal will now require a drilling rig, which is very unlikely to be available before end-year (and possibly well into 2007). Although the company had already been looking to source a rig for potential drilling at Chaal and Ezzaouia, no firm commitments had been made.

This most recent disappointment has now confirmed that a fast-track development at Chaal will not be possible. We have therefore revisited our valuation for the Chaal field and assume production will not come onstream until 2009, a year later than previously assumed. This is the main reason for the reduction in our risked discounted cash flow valuation (upon which our target price is based).

Management was aware that the chances of achieving successful tests using the coiled-tubing unit were limited (to perhaps around 50%), although this was mainly due to the risk of formation damage being unrepairable, which can now not be tested. The technical challenge of CAX's planned work program (in particular at Chaal), remains the reason for our speculative rating for investment in shares of CAX.

We also believe that most of the issues at Chaal are unlikely to reoccur during any future appraisal drilling, since the company should now be prepared for the higher pressures, although the drilling will remain challenging (the potential use of under-balanced drilling would present further technical challenges). We note that many of CAX's recent operational disappointments have been due to contractor and supply chain issues. Tunisia remains a difficult market in which to secure oil field services and equipment, especially for a small company. We therefore welcome management's willingness to consider new operating arrangements going forward.

Chaal remains a very promising discovery with large potential. We again stress that the results initially obtained from the Chaal-1 well were very promising, in particular the larger than expected hydrocarbon columns and pressures encountered. We therefore believe, despite the company's inability to achieve commercial flow rates, that there is a considerable potential for reserve valuations at end of 2006 to increase from the previous year.

Further Delays at El Bibane

Although only minor, we have been informed that rig construction delays for the El Bibane redevelopment are continuing (due to issues with the rig construction contractor). We now expect the rig to be mobilized during September, which could still result in production starting up during 2006. However, any cashflow contribution from the field will likely be minimal this year. We have adjusted our assumptions for this field, but note that while this impacts our 2006 production and cash flow forecasts, it makes little difference to our 2007 estimates or our NAV calculations.

Recommendation

We are maintaining our Speculative BUY recommendation for shares of Candax Energy with a target price reduced from \$1.30 to \$1.18 per share. Our target price is based on 1.0x our updated estimate of future NAV using a risked expected monetary value. Due to a sharp decline in share price of \$0.19 (21.8%) following the announcement yesterday, our target price now represents a potential return of 73.5% from the yesterday's closing price of \$0.68.

Following a recent visit to CAX's offices in both London and Tunisia over the last three weeks, we remain convinced of management's technical abilities. Although the El Bibane redevelopment holds the potential for minor disappointments in the form of further small delays, we continue to expect mobilization or commencement of operations there to be announced during September, leading to production start-up during Q4. In addition, CAX's management continues to pursue large acquisition opportunities that could potentially change the nature of the company. The company's track record for creating value in transactions is a considerable contributor (together with the underlying value of the existing assets) to our positive view of investment in shares of Candax Energy. Positive news from El Bibane or a potential acquisition could result in a share price recovery in the relatively near future.

Candax Energy Inc.		TSX - CAX		Current Price \$0.68	
SHARES		TARGET PRICE		RECOMMENDATION	
Shares Outstanding Basic (MM)	168.9	\$1.18		Buy	Speculative BUY
Shares Outstanding F.D. (MM)	180.4			Spec Buy	
Market Capitalization (MM\$)	\$114.8			Hold	
Percent of Shares Held by Management	11%	Return to Target	73.5%	Sell	

Production (Net Sales)					
Units	Year-end Dec.31	2004A	2005A	2006F	2007F
(bbl/d)	Oil & Liquids	0	493	637	2,512
(mmcf/d)	Natural Gas	0.0	1.1	0.6	4.6
(6:1)	BOEPD	0	675	741	3,279

Financial Results					
Units	Year-end Dec.31	2004A	2005A	2006F	2007F
(MM)	Cash Flow	n/a	\$5.3	\$7.3	\$41.0
	CFPS - Basic	n/a	0.06	0.05	0.24
	CFPS - Fully Diluted	n/a	0.05	0.04	0.23
(MM)	Net Income	n/a	(\$1.5)	(\$0.9)	\$12.1
	EPS - Basic	n/a	(0.02)	(0.01)	0.07
	EPS - Fully Diluted	n/a	(0.01)	(0.00)	0.07

Comment:

Valuation Metrics					
Units	Year-end Dec.31	2004A	2005A	2006F	2007F
	P/CF - Fully Diluted	n/a	13.7 x	16.8 x	3.0 x
	P/E - Fully Diluted	n/a	(52.5) x	(143.3) x	10.2 x
	EV/DACF	n/a	10.1 x	10.1 x	2.0 x
(\$/BOEPD)	EV/BOEPD	n/a	\$104,614	\$108,910	\$28,009
(\$/BOE)	EV/BOE - P+P Reserves	n/a	\$4.51		

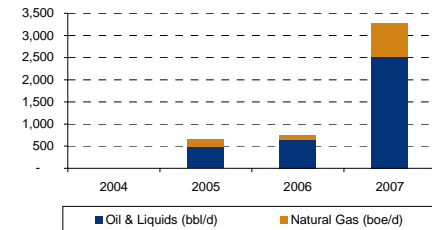
Comment: 2005A metrics based on weighted average 2005 share price

Capital Structure					
Units	Year-end Dec.31	2004A	2005A	2006F	2007F
(MM)	Basic Shares O/S	4.7	130.7	168.9	168.9
(MM)	F.D. Shares O/S	4.7	183.1	180.4	180.4
(MM)	Market Capitalization	n/a	\$82.0	\$114.8	\$114.8
(MM)	Net Debt	(\$3.7)	(\$11.4)	(\$34.2)	(\$23.0)
(MM)	Enterprise Value	n/a	\$71	\$81	\$92
(MM)	Capex	\$0.1	\$46.3	\$25.8	\$28.0
	Net Debt to Cash Flow	8.2 x	(2.1) x	(4.7) x	(0.6) x

Core Areas



Production Mix



Per Share Growth

	2006F	2007F
Production per share	-72.5%	336.7%
Cash Flow per share	-27.2%	421.4%

Net Asset Value

	2005A	2006F
NAV per Share (\$/share)	\$ 1.06	\$ 1.18
P/NAVPS	0.6 x	0.6 x
Net Land (acres)	301,973	254,529

Sensitivities

Cash Flow Per Share, Fully Diluted

	2007F
WTI +/- US\$1.00/bbl	\$1.05
Gas +/- \$1.00/mcf	\$0.19
Oil +/- 100 bbl	\$0.26
Gas +/- 1 Mmcf	\$0.00

Financing History

Date	Issue Price	# of Shares	Proceeds
22-Nov-04		13,607,000	\$3,401,750
04/14/2005*	\$0.80	82,500,000	\$66,000,000
04/18/2006**	\$1.20	35,497,106	\$42,596,527

* Units included half a warrant exercisable at \$1.20 for one year

** 86% of previously awarded warrants exercised

RESERVES				FINDING & DEVELOPMENT			
Proven Reserves		P + P Reserves		Proven		P + P	
Oil & Liquids (mmbbl)	2,362	Oil & Liquids (mmbbl)	5,424	Reserve Additions	3,989.5	Reserve Additions	15,659.0
Natural Gas (Bcf)	9,765.0	Natural Gas (Bcf)	61,410	F&D (\$/BOE)	\$12.61	F&D (\$/BOE)	\$3.96
Total mboe (6:1)	3,990	Total mboe (6:1)	15,659	Replacement Ratio	16.2	Replacement Ratio	63.5
Proven Reserve Growth	n/a	P + P Reserve Growth	n/a	Recycle Ratio	1.6	Recycle Ratio	5.2
Proven RLI (years)	16.7	P + P RLI (years)	65.6				

COMMODITY PRICE ASSUMPTIONS								
WTI (US\$/bbl)	2005	\$56.59	Brent (US\$/bbl)	2005	\$54.51	Foreign Exchange (C\$/US\$)	2005	\$0.83
	2006	\$68.00		2006	\$66.50		2006	\$0.88
	2007	\$60.00		2007	\$57.50		2007	\$0.89

Source: Company Reports & MGI Securities Inc.

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

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