

October 15, 2010

Orca Exploration¹ (ORC/B CN)

Last: C\$4.49

BUY

Target: C\$7.10↓

WHAT'S CHANGED

	NEW	OLD
Rating	nc	BUY
Target	C\$7.10	C\$7.40
Production 2010E (boe/d) 6:1	nc	5,763
Production 2011E (boe/d) 6:1	nc	6,075
CFPS 2010E (f.d.)	\$0.48	\$0.53
CFPS 2011E (f.d.)	\$0.55	\$0.81

SHARE DATA

Shares o/s (mm, basic/f.d.)	29.5/32.1
52-week high/low	C\$5.43/C\$3.00
Market capitalization (mm)	\$130
Enterprise value (mm)	\$110
Net debt (mm) – 2009A	(\$16.8)
Dividend yield	n/a
Projected return	58%

FINANCIAL DATA

	2009A	2010E	2011E
Oil & NGLs (mb/d)	0.0	0.0	0.0
Natural Gas (mmcf/d)	28.5	34.6	36.5
Total (mboe/d) 6:1	4.8	5.8	6.1
Equivalent growth	20%	21%	5%
Brent (US\$/b)	62.04	77.50	79.50
UK Gas (US\$/mmbtu)	4.83	6.84	6.50
FX rate (USD/CAD)	0.88	0.96	0.95
EPS (f.d.)	\$0.11	\$0.24	\$0.31
CFPS (f.d.)	\$0.43	\$0.48	\$0.55
Net Debt (mm)	(\$16.8)	(\$50.2)	(\$24.7)
Debt/CF	nm	nm	nm
P/CF	11.5x	9.8x	8.6x
P/CF (d'adj'd)	18.7x	5.2x	5.5x

*(In US\$ unless otherwise stated)

Resuming coverage of ORC/B following the \$19 mm rights issue

The company is well positioned to fund its activities in 2011

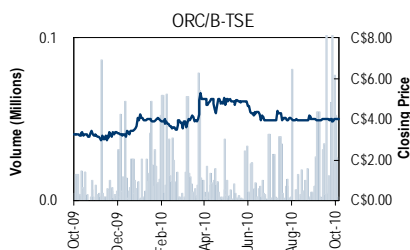
On 12 October, 2010, Orca Exploration completed the rights offering of 4,955,687 class B shares at a price of \$3.90/sh for gross proceeds of \$19,327,179. The proceeds are planned to be used to drill the Songo Songo West exploration prospect in Tanzania in H2/11 and to drill the Elsa-2 appraisal well in Italy once the drilling ban issues are resolved. Orca is expected to continue to focus on infrastructure development in Tanzania to accelerate the commercialization of its gas reserves.

High impact drilling in 2011

Exploration drilling at the Songo Songo West prospect is expected in H2/11. Given its proximity to the main Songo Songo field, McDaniel & Associates Consultants Ltd. views it as a low risk prospect with unrisked mean recoverable resources of 551.6 bcf. In Italy, the appraisal of the Elsa discovery by drilling and testing the Elsa-2 well is suspended due to unresolved legislative issues. Orca is committed to fund 30% of the Elsa-2 appraisal well up to a maximum of US\$11.5 mm to earn a 15% WI in the permit and also pay 15% of the back costs up to a maximum of US\$0.5 mm.

Changes to our target price

Our 12 month price target decreases slightly to C\$7.10/sh (from C\$7.40/sh) following the rights issue and the consequent dilution in per share values. Our view on Orca remains unchanged and with a 58% return we maintain our BUY recommendation. We believe the company is well positioned to finance its activities going forward with ~\$49 mm of working capital available. As the company addresses the infrastructure bottle-neck issues we believe we will see cash flow growth from the increased gas sales in Tanzania. In 2011, Orca plans to drill two high impact wells, SSW in Tanzania and Elsa-2 in Italy, providing potential catalysts for next year.





THE COMPANY IS WELL POSITIONED TO FUND ITS ACTIVITIES IN 2011

On 12 October, 2010, Orca Exploration completed the rights offering of 4,955,687 class B shares at a price of \$3.90/sh for gross proceeds of \$19,327,179. The proceeds are planned to be used to drill the Songo Songo West exploration prospect in Tanzania in H2/11 and to drill the Elsa-2 appraisal well in Italy once the drilling ban issues are resolved. Orca is expected to continue to focus on infrastructure development through recently created EastCoast Transmission in Tanzania to accelerate the commercialization of its gas reserves.

HIGH IMPACT DRILLING IN 2011

Exploration drilling at the Songo Songo West prospect is expected in H2/11. Songo Songo West lies on a separate fault block ~2.5 km to the west of the main field and is believed to be very similar to the main field in terms of trap and reservoir presence. Like the main field, two reservoirs are believed to be present, the Neocomian and Cenomanian. Given its proximity to the main Songo Songo field, McDaniel's views it as a low risk prospect with a 52% chance of success in the Neocomian and 35% chance of success in the Cenomanian. McDaniel's estimates an unrisks combined P50 OGIP of 609 bcf and unrisks resources of 450 bcf. SSW requires a jack-up to drill and Orca believes that deferring drilling will result in lower drill costs due to the current weak jack-up market. In addition, the reserves in the main Songo Songo field main are sufficient to meet current gas demand in Tanzania and significant additional processing facilities would be required to commercialize SSW. We believe the largest risk for SSW will be gas demand growing sufficiently for the gas to be produced in the life of the PSC (until 2026).

In Italy, the appraisal of the Elsa discovery by drilling and testing the Elsa-2 well is suspended due to unresolved legislative issues. As a reminder in June 2010, Orca Exploration signed an agreement with Petroceltic International to farm in on PCI's B.R268.RG Permit offshore Italy (PCI 55% WI). Orca is committed to fund 30% of the Elsa-2 appraisal well up to a maximum of US\$11.5 mm to earn a 15% WI in the permit and also pay 15% of the back costs up to a maximum of US\$0.5 mm. The Elsa field tested 15 degree API oil in the Elsa-1 well and holds ~100 mmb P50 contingent resources.

ADDRESSING BOTTLE-NECK ISSUES

Part of the funds received from the rights issue will be used to address bottle-neck issues and to accelerate infrastructure development in Tanzania.

In July 2010, the company announced the creation of EastCoast Transmission and Marketing as the new infrastructure division of the company. EastCoast Transmission is initially focused on expanding the onshore natural gas pipeline system transporting Songo Songo gas to Dar es Salaam in Tanzania. Currently the installed infrastructure configuration that transports the Songo Songo gas to Dar es Salaam is at capacity at 90 mmcf/d. Orca is planning to expand the existing system and increase the throughput to a peak of 140 mmcf/d by Jan/13. Pipeline expansion is intended to address capacity constraints.



ITALIAN DRILLING BAN

On July 1 2010, the Italian Minister of Environment announced that an outline proposed decree to amend the Italian Environmental Code had been adopted by the Council of Ministers that will inter alia prohibit drilling in the Italian seas within 5 nautical miles of the coastline and within 12 nautical miles around the perimeter of protected Marine Parks. Consequently, the Elsa-2 well on the B.R268.RG permit in Italy was suspended by the operator, Petroceltic International.

Italy's proposed ban on drilling has received a lot of criticism from various government officials, party representatives, business community and environmental associations. We believe that the economic repercussions of the ban could be very significant. We also believe that ENI will likely be lobbying against the ban as it has been reported in the Italian media that ENI is in the process of selling two packages of assets, one in the North and one in the Adriatic Sea to the Italian utility Gas Plus SpA (and possibly Enel) for around €800 mm. It was reported that ENI had been hoping to raise €1.5-2 bn for the assets to pay down debt, but the proposed drilling ban could result in the sale being cancelled or the price being re-negotiated. The Italian Government owns 30.3% of ENI and four of ENI's directors are voted from a list nominated by the Italian Government's Ministry of Finance. Given this and the fact that the Government is implementing an austerity program suggests that there will be many competing views within the Government itself to this proposal. In light of this information, the operator remains optimistic and estimates that it may be possible to commence drilling on Elsa in Q1/11.

CHANGES TO OUR TARGET PRICE

We are updating our EMV to reflect the dilution due to the increased number of shares following the rights issue from 32.2 mm to 37.1 mm. The per share value of the main producing Songo Songo asset decreases from C\$5.35/sh to C\$4.45/sh. Songo Songo West exploration that is planned for H2/11 is valued at C\$1.10/sh compared to the previous C\$1.32/sh. The Elsa-2 appraisal well is targeting 33 mmboc of gross resources and is included in our target price calculation. We value Elsa field's C90 resources at C\$0.56/sh and its C50 potential at C\$0.67/sh. We continue to include 3 of the 11 Adriatic permits and value d505BR/ d497BR and d493BR at C\$0.88/sh and C\$0.12/sh respectively.



Exhibit 1: Risked Exploration Value

Country	Property/Prospect	Gross Resource (mboe)	Working Int. (%)	Well Costs (US\$ mm)	Overall COS (%)	Value/BOE (US\$)	Net Risked Resources (mboe)	Risked NAV (US\$ mm)	US\$/sh (FD)	C\$/sh (FD)	Unrisked NAV (C\$/sh)
Producing Assets											
Tanzania	SS Main (Proved Producing)	50.1	100%	100%	100%	\$ 3.46	50.1	173.65	4.68	4.45	4.45
							50.1	173.65		4.45	
Risked Upside											
Tanzania	SS Main (Proved Non Prod.)	14.0	100%	100%	4.00	80%	11.2	38.10	1.03	0.98	1.25
Tanzania	SS Main (Probables)	17.6	100%	100%	5.00	80%	14.0	47.65	1.28	1.22	1.56
Tanzania	SS West	90.9	100%	100%	5.00	30%	1.71	27.3	43.01	1.16	1.10
Tanzania	SS Main (Possibles, Contract ext)	56.4	100%	100%	5.00	50%	1.71	28.2	45.64	1.23	1.17
Tanzania	SS North	28.3	100%	100%	5.00	60%	1.71	17.0	26.92	0.73	0.69
Italy	Elsa-2	33.0	15%	30%	15.00	40%	\$ 12.47	2.0	22.00	0.59	0.56
Italy	Elsa (C50 upside)	56.0	15%	30%	55.00	25%	\$ 18.26	2.1	25.97	0.70	0.67
Italy	Adriatic - Sangiovese (d505BR/d497BR)	180.0	15%	15%	50.00	10%	\$ 15.21	2.7	34.33	0.93	0.88
Italy	Adriatic - Pampanuto (d493BR)	50.0	15%	15%	50.00	10%	\$ 15.21	0.8	4.66	0.13	0.12
							105.2	288.28		7.38	
Gross Resources Total		576.3					155.3	461.92	12.45	11.83	35.91
Fully Diluted Shares Outstanding (mm)		37.10									
USD:CAD Exchange Rate		0.95									
Notes											
Estimates of Reserves and Resources are provided by third party engineering firms, management and GMP securities											
Overall COS = Chance of success after taking all risks into consideration including geological risk, political risk, etc											
Value/BOE is calculated from a field model in the specific fiscal regime of the host country after government take, all capex and costs have been removed, and the time value of money is applied											
Risked NAV is equivalent to Expected Monetary Value (EMV). Risked NAV = (Reward*C.o.S.) - [Capital at Risk*(1-C.o.S.)]											
Fully diluted shares outstanding = shares at period end + options + all dilutive securities											
Cost % = the difference (if any) in costs paid versus working interest. Of relevance when farm-outs or farm-ins occur											

Source: Orca Exploration, GMP Estimates

The bulk of Orca's value is very robust and is based on its long life producing Songo Songo gas field, Tanzania. Our core NAV of C\$5.29/sh (vs previous C\$5.23/sh) consists of the proved producing reserves currently supplying the gas market in Dar es Salaam. Although the per share values of the producing and undeveloped assets have decreased slightly following the rights issue, we reflect the company's current cash position which has improved from C\$0.53/sh to C\$1.40/sh.

Exhibit 2: Net Asset Value

Net Asset Value Breakdown				
	MMBOE	US\$/BOE	US\$MM	C\$/sh
Production Assets	50.1	3.46	173.65	4.45
Cash/(Net Debt)			49.41	1.40
Other items incl G&A			(19.60)	(0.56)
Core NAV	50.1	4.06	203.45	5.29
<i>Price to NAV (%)</i>				<i>0.85</i>
Option Proceeds			10.13	0.29
Risked Upside	105.2	2.74	288.28	8.18
Risked NAV	155.3	3.23	501.86	14.24
<i>Price to Risked NAV (%)</i>				<i>32%</i>
			Current Stock Prices	C\$ 4.49
			Unrisked	C\$ 41.49
Notes				
Reserves evaluated by McDaniel and Associates Ltd. as of December 31st, 2008.				
Long term Brent flat price is US\$84.00 and UK Gas price is US\$8.00/mmBtu.				
All asset values are NPV10 After Tax and in USD unless noted.				
Two years of G&A are deducted to ensure 'going concern' costs are captured.				

Source: Orca Exploration, GMP Estimates

Exhibit 3: Target Price

Target Price Calculation	
Orca Exploration Group	C\$/sh
Production Assets	4.45
Cash/(Net Debt)	1.40
Undeveloped Assets	-
<u>Other Items incl G&A</u>	<u>(0.56)</u>
Core NAV	5.29
Risked Upside - Included from EMV Sheet	
SS Main (Proved Non Prod.)	0.98
Elsa-2	0.56
<u>Option Proceeds</u>	<u>0.29</u>
Sum of Parts	7.12
TARGET PRICE	7.10
Share Price	4.49
Expected Return	58.5%
USD:CAD Exchange Rate	0.95
Notes:	
Target set off the Proved Reserves for SongoSongo (producing and non-prod)	

Source: Orca Exploration, GMP Estimates

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BUY. These stocks will have 15% or greater (small cap) or 10% or greater (large cap) total return potential.

SPECULATIVE BUY. These stocks will have a 30% or greater total potential return and they will have a speculative component which could be material to the return expectations.

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REDUCE. Companies ranked Reduce have a negative potential total return.

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