

**Orca Exploration Group Inc.**

ORC.B-TSX V: \$5.35 — BUY

TARGET PRICE: \$7.75 (UP FROM \$6.25); PROJECTED RETURN: 40%

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**Active Exploration Program Planned for 2011**

**EVENT – Operational Update**

Increasing our target price after discussions with management on the potential of Orca’s new onshore exploration play in Italy.

**HIGHLIGHTS – Large Natural Gas Potential Near Infrastructure**

Last week, Orca announced an agreement to earn up to a 75% interest in the Longastrino Exploration Permit, located onshore in the Po Valley Basin in Italy (see our research report dated December 9, 2010). The permit is surrounded by several large natural gas fields, including the Alfonsine Field (300 bcf) and the Ravenna field (185 bcf). Orca expects to commence drilling of the La Tosca prospect late in the second quarter or early in the third quarter of next year. The prospect has been defined by 3D seismic and is located just 2 km to the northeast of the Alfonsine gas field. While the primary reservoir is located at a depth of approximately 1,600 metres, the La Tosca-1 well will be drilled to a total depth of approximately 2,500 metres in order to test a deeper secondary target.

The surrounding production infrastructure has spare capacity and first production could be achieved within 18-24 months of a discovery. The price of natural gas in Italy is currently over US\$10/mcf.

**VALUATION – Increasing Risked NAV Estimate**

Management estimates the La Tosca prospect has a 45 bcf (34 bcf net) mean prospective resource. To reflect the risked value for La Tosca, our risked NAV increases from \$12.40/fd share to \$12.88/fd share.

**RECOMMENDATION – BUY on 2011 Exploration Program**

We expect Orca to demonstrate steady natural gas production growth from Tanzania as infrastructure is expanded to meet growing demand. Orca continues to trade at a significant discount to our risked net asset value due to its concentrated asset base and slow but consistent production growth. The acquisition of the Longastrino Exploration Permit helps diversify Orca’s exploration portfolio and provides another near-term catalyst. We maintain our **BUY** on the B shares and are increasing our target price to \$7.75 from \$6.25 per share, equivalent to a 0.6x multiple (up from 0.5x multiple) of our new risked NAV. Our higher multiple reflects Orca’s increased exploration activity planned for 2011.

**VALUATION CATALYSTS – Exploration Success**

1. Spud of the SSW exploration well anticipated in 2H/11.
2. Spud of the La Tosca-1 exploration well (Q2/11).
3. Removal of the offshore Italy drilling ban and spud of the Elsa-2 appraisal well (timing unknown).

**Financial Metrics (C\$)**

Shares O/S (mm)*:	34.4	Mkt. Cap (\$ mm):	\$184.3
FD Shares (mm):	37.2	W.Capital (\$ mm)**:	\$48.0
Price:	\$5.35	Ent.Value (\$ mm):	\$136.3
52-Wk High:	\$6.30	52-Wk Low:	\$3.05

\* 32.7 million Class B shares and 1.75 million Class A shares.

\*\*Estimated working capital in C\$ as at October 12, 2010

**FY December 31 2008A 2009A 2010E 2011E**

**Production**

Liquids (bbl/d)	-	-	-	-
Gas (mmcf/d)	23.7	28.5	36.3	41.8
Boe/d (6:1)	3,945	4,756	6,044	6,962

**Financials (US\$)**

Cash Flow (US\$ mm)	\$9.8	\$12.7	\$20.9	\$31.8
CFPS (FD)	\$0.33	\$0.43	\$0.66	\$0.88
EV/DACF	17.4x	13.6x	6.3x	4.3x
D/CF	na	na	na	na

**2010 Quarters**

	<b>Q1A</b>	<b>Q2A</b>	<b>Q3A</b>	<b>Q4E</b>
Liquids (bbl/d)	-	-	-	-
Gas (mmcf/d)	34.9	33.0	40.1	37.0
Boe/d (6:1)	5,817	5,500	6,683	6,167
CFPS (FD) US\$	\$0.14	\$0.16	\$0.20	\$0.16

**Target Valuation Parameter**

0.75x Risked NAV; 7.3x 2011 EV/DACF



Courtesy of BigCharts.com

**Key Risks**

Expansion of the processing and transportation infrastructure projects will require Songas Limited and EWURA to reach an agreement on terms. Any delays in an agreement could impact Orca’s ability to achieve our forecasts

**Corporate Profile**

Orca Exploration Group Inc. ([www.orcaexploration.com](http://www.orcaexploration.com)) is an international oil and gas exploration and production company that produces and markets natural gas in Tanzania.

**Multiple Share Structure**

Two-share structure: 1.75 million Class A shares outstanding with 20 votes each, and 34.5 million Class B single-voting shares. The Chairman & CEO of Orca holds 99.5% of the Class A shares.

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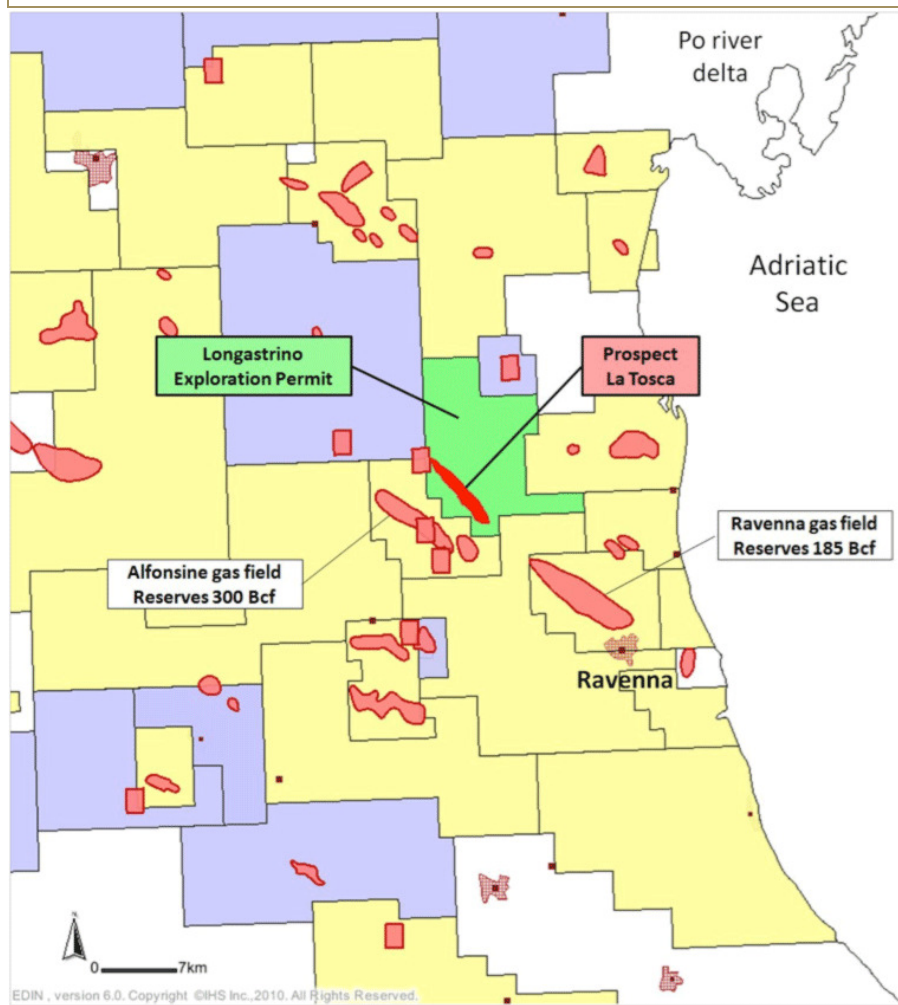


Figure 1. Longastrino Exploration Permit and Surrounding Blocks  
 Source. Company reports

### Elsa – Drilling Embargo Puts Project on Hold

On May 31, 2010, Orca announced an agreement with Petroceltic International plc (Petroceltic) to farm in on the Central Adriatic B.R268.RG Permit (Elsa Block) located offshore Italy. Under the terms of the agreement, Orca is obliged to fund 30% of the Elsa-2 appraisal well to earn a 15% working interest in the permit. The maximum that will be contributed by Orca is US\$11.5 million. Thereafter, Orca will fund 15% of future costs relating to the well and the permit. The farm-in agreement also provides Orca the opportunity to participate at its 15% working interest in 11 additional Petroceltic licences (Figure 1).

**Large resource upside:** The Elsa field was discovered in 1992 and is in a proven basin with other commercial discoveries, including the Rospo Mare and Ombrina Mare fields. The original Elsa-1 well encountered an oil column of 65 metres in the Lower Cretaceous Maiolica Formation at a depth of approximately 4,500 metres. The Elsa-2 appraisal well has the objective of confirming the potential of the reservoir. Management’s internal median estimate is that the field could contain approximately 400 million barrels of original oil in place.

**Timing of Elsa-2 uncertain:** In June, 2010, in response to Gulf of Mexico oil spill, the Italian environment minister proposed a drilling embargo on wells located within five miles of the coast and within 12 miles of marine parks. Unfortunately, the Elsa structure straddles the 5-mile restriction. The decree has not been passed into law and it is unclear whether the ban applies to existing permits. As a precaution, Petroceltic has applied to suspend the licence until the proposed law is clarified. It is worth noting that in October 2010, the European Parliament voted against a moratorium on

deep sea drilling and the U.S. lifted its ban on deep-water drilling. Given that the Elsa field is located in shallow waters (~34 metres) and that EU and U.S. have decided to allow deep water drilling, it is hopeful that the Italian government will lift its drilling embargo.

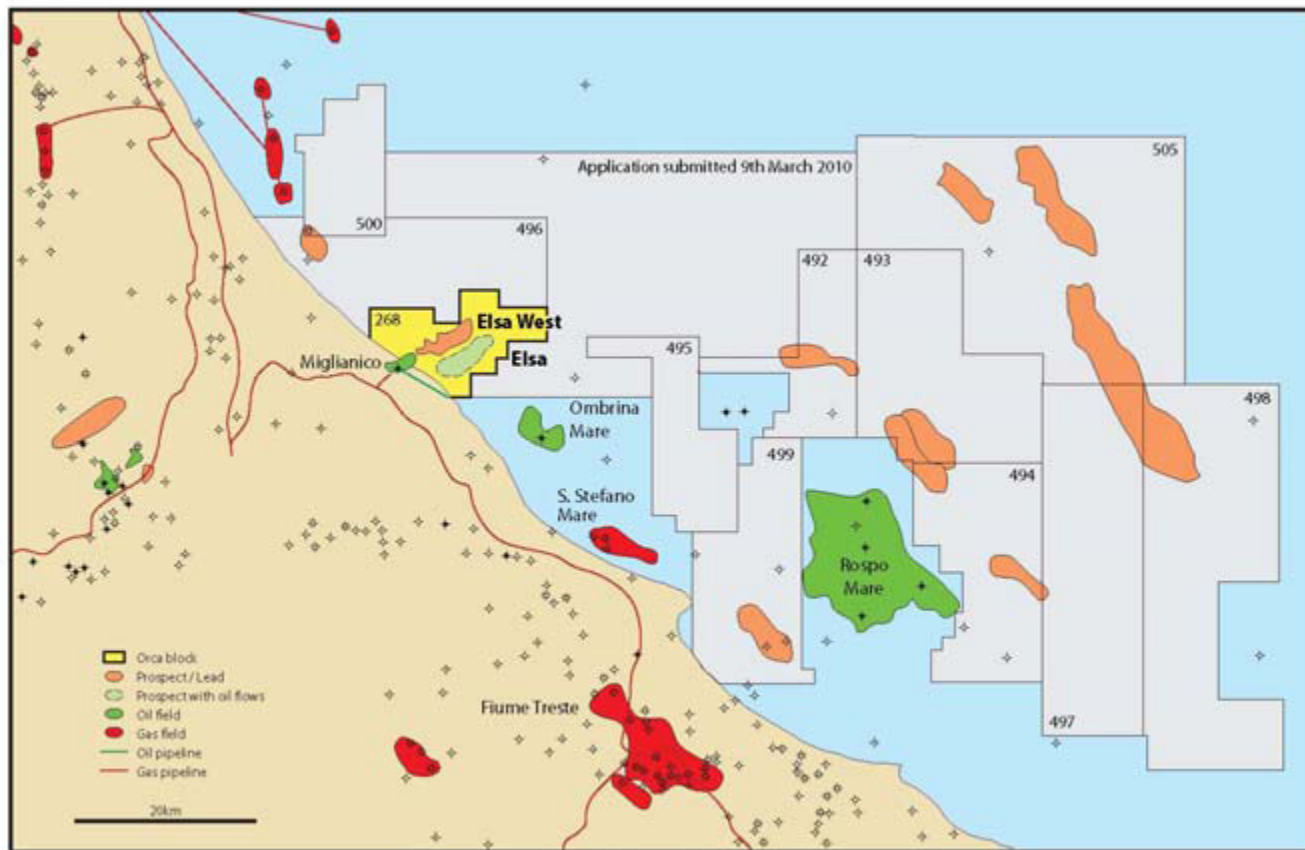


Figure 2. Elsa and Surrounding Block  
Source. Company presentation

**Orca Exploration Group Inc.**
**ORC.B**

Share Data and Market Value		Price and Target			
Basic Shares (mm)	34.4	Close C\$:	\$5.35		
Diluted Sh. (Treasury)	35.8	52-Week High C\$:	\$6.30		
Fully Diluted (mm)	37.2	52-Week Low C\$:	\$3.05		
Market Cap. (C\$ mm)	184.3	Target Price C\$:	\$7.50		
Enterprise Value (C\$ mm)	136.3	Potential Return:	40.2%		
Net Debt (W.C) (C\$ mm)	(48.0)	Risked NAV	0.75x		
Production		2008A	2009A	2010E	2011E
Oil & Liquids	bbl/d	-	-	-	-
Natural Gas	mmcf/d	23.7	28.5	36.3	41.8
Boe/d	6:1	3,945	4,756	6,044	6,962
Production Growth	%	(43%)	21%	27%	15%
Percentage Natural Gas	%	100%	100%	100%	100%
Cash Flow & Earnings (US\$)		2008A	2009A	2010E	2011E
Cash Flow	\$ mm	9.8	12.7	20.9	31.8
Cash Flow/FD Share	\$/share	0.31	0.41	0.65	0.88
CF Per Share Growth	%	9%	30%	58%	37%
\$/B arrel of Oil Equivalent (US \$)		2008A	2009A	2010E	2011E
Revenue	\$/boe/d	24.12	21.59	22.52	21.10
Operating Costs	\$/boe/d	1.03	1.62	1.64	1.50
G&A	\$/boe/d	8.52	5.96	4.98	4.72
Cash Flow	\$/boe/d	6.77	7.30	9.47	12.53
Valuation Metrics (C\$)		2008A	2009A	2010E	2011E
FD Cash Flow Multiple		16.2x	12.4x	8.1x	6.1x
EV/DACF Multiple		17.4x	13.6x	6.3x	4.3x
EV/Production	C\$/boe/d	34.5	28.7	22.6	19.6
EV/boe reserves	C\$/boe	1.66	1.67		
Commodity Price		2008A	2009A	2010E	2011E
Industrial	US \$/mcf	\$11.97	\$8.36	\$8.50	\$8.75
Power	US \$/mcf	\$2.37	\$2.40	\$2.40	\$2.63
Exchange Rate	US \$ per C\$	1.06	1.14	0.98	1.00
Capex and Capital Structure		2008A	2009A	2010E	2011E
Capex/Cash Flow	%	390%	42%	86%	110%
Weighted Average Basic	mm	34.5	29.4	30.6	34.5
Dilutive Shares	mm	31.0	31.0	32.3	36.0
Market Cap	C\$ mm	184.3	157.3	163.8	184.3
Enterprise Value	C\$ mm	175.9	142.5	113.1	137.7
Year-end Net Debt (WC)	C\$ mm	(8.4)	(14.8)	(50.7)	(46.6)
Net Debt/Cash Flow		na	na	na	na
Net Asset Value Estimate		Reserve Estimate			12/31/2009
	(C\$ thous ands)				(mboe)
Reserves (P + P)*	345,041	Proven	79%		64,150
Net Debt (W.C capital)	48,000	Probable	21%		17,550
Other Assets	-	P+P			81,700
Other Liabilities	-	Reserve Life Index			
Net Asset Value	297,041	Production			
NAV/Share	\$10.02		2010	2011	
NAV/FD Share	\$9.67	Proven	29.1	25.2	
Risked Exploration (C\$)	\$84,180	P+P	37.0	32.2	
Risked NAV/share (C\$)	\$11.07				
Risked NAV/FD share (C\$)	\$12.88				

Figure 3. Fundamentals &amp; Key Ratios

Source: Company reports, Mackie Research Capital

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