

Orca Exploration Group Inc.

ORC.B-TSX V: \$5.00 — BUY

TARGET PRICE: \$6.25; PROJECTED RETURN: 25%

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Orca Achieves Record Production Rate of 40.1 mmcf/d

EVENT - Q3/10 Financial and Operating Results

Q3/10 production of 40.1 mmcf/d was higher than our forecast of 35.0 mmcf/d due to higher-than-expected sales to the power sector. As a result, cash flow of US\$6.1 million (\$0.20/fd share) was above our estimate of US\$4.8 million (\$0.16/fd share).

HIGHLIGHTS - Strong Balance Sheet to Fund Growth Projects

Expansion of processing infrastructure to meet demand: Production from the Songo Songo field averaged 81.3 mmcf/d during the quarter, near to current infrastructure capacity of 90 mmcf/d. Infrastructure capacity is anticipated to increase to 105 mmcf/d early in 2011 with the re-rating of the processing facilities. In Q4/10, Songas, the owner of the Songo Songo facilities, plans to submit an application to the government for an expansion of the infrastructure capacity to 140 mmcf/d, targeted to be operational by the end of 2012.

Songo Songo West prospect to be drilled in 2011: Orca plans to drill the Songo Songo West (SSW) exploration prospect late in 2011 or early in 2012. Independent engineering firm McDaniel & Associates Consultants Ltd. assigned an unrisks recoverable resource estimate of 551.6 bcf to the prospect. Success could more than double Orca's 2P reserves of 490.2 bcf and could add 100 mmcf/d of additional sustained production.

Drilling in Italy delayed: In May 2010, Orca announced that it had signed an agreement with Petroceltic to farm in on the Elsa block located offshore Italy. Orca will fund 30% of the Elsa-2 appraisal well to earn a 15% working interest in the permit. However, in June, 2010, in response to Gulf of Mexico oil spill, the Italian government placed an embargo on wells located within five miles of the coast. Unfortunately, the Elsa structure straddles the 5-mile restriction. Drilling will commence once the legislative issues concerning offshore drilling have been resolved.

Strong balance sheet: In October, Orca completed a \$19 million rights offering, increasing working capital to approximately \$48 million.

VALUATION - No Change

Based upon the valuation for the Songo Songo natural gas field and including Orca's positive working capital, we calculate a core NAV of \$9.67/fd share. Including our risked valuation for the SSW exploration prospect, our risked NAV is \$12.40/fd share.

RECOMMENDATION - BUY on Exploration Potential

We expect Orca to demonstrate steady natural gas production growth from Tanzania as infrastructure is expanded to meet the growing market demand. The company continues to trade at a discount to our risked net asset value due to its concentrated asset base and slow but consistent production growth. We maintain our BUY recommendation on the B shares and our \$6.25 target price, equivalent to a 0.5x multiple of our risked NAV.

VALUATION CATALYSTS - Exploration Success

Spud of the SSW exploration well and spud of the Elsa-2 appraisal well.

Financial Metrics (C\$)

Shares O/S (mm)*:	34.4	Mkt. Cap (\$ mm):	\$172.2
FD Shares (mm):	37.2	W.Capital (\$ mm)**:	\$48.0
Price:	\$5.00	Ent.Value (\$ mm):	\$124.2
52-Wk High:	\$5.43	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	16.4x	12.8x	6.3x	4.4x
D/CF	na	na	na	na

2010 Quarters

	Q1A	Q2A	Q3A	Q4E
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

0.5x Risked NAV; 7.4x 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) 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 are 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.

Natural Gas Sales

Industrial demand: During the third quarter, Orca supplied 8.4 mmcf/d of natural gas to industrial customers in Dar es Salaam at an average price of US\$8.01/mcf. Industrial sales increased by 33% over the same quarter in 2009.

Power-generation demand: Power sector natural gas sales in the quarter averaged a record 31.7 mmcf/d. Orca supplied natural gas to the power sector at an average price of US\$2.63/mcf. TANESCO, the Tanzanian electricity utility, is finalising contractual terms with Jacobsen Elektro AS to install 105 MWs of power generation capacity over the next 15 months. In addition TANESCO plans to re-commission a 112 MW plant in Dar es Salaam in Q1/2011. Combined, these facilities will require over 40 mmcf/d of natural gas.

Songas Expansion Project - Increasing Capacity to 140 mmcf/d

The Songo Songo processing facilities are owned by Songas and are operated by Orca on a no-gain, no-loss basis. According to the PSA, natural gas is classified as either Protected Gas or Additional Gas. The Protected Gas is capped at a maximum of 45.1 mmcf/d and is used primarily as feedstock for the Ubungo power plant at Dar es Salaam. Orca receives no revenue for Protected Gas; however, the company has the right to market Additional Gas, which is production in excess of the Protected Gas requirements. Generally, Protected Gas utilization has been averaging 85% per year (38 mmcf/d).

Orca's Songo Songo field is capable of delivering over 210 mmcf/d from six high-deliverability wells, while the two existing dehydration and refrigeration trains have a current combined capacity of 90 mmcf/d. Early in 2011, the processing facilities could be re-rated to 110 mmcf/d which would take the overall system capacity to 105 mmcf/d (restricted by the pipeline). With the installation of a third and fourth gas trains, processing capacity could increase to an initial 200 mmcf/d, and with installation of pipeline compression, the overall system capacity would increase to 140 mmcf/d. That expansion is targeted to be operational at the end of 2012.

EastCoast Transmission and Marketing - Increasing Capacity to Over 200 mmcf/d

In July, Orca created a new infrastructure unit called EastCoast Transmission and Marketing that will help it build a natural gas pipeline network in east Africa. The first project being evaluated is the feasibility twinning of the 207 kilometres onshore pipeline from the Songo Songo field area to Dar es Salaam in order to increase overall capacity of the infrastructure system to over 200 mmcf/d. Based upon projected natural gas demand growth, the need for the expanded capacity could be required by 2015 or 2016.

SSW Exploration Prospect to Spud Late in 2011

Independent engineering firm McDaniel & Associates Consultants Ltd. completed a resource estimate of the SSW exploration prospect, which is located approximately 2.5 kilometres west of the producing Songo Songo field. McDaniel's unrisks recoverable resource estimate of 551.6 bcf and if successful production could reach an average plateau production rate of approximately 100 mmcf/d net to Orca. McDaniel assigned a relatively high chance of success to the exploration prospect of 50%. The cost to mobilize and demobilise a rig is anticipated to be US\$12 million which Orca hopes to share with other operators in the area. The cost to drill and test the SSW wells is expected to be US\$36 million.

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.

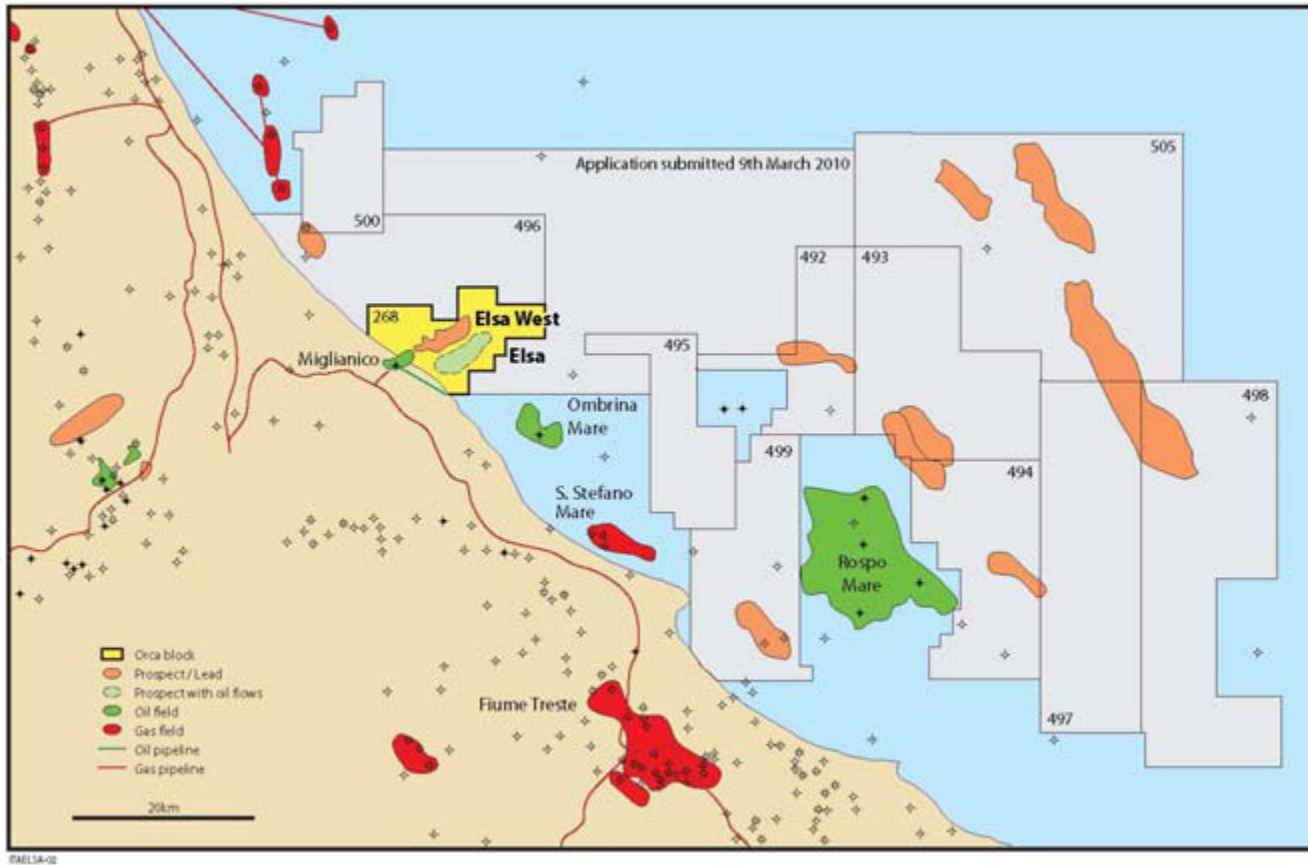


Figure 1. Elsa and Surrounding Block
Source. Company presentation

Orca Exploration Group Inc.
ORC.B

Share Data and Market Value		Price and Target			
Basic Shares (mm)	34.4	Close C\$:	\$5.00		
Diluted Sh. (Treasury)	35.8	52-Week High C\$:	\$5.43		
Fully Diluted (mm)	37.2	52-Week Low C\$:	\$3.05		
Market Cap. (C\$ mm)	172.2	Target Price C\$:	\$6.25		
Enterprise Value (C\$ mm)	124.2	Potential Return:	25.0%		
Net Debt (W.C.) (C\$ mm)	(48.0)	Risked NAV	0.5x		
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%
\$/Barrel 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		15.1x	11.6x	7.6x	5.7x
EV/DACF Multiple		16.4x	12.8x	5.7x	3.9x
EV/Production	C\$/boe/d	31.5	26.1	20.6	17.8
EV/boe reserves	C\$/boe	1.52	1.52		
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	172.3	147.0	153.1	172.3
Enterprise Value	C\$ mm	163.9	132.2	102.4	125.7
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. Capital)	48,000	Proba ble	21%		17,550
Other Assets	-	P +P			81,700
Other Liabilities	-	Reserve Life Index			
Net Asset Value	297,041			Production	
NAV/Share	\$10.02			<u>2010</u>	<u>2011</u>
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\$)	\$12.40				

Figure 2. Fundamentals & Key Ratios

Source: Company reports, Mackie Research Capital

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