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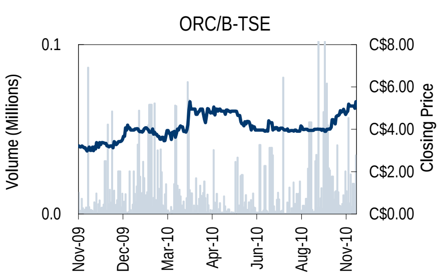
Orca Exploration[1] (ORC/B CN) BUY

Last: C$5.65 Target: C$8.80↑

WHAT'S CHANGED	NEW	OLD
Rating	nc	BUY
Target	C$8.80	C$7.10
Production 2010E (boe/d) 6:1	6,175	5,763
Production 2011E (boe/d) 6:1	7,563	6,075
CFPS 2010E (f.d.)	$0.58	$0.48
CFPS 2011E (f.d.)	$0.84	$0.55

SHARE DATA	
Shares o/s (mm, basic/f.d.)	29.5/32.1
52-week high/low	C$5.38/C$2.97
Market capitalization (mm)	$164
Enterprise value (mm)	$145
Net debt (mm) – 2009A	($16.8)
Dividend yield	n/a
Projected return	56%

FINANCIAL DATA	2009A	2010E	2011E
Oil & NGLs (mb/d)	0.0	0.0	0.0
Natural Gas (mmcf/d)	28.5	37.0	45.4
Total (mboe/d) 6:1	4.8	6.2	7.6
Equivalent growth	20%	30%	22%
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.)	$0.10	$0.31	$0.47
CFPS (f.d.)	$0.39	$0.58	$0.84
Net Debt (mm)	($16.8)	($54.8)	($39.2)
Debt/CF	nm	nm	nm
P/CF		10.4x	7.2x
P/CF (d'adj'd)		6.1x	4.8x
*(In US$ unless otherwise stated)			



Increasing our target price ahead of 2011 exploration in Tanzania and Italy

New farm-in in Italy

Orca Exploration has agreed to farm into Northern Petroleum's Longastrino Permit in the Po Valley Basin, onshore Italy. Although a relatively minor transaction, ORC continues to expand its Italian portfolio in-line with its plan to acquire exploration/appraisal prospects that meet company's strategic criteria. ORC will earn 70% by paying 100% of the costs of the first well up to EUR4.3 mm and 70% thereafter. If the well is tested, then ORC will earn an additional 5% by paying 100% of the testing costs up to EUR1.3 mm and 75% thereafter. ORC will also pay back costs of EUR0.6 mm. NOP's equity will reduce to 30% during drilling and then by a further 5% if the well is flow tested. The La Tosca prospect, which is believed to hold 45 bcf of gross mean prospective resources, is expected to be drilled in 2011. The prospect has an upside of 85 bcf of gross prospective resources of gas.

High impact drilling in Tanzania 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.

Changes to our target price

We now reflect the upcoming exploration drilling both in Tanzania (Songo Songo West) and Italy (La Tosca) in our 12 month price target which increases to C$8.80/sh (from C$7.10/sh). Our view on Orca remains unchanged and with a 56% return we maintain our BUY recommendation. We believe the company is well positioned to finance its activities going forward after the ~$19 mm rights issue in Oct/10. As the company addresses the infrastructure bottle-neck issues we believe we will see cash flow growth from the increased gas sales in Tanzania.

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EXPLORATION DRILLING IN 2011

In Italy, Orca Exploration has agreed to farm into Northern Petroleum's Longastrino onshore permit in the Po Valley Basin. ORC will earn 70% by paying 100% of the costs of the first well up to EUR4.3 mm and 70% thereafter. If the well is tested, then ORC will earn an additional 5% by paying 100% of the testing costs up to EUR1.3 mm and 75% thereafter. ORC will also pay back costs of EUR0.6 mm. NOP's equity will reduce to 30% during drilling and then by a further 5% if the well is flow tested. The La Tosca prospect, which is believed to hold 45 bcf of gross mean prospective resources, is expected to be drilled in 2011. The prospect has an upside of 85 bcf of gross prospective resources of gas. Orca is executing on its acquisition plans adding exploration prospects to its stable production and development portfolio and is also balancing its risk by picking lower risk exploration/appraisal opportunities in proven hydrocarbon basins with significant upside.

The appraisal of the Elsa discovery by drilling and testing the Elsa-2 well is suspended due to unresolved legislative issues. In our previous note dated October 15, 2010, we provided a detailed information on the situation around the Italian drilling ban which to this date remains unchanged.

Exploration drilling at the Songo Songo West prospect in Tanzania 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 unrisked combined P50 OGIP of 609 bcf and unrisked 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 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).

PRODUCTION ESTIMATES AND ADDRESSING BOTTLE-NECK ISSUES

Addressing bottle-neck issues and accelerating infrastructure development in Tanzania is one of the key activities for Orca. The company is making progress in finalising a re-rating agreement with Songas Limited to increase capacity from 90 mmcf/d to 105 mmcf/d. A permanent expansion upgrade is expected to increase capacity to ~140 mmcf/d by the end of 2012. Songas expects to submit an application for the permanent infrastructure expansion to 140 mmcf/d in Q4/10.

Taking into account long-term plans to increase gas sales in Tanzania, as well as recently reported Q3/10 production levels, we adjust our production and cash flow estimates going forward.

Exhibit 1: Changes to our estimates

	2010E			2011E		
	Old	New	% Change	Old	New	% Change
Production						
Total (mboe/d) 6:1	5.763	6.175	7%	6.075	7.563	24%
CFPS						
CFPS (FD)	$ 0.48	$ 0.58	21%	$ 0.55	$ 0.84	53%

Source: Orca Exploration, GMP Estimates

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VALUATION AND RECOMMENDATION

We are increasing our target price from C$7.10 to C$8.80 following the inclusion of the upcoming exploration drilling both in Tanzania (Songo Songo West) and Italy (La Tosca). Songo Songo West exploration that is planned for H2/11 is valued at C$1.21/sh risked and C$4.36/sh unrisked. La Tosca prospect, onshore Italy, is carried at C$0.39/sh risked and C$2.51/sh unrisked and is now included in our target price calculation. Due to unresolved situation in Italy around the drilling ban, we temporarily exclude the Elsa-2 appraisal well from our target price, but continue to value its C90 resources at C$0.62/sh risked (C$1.74/sh unrisked) and its C50 potential at C$0.99/sh (C$4.33/sh unrisked) in our EMV.

Our view on Orca remains unchanged and with a 56% return we maintain our BUY recommendation. We believe the company is well positioned to finance its activities going forward after the ~$19 mm rights issue in Oct/10. As the company addresses the infrastructure bottle-neck issues we believe we will see cash flow growth from the increased gas sales in Tanzania. High-impact exploration in Tanzania and Italy provide further catalysts for the stock in 2011. As more information on the drilling ban in Italy becomes available, we will be able to adjust our valuation, as we continue to believe that there is significant potential value in Elsa.

Exhibit 2: Net Asset Value

Net Asset Value Breakdown

	MMBOE	US$/BOE	US$MM	C$/sh
Production Assets	50.1	3.46	173.44	4.90
Cash/(Net Debt)			55.27	1.56
Other items incl G&A			(20.69)	(0.58)
Core NAV	50.1	4.15	208.03	5.87
Price to NAV (%)				*96%*
Option Proceeds			10.13	0.29
Risked Upside	108.3	2.82	305.52	8.62
Risked NAV	158.4	3.31	523.67	14.78
Price to Risked NAV (%)				*38%*
			Current Stock Prices	C$ 5.65
			Unrisked	C$ 43.48

Notes

Reserves evaluated by McDaniel and Associates Ltd. as of December 31st, 2009.

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

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Exhibit 3: Risked Exploration Value

Country	Property/Prospect	Gross Resource (mmboe)	Working Int. (%)	Costs (%)	Well Costs (US$ mm)	Overall COS (%)	Value/BOE (US$)	Net Risked Resources (mmboe)	Risked NAV (US$ mm)	US$/sh (FD)	C$/sh (FD)	Unrisked NAV (C$/sh)
Producing Assets												
Tanzania	SS Main (Proved Producing)	50.1	100%	100%	0.00	0%	3.46	50.1	173.44	4.65	4.90	4.90
								50.1	173.44		4.90	
Risked Upside												
Tanzania	SS Main (Proved Non Prod.)	14.0	100%	100%	4.00	80%	3.46	11.2	38.05	1.02	1.07	1.37
Tanzania	SS Main (Probables)	17.6	100%	100%	5.00	80%	3.46	14.0	47.59	1.28	1.34	1.71
Tanzania	SS West	90.9	100%	100%	5.00	30%	1.70	27.3	42.85	1.15	1.21	4.36
Tanzania	SS Main (Possibles, Contract ext)	56.4	100%	100%	5.00	50%	1.70	28.2	45.47	1.22	1.28	2.71
Tanzania	SS North	28.3	100%	100%	5.00	60%	1.70	17.0	26.82	0.72	0.76	1.36
Italy	Elsa-2	33.0	15%	30%	15.00	40%	12.47	2.0	22.00	0.59	0.62	1.74
Italy	Elsa (C50 upside)	56.0	15%	30%	15.00	25%	18.26	2.1	34.97	0.94	0.99	4.33
Italy	Adriatic - Sangiovese (d505BR/d497BR)	180.0	15%	15%	50.00	10%	7.81	2.7	14.34	0.38	0.40	5.95
Italy	Adriatic - Pampanuto (d493BR)	50.0	15%	15%	50.00	10%	7.81	0.8	0.00	0.00	0.00	1.65
Italy	La Tosca	7.5	70%	100%	5.00	20%	16.92	1.1	13.76	0.37	0.39	2.51
Italy	La Tosca Upside	14.2	70%	100%	5.00	20%	16.92	2.0	29.55	0.79	0.83	4.74
								108.3	315.41		8.90	
	Gross Resources Total	597.9						158.4	488.85	13.11	13.80	37.32

Fully Diluted Shares Outstanding (mm)	37.30
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

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Exhibit 4: Target Price

Target Price Calculation		
Orca Exploration Group	C$/sh	
Production Assets	4.90	
Cash/(Net Debt)	1.56	
Undeveloped Assets	-	
Other Items incl G&A	(0.58)	
Core NAV	5.87	
Risked Upside - Included from EMV Sheet	Risked	Unrisked
SS Main (Proved Non Prod.)	1.07	1.37
SS West	1.21	4.36
La Tosca	0.39	2.51
Option Proceeds	0.29	
Sum of Parts	8.83	14.11
TARGET PRICE	8.80	
Share Price	5.65	
Expected Return	56.3%	
USD:CAD Exchange Rate	0.95	

Notes:

Target set off the Proved Reserves for SongoSongo (producing and non-prod)

Elsa prospect is temporarily excluded due to Italian drilling ban

Source: Orca Exploration, GMP Estimates

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