CLARUS SECURITIES INC.

Kirk Wilson, CFA (403) 767-0820

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Epsilon Energy Ltd.

(EPS-TSX, $2.60)

Stock Rating: **BUY**

12-Month Target: **$4.60**

Estimates - Dec 31 YE	2008	2009	2010E	2011E
Production:				
Gas (mmcf/d)	2.0	3.0	8.8	21.3
Liquids (bbls/d)	33	1	46	124
Total boe/d	374	494	1,509	3,670
Change in Forecasts (boe/d)		*-17*	*na*	*na*
Financial:				
FD CFPS	$0.04	$0.00	$0.22	$0.66
Change in FD CFPS		*$0.03*	*$0.00*	*$0.00*
FD EPS	-$0.65	-$0.40	$0.00	$0.17
Change in FD EPS		*-$0.08*	*$0.00*	*$0.00*
Price Assumptions				
WTI (US$/bbl)	$99.50	$59.75	$75.00	$80.00
NYMEX (US$/mmbtu)	$8.86	$3.93	$6.50	$7.50

Quarterly Estimates		Q1	Q2	Q3	Q4
Production:					
	2009	374	316	330	953
	2010E	853	1,182	1,742	2,242
CFPS:	***2009***	$0.00	-$0.02	-$0.01	$0.03
	2010E	$0.01	$0.03	$0.08	$0.11

Valuation		
P/E (x)	-1,132.2	15.1
EV/DACF (x)	10.1	2.6
EV/boe Production	$73,814	$23,647
Target EV/DACF (x)	14.5	4.0

Market Data		
52-week High-Low	$3.50 —	$0.50
Shares Outstanding Basic / Diluted (millions)	50.3 /	52.5
Market Capitalization (millions)		$130.8
Enterprise Value (millions)		$117.8
Potential Return		77%

Financial Data	
2009E Net Debt (millions)	na
2009E Net Debt/Q4 annualized CF (x)	na
2009E EPS/CFPS	65169%

Source: Stockwatch.com

Company Profile

Epsilon is engaged in the acquisition, exploration and development of oil and natural gas reserves. Primary areas of focus include U.S. northeast shale gas and the SE Sask Bakken.

Impressive FD&A Costs Highlight YE'09 Results

EVENT

1. **CFPS Beats Expectation in Q4/09**
   EPS generated a FD CFPS of $0.03 in the quarter compared to our expectation of nil. Production was relatively close to our estimate at 953 boe/d. However, it was a cash cost structure that was less than half our expectation that lead to the positive variance.
2. **2P Reserves Up 39%**
   EPS announced that it increased its proved reserves by 90% to 16.1 mmboe and its 2P reserves rose 39% to 22.1 mmboe from the previous year. This impressive growth was accomplished despite the disposition of 10.2 mmboe of 2P reserves in the U.S. and Yemen.
3. **FD&A Costs Should Be Near Best in Peer Group**
   EPS posted an FD&A (incl. future development capital) of $4.16/boe for proved reserves and $5.79/boe for 2P reserves in 2009 on a net capex program of $1.4 million. This is the 2nd lowest figure we have seen to date, which means EPS should remain near the top of its peer group.
4. **Chesapeake Joint Venture To Lead The Way**
   Although Epsilon was able to reach close to 14 mmcf/d in production by the end of 2009, it has made several dramatic changes in 2010. Virtually all of the international assets are gone and EPS's fortunes in the near-term are in the hands of Chesapeake Energy and the joint venture on the Highway 706 project in Pennsylvania. With as many as 35 gross wells to drill over the next couple of years, EPS should benefit with a stable production base of more than 30 mmcf/d by the end of 2011.

Conclusion and Recommendation

Epsilon has done a very commendable job of meeting various production goals while maintaining strong financial flexibility over the past year. We look for the initiation of drilling by Chesapeake and additional EPS wells in the Bakken as potential catalysts in the next few months. We maintain our **BUY** recommendation and our 12-month target price of **$4.60**.

FOURTH QUARTER RESULTS

Exhibit 1: Summary Operating and Financial Data

Daily Production									
	Expectations	Q4/09	%	Q3/09	%	2008	2009	2010E	2011E
Liquids (bbl/d)	20	3	-605%	0	12948%	33	1	46	124
Natural gas (mmcf/d)	6.0	5.7	-5%	2.0	188%	2.0	3.0	8.8	21.3
Total (boe/d)	1,020	953	-7%	330	189%	374	494	1,509	3,670
% Natural gas	98%	100%	2%	100%	0%	91%	100%	97%	97%
boe/d per mm shares	8	7	-22%	6	4%	8	10	30	0
Financial Data ($mm except per share amounts)									
Revenue	2.7	2.4	-11%	0.6	294%	9.4	5.4	25.0	61.5
Cash flow	(0.2)	1.3	113%	(0.7)	275%	1.9	(0.0)	11.0	33.6
Net income	(1.7)	(3.1)	-45%	(2.8)	-12%	(33.7)	(20.2)	(0.1)	8.7
Capital expenditures	(8.2)	(11.1)	-26%	5.9	-288%	46.2	1.4	5.0	9.0
Net debt	(7.7)	(13.5)	-43%	0.4	-3793%	(15.9)	(13.5)	(19.5)	(44.1)
Diluted CFPS	**($0.00)**	**$0.03**	**104%**	**($0.01)**	**275%**	**$0.04**	**($0.00)**	**$0.22**	**$0.66**
Diluted EPS	**($0.03)**	**($0.06)**	**-52%**	**($0.06)**	**-12%**	**($0.65)**	**($0.40)**	**($0.00)**	**$0.17**
Unit Values ($ per boe)									
Revenue	$28.25	$28.11	-1%	$19.99	41%	$60.63	$30.16	$45.44	$45.95
Cash costs	$25.56	$12.23	-109%	$45.51	-73%	$54.51	$29.29	$18.29	$13.51
Cash flow	($1.80)	$15.87	111%	($25.52)	162%	$6.10	($12.21)	$19.94	$25.10
Earnings	($18.37)	($35.79)	-49%	($92.64)	61%	($246.10)	($112.14)	($0.21)	$6.49

Source: Company reports, Clarus Securities Inc.

Epsilon's average production of 953 boe/d (100% natural gas) during the fourth quarter was 7% below our expectation of 1,020 boe/d. The 189% gain in production from the prior quarter was a result of bringing previously drilled wells on-stream. In fact, the Company's 2009 exit rate was more than double the average for the fourth quarter at between 12 and 14 mmcf/d. Production per share was up 4% quarter-over-quarter.

Epsilon beat our Q4/09 FD CFPS expectation of $0.00 with an actual result of $0.03. The Q4/09 figure was also up from -$0.01 in the previous quarter. The Company posted remarkable improvements in its cash cost structure during the quarter. Of note is that operating cost came in at $3.42/boe compared to our expectation of $9.57/boe and its G&A expense was 44% below our expectation at $8.99/boe.

Fourth quarter capital expenditures (net of dispositions) were negative $11.1 million. We had expected a negative figure due to the asset disposition in Pennsylvania. As such, net positive working capital of $13.5 million was a bit higher than our expectation of $7.7 million. Including the Company's restricted cash position of $0.7 million, EPS ended the year with a $14.2 million net positive working capital position.

FD&A AND RECYCLE RATIO ANALYSIS

In Exhibit 2, we review the Company's finding, development and acquisition costs (FD&A) for the past two years. In 2009, Epsilon achieved a 2P FD&A (incl. future development capital) of $5.79/boe based on a net capital program of $1.4 million (post dispositions of $25.6 million). This is a vast improvement from the prior year when the 2P FD&A cost was negative. Epsilon's 2009 results compare very favorably to the average for its peer group of Canadian listed junior companies at $14.50/boe. These results are likely to remain near the top of its peer group average and underscores that high impact nature of the Company's asset base. With virtually no capital costs in Pennsylvania over the next couple of years (due to the Chesapeake JV), EPS should continue to lead the pack in its FD&A costs.

Exhibit 2: FD&A and Recycle Ratio Review

	2009	2008	2 Year
Capital Expenditures ($mm)			
FD&A activity	$1.4	$46.2	$47.6
Change in proved future development capital	$47.0	$0.3	$47.3
Change in 2P future development capital	$35.6	($4.3)	$31.2
Reserve Additions (mboe)			
Proved	11,615	1,345	12,960
Proved + Probable	6,376	-2,195	4,181
F&D Cost ($ per boe) (including future capital)			
Proved	$4.16	$34.54	$7.32
Proved + Probable	$5.79	($19.08)	$18.85
Cash Flow per boe	($12.21)	$6.10	$5.94
Recycle Ratio			
Proved	n/a	0.0x	0.0x
Proved + Probable	n/a	0.0x	0.0x

Source: Company reports, Clarus Securities Inc.

We also show Epsilon's cash flow recycle ratio in Exhibit 2. As the Company's cash flow netback was negative last year, the cash flow recycle ratio is meaningless. However, its operating recycle ratio was 3.9x on an operating netback of $22.72/boe. As the Company moves forward with its Chesapeake joint venture we expect that its cash flow recycle ratio will improve as EPS should be cash flow positive in 2010 and 2011.

RESERVES ANALYSIS

In Exhibit 3, we present a comparison of EPS' 2009 year-end reserves with the prior year as per independent evaluators Miller and Lents, Ltd. The Company's proved reserves rose 90% over the course of the past year and its 2P reserves increased 39%. These impressive increases were achieved despite the Company disposing of 35.3 bcf of gas reserves in the U.S. Northeast and 4.9 mmbbl of oil reserves in Yemen. Notable points for the reserve report include:

- Proved producing reserves actually fell by 18% to 4.0 mmboe.
- Proved producing reserves as a percentage of proved reserves decreased to 25% from 58%.
- Proved reserves as a percentage of 2P reserves are 73%, up from 53% at YE'08.

Exhibit 3: Reserves Summary

	2009					2008			YoY Change
	Nat Gas bcf	Oil mbbl	Total mboe	% of Total	RLI Years	Total mboe	% of Total	RLI Years	in Reserves %
Proved Producing	24.0	2.0	4,004	18%	11.5	4,899	31%	32.6	-18%
Proved Non-Producing	0.8	0.0	126	1%	0.4	1,387	9%	9.2	-91%
Proved undeveloped	71.6	0	11,933	54%	34.3	2,188	14%	14.6	445%
Total Proved	96.4	2	16,063	73%	46.2	8,473	53%	56.4	90%
Probable	36.3	0	6,050	27%	17.4	7,410	47%	49.4	-18%
2P	132.7	2	22,113	100%	63.6	15,883	100%	105.8	39%

Source: Company reports, Clarus Securities Inc.

VALUATION & RECOMMENDATION

Epsilon is currently trading at debt-adjusted cash flow multiples of 2.6X our 2011 forecasts. With a large exposure to resource plays in the Pennsylvanian Marcellus, SE Saskatchewan Bakken and Quebec Utica, the Company has a substantial amount of identifiable growth – albeit much of it in early stages. With Chesapeake carrying EPS for capital costs for the next two years or so on the Highway 706 project in Pennsylvania, Epsilon should build its production base to more than 30 mmcf/d by the end of 2011 for virtually no cost, which makes EPS a low-risk investment. We maintain our target price of $4.60 per share, which is generated by applying a combination of a 2011 DACF multiple of 4.0x and our risked net asst value calculation. We reiterate our BUY recommendation.

Target Price Calculation: We value EPS using a NPV approach.
Key Risk to Target Price: Please refer to the risks disclosed in the initiating report dated December 10, 2007.