

**Recommendation: Buy**  
**Target Price: C\$4.00**

## ◆ Epsilon Energy Ltd. (EPS -TSX) 2009 Results; Activity Levels Expected To Ramp-up With Chesapeake Farm-out

Current Price (C\$)	\$2.60	Target (C\$)	\$4.00
52 Wk High (C\$)	\$3.50	Proj. Return	54%
52 Wk Low (C\$)	\$0.45	Basic Sh. (O/S)	50.3
NAV - (1) C\$	\$2.78	FD Sh. (O/S)	53.3
P/NAV	0.9x	Mngt. & Dir.	7.6
Net Debt - 10E (MM)	-\$32.8	- Pct. of basic	15%
D/CF (2)	NA	Mkt. Cap. (MM)	\$118
DPS	NA	Float (MM)	\$100
Dividend Yield	NA	EV (MM)	\$85

Fiscal YE Dec.		2008A	2009A	2010E
Production (BOE/d)	Q1	272	374	833
	Q2	317	316	1,000
	Q3	494	335	1,385
	Q4	412	947	2,762
	<b>FY</b>	<b>374</b>	<b>494</b>	<b>1,500</b>
% Gas		91%	100%	100%
Growth (3)		-16%	24%	205%
CFPS	Q1	\$0.01	\$0.00	\$0.06
	Q2	\$0.01	(\$0.02)	\$0.06
	Q3	\$0.01	(\$0.01)	\$0.09
	Q4	\$0.01	\$0.03	\$0.17
	<b>Basic</b>	<b>\$0.04</b>	<b>(\$0.00)</b>	<b>\$0.38</b>
<b>Diluted *</b>	<b>\$0.01</b>	<b>(\$0.03)</b>	<b>\$0.36</b>	
NYMEX WTI (US\$/Bbl)		\$99.52	\$61.89	\$75.00
NYMEX Gas (US\$/MMBtu)		\$8.85	\$4.01	\$8.00
P/CF			nm	7.1x
EV/DACF			nm	4.6x
EV/BOE/d			\$205,755	\$56,621

\* Diluted, discretionary

(1) 15% DCF, AT based on engineer's price deck at Dec. 31, 2008

(2) Net debt to trailing cash flow

(3) Per share production growth.

### Company Description:

Epsilon is a Canadian based international oil and gas exploration company focused in North America. It listed in Canada on the TSX exchange in October 2007.

Unless otherwise denoted, all figures shown in US\$

### Investment Thesis:

Epsilon is focused on the development of the Marcellus gas play in the Appalachia region of the US. It also offers investors a free option on acreage in New York, Quebec, and in Ethiopia.

### Highlights:

#### • Event

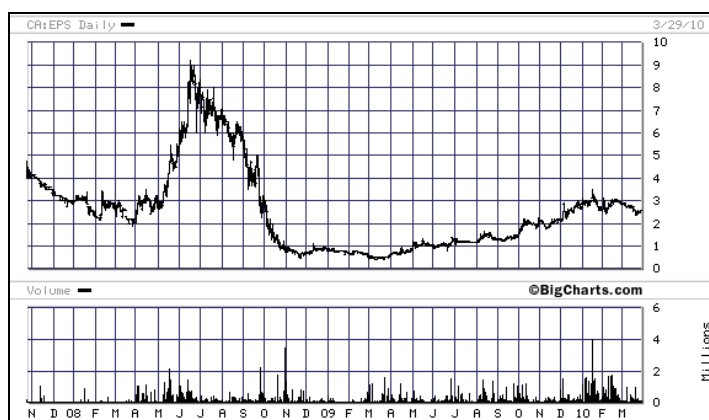
Yesterday, Epsilon released its 2009 year-end financial and operational results as well as updated reserve estimates.

#### • Details

Q4 production averaged 947 BOE/d (5.7 MMcf/d), in line with our 972 BOE/d (5.8 MMcf/d) estimate. Cash flow came in at \$1.3 MM (\$0.02 per share, f.d.d.), ahead of our \$0.7 MM (\$0.01 per share) estimate on lower than expected operating costs during the quarter. Year-end natural gas reserves were reported at 104 Bcf (proved plus probable), up from 30 Bcf at the end of 2008. As previously announced, Epsilon completed a farm-out of 50% of its Marcellus acreage in Penn. to Chesapeake Energy Corp. (CHK-N) for \$5 MM cash and a \$95 MM capital carry. As Chesapeake will be spending on Epsilon's behalf over the next two years, this year the Company will be focusing on emerging opportunities with no debt and a current cash position of \$20 MM.

#### • Recommendation

We maintain our Buy recommendation and C\$4.00 target on Epsilon.



Source: BigCharts.com, March 29, 2010 (Chart C\$)

◆ During the past twenty-four months, Cormark Securities Inc., either on its own or as a syndicate member, participated in the underwriting of securities and/or provided financial advice regarding the stock market insight and financial analysis regarding potential transactions for Epsilon Energy Ltd.

Our disclosure statements are located at the end of this report

**Details:**

Q4/09 Summary:

- Production averaged 947 BOE/d (5.7 MMcf/d) which was in line with our estimate of 972 BOE/d (5.8 MMcf/d).
- Cash flow came in at \$1.3 MM (\$0.02 per share, f.d.d.), bettering our estimate of \$0.7 MM (\$0.01 per share) on lower than expected operating costs during the quarter.
- Epsilon exited 2009 with net positive working capital of \$13.5 MM. The Company's farm-out to Chesapeake, which brought in cash of \$5 MM, closed subsequent to year-end.

Chesapeake Joint Venture / Outlook:

- In February, Epsilon completed a farm-out of a 50% interest in its Highway 706 project area to Chesapeake, whereby Chesapeake paid \$5 MM in cash up front and will be carrying the first \$95 MM of Epsilon's 50% share of leasehold, drilling, completing, equipping and gathering costs attributable to the project area. In addition, Chesapeake will spend \$95 MM of its own capital, bringing the Joint Venture spending commitment up to \$190 MM, of which 75% must be spent on drilling and completion activity. To that end, Chesapeake plans to commit two rigs to the project and will drill 18 horizontal wells during the first 12 months. The carry obligation is expected to be completed within 30 months after the closing date of February 1, 2010.
- As a result of this transaction, we believe that Epsilon's Highway 706 project will benefit from both higher spending than Epsilon would have been able to do on its own and having an experienced shale operator in Chesapeake. This will allow the Company to focus on its other core areas as well as explore other potential opportunities.
- The Company's 2010 capital program will focus on several small projects outside of Pennsylvania, including vertical drilling (with no fracturing) in New York and a 3D seismic shoot in SE Saskatchewan. Epsilon is also planning a second aeromag survey in Ethiopia that, in combination with an earlier survey, will cover the entire area of Epsilon's block.

**Guidance/Estimates:**

- Our 2010 production and cash flow estimates stand largely unchanged as follows:
  - 2010: Production of 1,500 BOE/d (unchanged) with cash flow of \$0.36 per share, f.d.d., versus \$0.33 per share previously.

**Financial Flexibility:**

- Epsilon exited 2009 with net positive working capital of \$13.5 MM, which included cash amounts totalling \$15.3 MM.
- We forecast Epsilon to have positive working capital of \$32.8 MM at the end of 2010, putting the Company in a strong financial position going forward.
- At the end of 2009, Epsilon had two forward sale contracts on natural gas, one for 3 MMcf/d at \$5.12/Mcf to the end of April 2010 and one for 3 MMcf/d at \$5.50/Mcf to the end of June 2010.

**Valuation:**

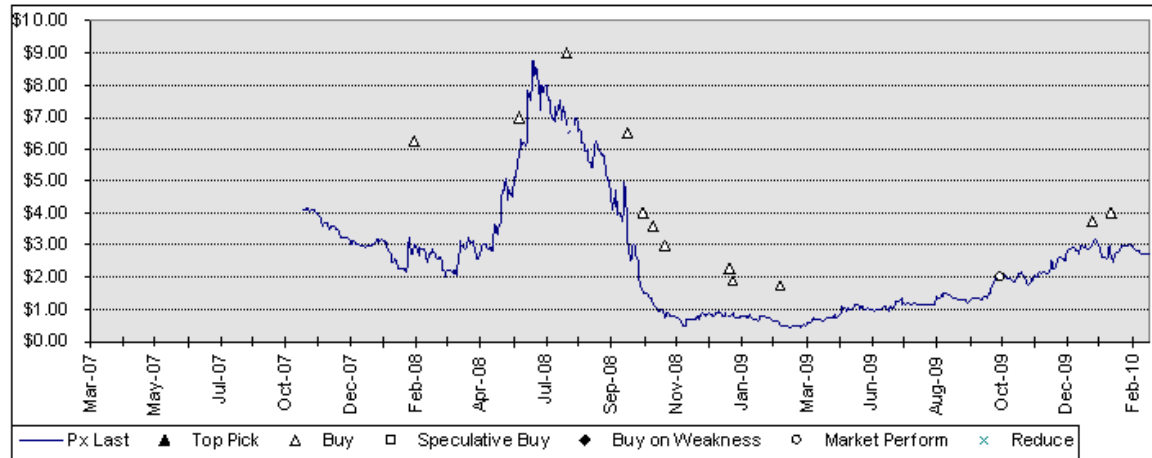
- Our target price on Epsilon stands unchanged at C\$4.00 per share. The terms of the Chesapeake Joint Venture (\$100 MM for 50% WI) effectively values Epsilon's Highway 706 asset at \$200 MM, or \$3.98 per share (basic). We note that this ascribes no value for the Company's other assets as they are seeing little capital spending this year and we view them more as option value at this time.
- Our C\$4.00 target implies a 9.2x debt-adjusted target multiple on 2010 cash flow, which is a premium to the average small-cap target multiple of 7.9x we have used for our Western Canadian producers; however we note that with significant production growth expected through 2012 with no capital outlay net to the Company, we believe Epsilon can grow into this multiple.

**Conclusion:** With a marquee shale player now operating Epsilon's Highway 706 property, the Company is able to focus on other projects with a high degree of financial flexibility and a growing base of free cash flow. Epsilon could look at acquisition opportunities and it continues to hold a sizable land position in New York state (16,000 net acres) which may become prospective for Marcellus development pending progress on the fracturing moratorium in the state. With a strong base asset in Highway 706 and incremental option value in its other assets, we are reiterating our Buy recommendation and \$C4.00 target on the stock.

We, David Beddis and Brent Watson, hereby certify that the views expressed in this research report accurately reflect our personal views about the subject company(ies) and its (their) securities. We also certify that we have not been, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

**Epsilon Energy Ltd.**

Source: Cormark Securities Inc.



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 1) Is it a long and/or short position?   
 2) What type of security is it?

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Market Perform	19%
Reduce	2%
Not Rated	6%

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**Recommendation / Target Chg**

Date	C\$
04-Feb-10	4.00 (B)
18-Jan-10	3.75 (B)
14-Oct-09	2.00 (MP)
27-Feb-09	1.75 (B)
09-Jan-09	1.90 (B)
07-Jan-09	2.25 (B)
31-Oct-08	3.00 (B)
21-Oct-08	3.60 (B)
09-Oct-08	4.00 (B)
24-Sep-08	6.50 (B)
26-Aug-08	9.00 (Chng Cover.)
22-Jul-08	9.00 (B)
03-Jun-08	7.00 (B)
15-Feb-08	6.25 (B)

Updated March 19, 2010

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<b>Buy</b>	expected to outperform its peer group
<b>Market Perform</b>	expected to perform with its peer group
<b>Reduce</b>	expected to underperform its peer group

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Additionally, our target prices are set based on a 12-month investment horizon.

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