

Texalta Petroleum Ltd. (TSXV: TEX-A) – Low-risk model beneficial in current market conditions – FINAL REPORT

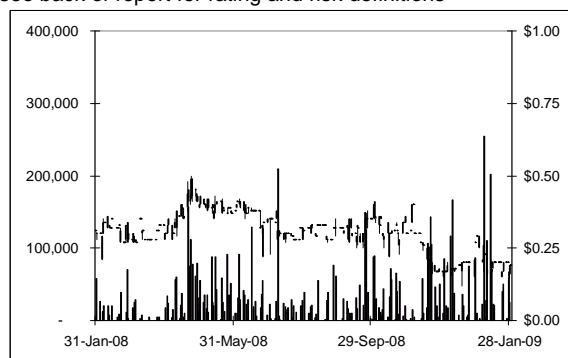
Sector/Industry: Oil & Gas

www.texalta.com

Market Data (as of February 2, 2009)

Current Price	C\$0.15
Fair Value	C\$0.40 (↓)
Rating*	BUY
Risk*	5 (Highly Spec)
52 Week Range	C\$0.12 – C\$0.50
Shares O/S	33.93 mm
Market Cap	C\$5.09 mm
Current Yield	N/A
P/E	N/A
P/B	0.94
YoY Return	-50.0%
YoY TSX	-65.7%

*see back of report for rating and risk definitions



Highlights

- In FY2008 (12 month period ended June 2008), the company reported production revenues of \$2.13 million, which were slightly below our estimate of \$2.19 million.
- An increase in oil prices, supported by lower operating costs (\$14/boe in FY2008) resulted in a significant improvements in netbacks. Texalta posted net income of \$0.08 million in FY2008, and \$0.09 million in Q1-2009.
- The first well of a multi-well horizontal development program to tap the central part of the Wordsworth pool turned out to be a discovery.
- As a result of the new discovery well at Wordsworth, we have raised our average production forecast for FY2009, from 84 boepd to 101 boepd. Our estimate for 2008 exit production is 130 boepd.
- About 95% of the company's production is high netback conventional light oil. The company continues to follow a lower-risk development drilling model; which we believe is the ideal strategy in current market conditions.
- In FY2009, the company plans to drill four horizontal development wells and one vertical well on its three key properties in Saskatchewan.
- We believe that the company is in a sound cash position, and our models indicate that cash flow from operations will be able to fund working capital and capital expenditures in FY2009.

Key Financial Data (FYE - June 30)

(C\$)	2006	2007	2008E	2009E	2010E
Revenue	638,549	1,704,449	1,850,773	1,814,018	2,098,677
Net Income	(24,961)	62,260	80,932	(81,117)	24,405
Cash	1,471,231	1,772,748	2,035,774	2,570,853	2,184,159
Working Capital	537,408	2,382,160	1,191,443	668,609	306,326
Total Assets	3,648,341	6,309,509	7,226,637	8,194,292	8,313,245

Texalta Petroleum Ltd. is a junior oil and gas company with some interesting exploration and development projects in the Northern Territory of Australia. The risks associated with exploration are offset by the company's interest in several existing producing wells in southeastern Saskatchewan, Canada.

The following is an update on the company’s three key projects in Saskatchewan, Canada, and the projects in the Georgina Basin in Australia.

**Wordsworth –
Second
discovery**

Texalta is the operating partner with a 47.5% working interest (WI) in the Wordsworth property that covers 4,000 acres of land. Texalta’s interest in Wordsworth contains about 2,000 acres of prospective Bakken rights located below the prolific Mississippian (Alida) pool. Texalta acquired interest in this property prior to the recent “Bakken rush”.

This property has one producing well currently producing at about 51 boepd gross (24.4 boepd net). The second well on the property, which was drilled in mid 2007, was not put into commercial production, as flow rates were lower than anticipated.

Puts second well into production – Based on information from the new 24-km 2D seismic survey shot in early 2008, combined with existing seismic, the company has planned a multi-well horizontal development program to tap the central part of the Wordsworth pool. The first well of this multi-well program, spudded in October 2008, turned out to be another discovery for the company. The new well, 1C2-23, tested at 257 bpd gross, was placed on production in November 2008. The company completed the installation of a flowline in December 2008, to tie the well to the existing battery at 2A2-23. The well has been continuously producing since then.

According to management, the new well will also drain parts of the dolomite oil reservoir, which was not encountered by the first well. Management estimates that the new well, like the first well, will produce at about 60,000 barrels in the first 2 years (average rate of 85 boepd). Note that declining flow rates are not uncommon for horizontal wells in Saskatchewan. Horizontal wells in the area normally experience rapid decline rates in the first two years, after which, the wells continue to produce at a lower rate for several years.

Plans for 2009: Texalta has identified locations for six horizontal and two vertical wells in the area.

Potential drilling locations as at November 24, 2008			Well type and number		Class	W.I.
Project areas	Location	Acreage	HZ	VR		
Wordsworth	T7 3 W 2	2,880	-	1	W	47.50%
Wordsworth	T7 3 W 2		6	-	D	47.50%
Wordsworth Deep	T7 3 W 2		-	1	W	47.50%

Plans at Wordsworth involve various farmout and participations in March, June, November and December of 2009 for the drilling of 4 vertical wells in the area.

Source: Company

In 2009, the company plans to drill at least one horizontal well and one vertical well at Wordsworth.

**West
Queensdale**

Texalta has 16.05% - 71.6% WI in about 1,440 acres of land in this area. This field has seven horizontal wells and five vertical producing wells. As of November 2008, these wells were

producing at a combined rate of 110 boepd gross (about 25 – 30 boepd net). The property has an oil and gas treatment plant. All of the oil produced by Texalta and its partners are treated and sold in this facility, which is connected to a producer’s pipeline.

Plans for 2009: The company and its partners have identified locations for four horizontal and two vertical wells in the area.

Queensdale West	T6 2 W 2	1,280	4	-	D	30% (avg)
Queensdale West	T6 2 W 2		-	1	O	30% (avg)
Queensdale South	T6 1 W 2	320	-	1	W	50%

New seismic work in the West Queensdale area should be completed in January 2009. Texalta plans to drill one of the horizontal wells in this area by August of 2009 and will be seeking a farmout on one Red River/Winnipegosis vertical well.

Source: Company

Subject to land negotiations and partner approval, the company plans to drill two horizontal wells (costing Texalta about \$0.6 million) in this area in 2009.

West Wildwood

Texalta is the operator of the 800 acre property with a 50% WI. A horizontal wild cat well drilled in July 2007 resulted in a pool discovery. The well, tied to the 8-26-6-2 Battery (in West Queensdale) in October 2007, is currently producing at about 30 boepd gross (15 boepd net), and is expected to be a long-life producer.

The company and its partners recently drilled a 2,500 m deep vertical test well. The well, named the Petrex Texalta Wildwood 4-31-6-1 W2, encountered hydrocarbon shows in two of the three targeted zones, namely the Winnipegosis reef (at 2,000 m), the Ordovician Red River (at 2,250 m), and the Ordovician Winnipeg Sand (at 2,350 m). Although logs indicated uphole Bakken potential, testing operations on the well have been suspended until P&NG rights and partner approvals to test the Bakken formation are approved.

Plans for 2009: The company and partners have identified locations for five horizontal wells and one vertical well in this area.

Wildwood West	T6 2 W 2	640	5	-	D	50%
Wildwood Deep	T8 2 W 2	320	-	1	W	19.55%

During 2008, the Company completed a rework of 3D seismic in the area. Texalta plans to drill one horizontal offset well in April 2009 and one horizontal well in November 2009.

Source: Company

The company and its partners are currently planning their second horizontal well, located immediately west of the currently producing well. Subject to lease negotiations and partner approval, the company plans to drill the well in early 2009.

To summarize, the company has identified locations for 15 horizontal wells and five vertical wells in their three main properties. In 2009, the company plans to drill four horizontal development wells, including two in West Queensdale, and one each in

Wordsworth and West Wildwood, and one vertical well at Wordsworth. Considering that the company’s cost to drill each of these wells ranges between \$0.30 and \$0.70 million, the company continues to follow a lower-risk development drilling model; which we believe is the ideal strategy in current market conditions. Texalta is also seeking joint venture partners to further lower their risks, and preserve cash. It is important to note that the timeline is subject to approvals from landowners and mineral right holders, and partner approvals, which could lead to delays.

Georgina Basin, Australia

Texalta was planning the first stage of a regional seismic program in September 2008, but the program has been delayed due to difficulties in obtaining clearances from the Central Land Council with respect to the Aboriginal Sacred Sites and objects of cultural significance on the proposed seismic route. Texalta has received approval from the N.T. government for a six-month extension. The company now hopes to commence the new 2D seismic survey in April-May 2009.

In addition, Rodinia has missed their second scheduled payment of \$2 million.

Revised Reserve Estimates

GLJ Petroleum’s revised reserve estimate of Texalta’s proved plus probable reserves increased from 0.165 mm boe gross (0.141 mm boe net) in June 2007, to 0.189 mm boe gross (0.162 mm boe net) in June 2008. The after-tax net present value of the reserves (discounted at 10%) increased from \$2.32 million to \$5.38 million. The increase in NPV was a result of higher commodity price forecasts used in the valuation. Note that price forecasts have dropped since June 2008.

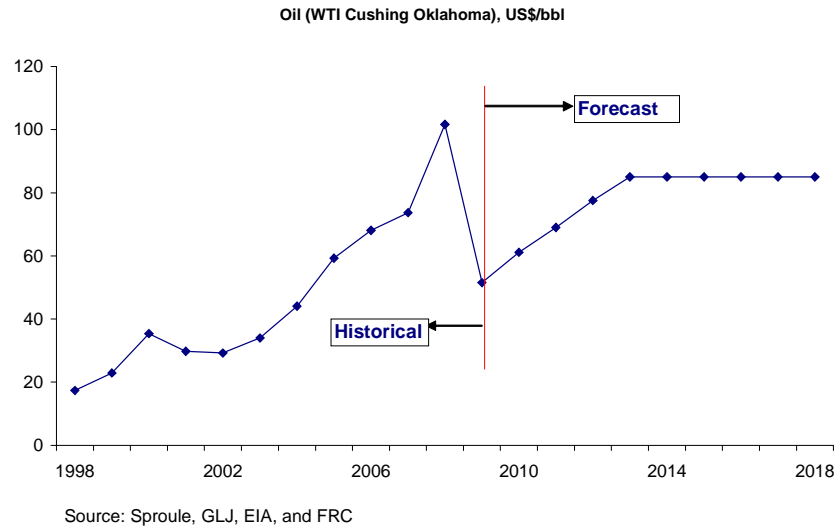
Review of Financials

Revenues increased despite drop in production: In FY2008 (12 month period ended June 2008), the company reported production revenues of \$2.13 million, which was slightly below our estimate of \$2.19 million. The average production during FY2008 was 70 boepd versus 78 boepd in 2007. 2008 revenues were up by 20% YOY, despite the decline in production volumes, due to an increase in oil prices during this time period.

Average production dropped, due to natural declines, from 80 boepd in the first nine months of FY2008, to 53 boepd in Q4-2008, and 56 boepd in Q1-2009. The company reported production revenues of \$0.57 million in Q1-2009 (up 4.5% YOY).

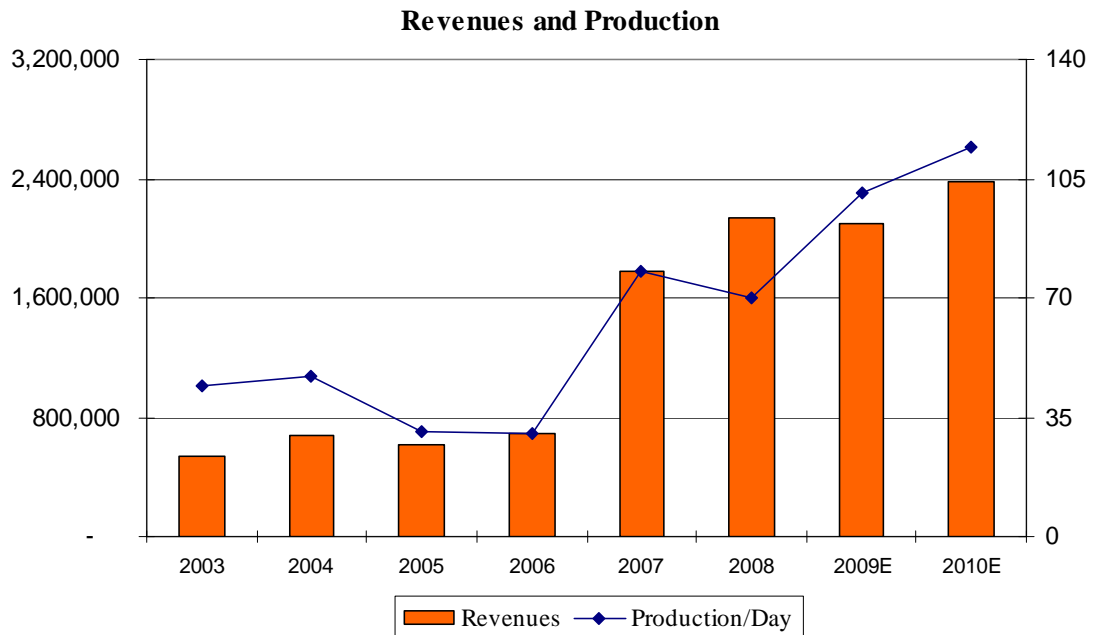
Production forecasts: As a result of the new discovery well at Wordsworth, we have raised our average production forecast for FY2009 from 84 boepd to 101 boepd. Our estimate for 2008 exit production is 130 boepd. Note that these estimates do not account for any additional production from successful wells in 2009.

Commodity Price forecasts: The global economic slowdown has resulted in revisions to near-term oil price forecasts. The global demand for oil is expected to drop YOY in 2009, due to recession in developed economies, and a slowdown in emerging economies worldwide. As a result, oil prices are expected to remain soft in 2009 and most of 2010. The following chart shows historic oil prices, along with revised projections through 2018.



We continue to maintain a positive outlook on long-term prices as we believe that long-term growth in demand, and increasing finding and development costs, will drive prices to a consensus forecast of US\$80/bbl in the longer-term.

Revised revenue forecasts: Based on our revised production and commodity price forecasts, we have lowered our revenue forecasts for FY2009, from \$2.19 million to \$2.10 million. We also introduce our FY2010 forecast of \$2.38 million in this report. The following chart shows the company’s revenues since FY2003, along with our revised forecasts.



Improved Netbacks

An increase in oil prices, supported by low operating costs (\$14/boe in FY2008) resulted in improvements in Texalta’s netbacks. About 95% of the company’s production is light crude oil. In 2008, netbacks improved YOY from \$36/boe to \$45/boe. In Q1-2009, netbacks improved YOY from \$39/boe to \$66/boe.

	2005	2006	2007	2008	2009E	2010E
Revenues - Royalties / boe	\$45.7	\$55.7	\$56.7	\$70.9	\$50.1	\$50.2
Op Costs / boe	\$13.2	\$14.2	\$10.5	\$14.4	\$15.2	\$15.0
G&A costs / boe	\$16.7	\$19.0	\$10.2	\$11.2	\$8.6	\$9.0
Netback	\$15.9	\$22.5	\$36.0	\$45.3	\$26.4	\$26.2

As oil prices have dropped since Q1, we expect netbacks to drop for the rest of the year. Our estimates for FY2009 and FY2010 are \$26/boe.

EBITDA improved due to the improved netbacks and relatively steady general and administrative expenses. In FY2008, EBITDA improved YOY from \$0.94 million to \$1.10 million, an increase of 17% YOY. In Q1-2009, EBITDA improved by 13% YOY from \$0.31 million to \$0.35 million.

EPS Estimates

Texalta posted net income of \$0.08 million in FY2008, and \$0.09 million in Q1-2009, versus \$0.06 million in FY2007, and \$0.01 million in Q1-2008. Based on all the previously mentioned changes, we have lowered our EPS forecasts for FY2009, to a net loss of \$0.08 million; EPS: -\$0.00 (down from net profit of \$0.15 million). Our forecast for FY2010 is net profit of \$0.02 million; EPS: \$0.00.

Cash Flows

In FY2008 and Q1-2009, cash flow from operations were \$2.60 million and \$0.86 million, respectively, versus (\$0.43 million) and \$0.41 million in the comparable periods in the previous year. Cash flow from operations more than offset cash required for investing activities of \$2.14 million in FY2008, and \$0.25 million in Q1-2009, resulting in positive free cash flows (FCF) of \$0.45 million in FY2008, and \$0.61 million in Q1-2009.

Cash Position and Liquidity

Positive free cash flows in Q1 resulted in an improvement in the cash position. At the end of Q1-2009, the company had \$2.65 million in cash and term deposits, and a working capital of \$1.29 million. The table below shows a summary of the company’s cash and liquidity position.

Liquidity Position	2005	2006	2007	2008	Q1-2009
Cash + Term Deposits	-	1,471,231	1,772,748	2,035,774	2,647,419
Working Capital	(200,312)	537,408	2,382,160	1,191,443	1,291,466
Current Ratio	0.28	1.46	10.63	1.98	1.74
Debt	257,942	-	-	-	-
Debt / Capital	16.9%	-	-	-	-

Texalta continues to be debt-free. The company has a revolving line of credit of \$0.50 million (at prime plus 1.5% p.a. interest); no amount was drawn from this facility at the end of Q1-2009.

We believe that the company is in a sound cash position, and our models indicate that cash flow from operations will be able to fund working capital and capital expenditures in FY2009.

Announced new Normal-Course Issuer Bid: On January 19, 2009, the company announced it will commence a new NCIB on January 29, 2009 (to expire on January 28, 2010) to acquire up to 1.69 million Class A shares, representing 5% of the outstanding number of shares. Over the past two years, Texalta has returned 0.86 million shares to its treasury.

Stock Options and Warrants

At the end of Q1-2009, the company had 2.75 million stock options outstanding (1.29 million are currently ‘in-the-money’ – assuming that none of the outstanding options were exercised since the end of September 2008), with a weighted average exercise price of \$0.28 per share, and maturity periods between March 2009 and April 2013. The company also had 1.50 million warrants outstanding (none of them are currently ‘in-the-money’), with an exercise price of \$1.75 per share, and maturing in December 2008.

Valuation

Our revised valuation on the company is \$0.40 per share (down from \$0.60 per share).

Valuation Summary		
	Previous	Revised
Georgina Basin Project	\$0.46	\$0.31
Producing Properties in Saskatchewan	\$0.10	\$0.06
Working Capital	\$0.04	\$0.04
Fair value of the company	\$0.60	\$0.40

Our valuation on the Georgina Basin projects dropped as a result of the drop in the average enterprise value of companies with comparable projects. Our valuation on the company’s producing projects in Saskatchewan dropped as the average EV (enterprise value)/boe and EV/boepd of its peers dropped from \$21.5/boe and \$47,382/boepd, to \$8.5/boe and \$22,736/boepd, respectively as shown on the next page.

		EV / boe
1	MSY	\$3.69
2	AXL	\$5.29
3	GPX	\$6.49
4	RE	\$6.81
5	HPX	\$6.82
6	TFL	\$6.88
7	ZCO	\$8.17
8	ITX	\$8.62
9	WTL	\$8.96
10	TBE	\$9.08
11	OEX	\$9.29
12	ONR	\$10.05
13	DEE	\$10.05
14	TSK	\$10.15
15	MOX	\$10.33
16	CNH	\$11.30
17	BEN	\$11.70
	Average	\$8.45

		EV / boepd
1	TFL	\$12,753
2	WTL	\$12,759
3	HPX	\$14,709
4	RE	\$17,133
5	GPX	\$18,091
6	ONR	\$20,674
7	ITX	\$22,633
8	TBE	\$22,644
9	ZCO	\$23,284
10	AXL	\$23,437
11	MSY	\$23,538
12	BEN	\$23,966
13	DEE	\$24,771
14	TSK	\$25,573
15	OEX	\$31,705
16	MOX	\$33,267
17	CNH	\$35,572
	Average	\$22,736

Rating

Therefore, based on our revised valuation models and review of the company’s progress since our previous report, we reiterate our BUY rating, and lower our fair value from \$0.60 to \$0.40 per share.

Risks

The following risks, though not exhaustive, will cause our estimates to differ from actual results:

- Texalta is exposed to all of the risks associated with exploration and production.
- The Georgina Basin is an underexplored basin, and projects carry exploration risks.
- Infrastructure is limited in the Northern Territory compared to other major petroleum regions.
- Delays in operations could occur because of negotiations with Australian native groups that hold surface rights throughout the region. In Saskatchewan, the main challenge is to gain participation from working interest partners as well as get approvals from landowners and mineral rights holders.
- While we do not expect the company to be in a cash crunch going forward, access to capital is crucial to be able to continue pursuing exploration and development programs.
- Volatility in commodity prices – As revenues are directly related to commodity prices, growth and profitability of the company will depend on oil and gas prices.

We have continued to rate the shares Risk 5 (Highly Speculative).

APPENDIX

Texalta Petroleum Ltd. - Income Statement
(in C\$)

	2005	2006	2007	2008	2009E	2010E
Revenues						
Oil and Gas Sales	611,505	693,547	1,776,628	2,131,474	2,095,658	2,384,382
Less: Royalties	(111,490)	(107,524)	(181,562)	(355,481)	(354,486)	(403,324)
Royalty Income	17,635	22,877	25,140	22,133	26,261	29,879
Other Income	103	29,649	84,243	52,647	46,586	87,741
	517,753	638,549	1,704,449	1,850,773	1,814,018	2,098,677
Operating Expenses	149,395	155,085	298,845	364,952	534,818	600,600
Gross Margin	368,358	483,464	1,405,604	1,485,821	1,279,200	1,498,077
Stock Based Compensation	53,000	83,500	170,000	42,785	41,935	48,516
Bad Debt				59,087		
General and Administrative	188,731	207,448	291,849	284,515	302,035	360,360
EBITDA	126,627	192,516	943,755	1,099,434	935,230	1,089,201
Depletion, Depreciation and Accretion	363,093	281,520	812,095	1,033,442	1,060,026	1,051,655
EBIT	(236,466)	(89,004)	131,660	65,992	(124,796)	37,547
Income Taxes						
Current						
Future	(105,039)	(64,043)	69,400	(14,940)	(43,679)	13,141
Net Income (Loss)	(131,427)	(24,961)	62,260	80,932	(81,117)	24,405
EPS	(0.01)	-	-	-	-	-

Texalta Petroleum Ltd. - Balance Sheet
(in C\$)

	2005	2006	2007	2008	2009E	2010E
Assets						
Current Assets						
Cash	-	805,616	158,324	903,828	438,907	52,213
Term Deposits	-	665,615	1,614,424	1,131,946	2,131,946	2,131,946
Accounts Receivables	77,707	235,449	856,835	372,563	365,164	422,466
	77,707	1,706,680	2,629,583	2,408,337	2,936,018	2,606,626
Property and Equipment	1,452,377	1,941,661	3,679,926	4,818,300	5,258,274	5,706,619
	1,530,084	3,648,341	6,309,509	7,226,637	8,194,292	8,313,245
Liabilities						
Current Liabilities						
Bank Loan and Advances	257,942	-				-
Accounts Payable and Accrued Liabilities	20,077	1,169,272	247,423	216,894	267,409	300,300
Liability (Australia)				1,000,000	2,000,000	2,000,000
Income Taxes Payables	-			-	-	-
	278,019	1,169,272	247,423	1,216,894	2,267,409	2,300,300
Asset Retirement Obligations	96,560	116,090	148,290	177,600	186,480	195,804
Future Income Taxes	128,843	472,300	541,700	526,760	483,081	496,223
	503,422	1,757,662	937,413	1,921,254	2,936,970	2,992,327
Shareholders' Equity						
Share Capital	1,797,548	2,414,891	5,905,608	5,808,248	5,799,368	5,790,044
Contributed Surplus	67,703	134,308	253,758	217,493	259,428	307,944
Purchase Warrants	-	205,030	14,020	-	-	-
Deficit	(838,589)	(863,550)	(801,290)	(720,358)	(801,475)	(777,070)
	1,026,662	1,890,679	5,372,096	5,305,383	5,257,321	5,320,918
Total Liabilities and S.E	1,530,084	3,648,341	6,309,509	7,226,637	8,194,292	8,313,245

**Texalta Petroleum Ltd. - Cash Flow Statement
(in C\$)**

	2005	2006	2007	2008	2009E	2010E
Operating Activities						
Net Income	(131,427)	(24,961)	62,260	80,932	(81,117)	24,405
Non-Cash Items:						
Depletions and Depreciation	363,093	281,520	812,095	1,033,442	1,060,026	1,051,655
Stock Based Compensation	53,000	83,500	170,000	42,785	41,935	48,516
Gain on Sale of Property and Equipment						
Future Income Taxes	(105,039)	(64,043)	69,400	(14,940)	(43,679)	13,141
	179,627	276,016	1,113,755	1,142,219	977,166	1,137,717
Change in Non-Cash Working Capital Items:						
Accounts Receivable	(46,728)	(157,742)	(621,386)	484,270	7,399	(57,302)
Accounts Payable and Accrued Liabilities	(32,935)	1,149,195	(921,849)	969,469	50,515	32,891
	(79,663)	991,453	(1,543,235)	1,453,739	57,914	(24,411)
	99,964	1,267,469	(429,480)	2,595,958	1,035,079	1,113,306
Financing Activities						
Payment of Bank Loans and Advances	257,942	(257,942)				
Shares Issued for Cash (net)	(100)	1,234,547	2,581,147	3,300		
Normal Course Issuer Bids	(8,854)	(21,570)	(66,990)	(193,729)		
	248,988	955,035	2,514,157	(190,429)	-	-
Investing Activities						
Acquisition of Property and Equipment	(396,720)	(751,243)	(1,783,161)	(2,142,503)	(1,500,000)	(1,500,000)
CAPEX for the projects in Australia					(1,000,000)	(2,000,000)
Payment from Rodinia					2,000,000	2,000,000
Short-Term Investments	-	(665,615)	(948,809)	482,478	(1,000,000)	
	(396,720)	(1,416,858)	(2,731,970)	(1,660,025)	(1,500,000)	(1,500,000)
Increase(decrease) in Cash	(47,768)	805,646	(647,293)	745,504	(464,921)	(386,694)
Cash (BOP)	47,768	-	805,616	158,324	903,828	438,907
Cash (EOP)	-	805,646	158,323	903,828	438,907	52,213

Fundamental Research Corp. Equity Rating Scale:

Buy – Annual expected rate of return exceeds 12% or the expected return is commensurate with risk

Hold – Annual expected rate of return is between 5% and 12%

Sell – Annual expected rate of return is below 5% or the expected return is not commensurate with risk

Suspended or Rating N/A— Coverage and ratings suspended until more information can be obtained from the company regarding recent events.

Fundamental Research Corp. Risk Rating Scale:

1 (Low Risk) - The company operates in an industry where it has a strong position (for example a monopoly, high market share etc.) or operates in a regulated industry. The future outlook is stable or positive for the industry. The company generates positive free cash flow and has a history of profitability. The capital structure is conservative with little or no debt.

2 (Below Average Risk) - The company operates in an industry where the fundamentals and outlook are positive. The industry and company are relatively less sensitive to systematic risk than companies with a Risk Rating of 3. The company has a history of profitability and has demonstrated its ability to generate positive free cash flows (though current free cash flow may be negative due to capital investment). The company’s capital structure is conservative with little to modest use of debt.

3 (Average Risk) - The company operates in an industry that has average sensitivity to systematic risk. The industry may be cyclical. Profits and cash flow are sensitive to economic factors although the company has demonstrated its ability to generate positive earnings and cash flow. Debt use is in line with industry averages, and coverage ratios are sufficient.

4 (Speculative) - The company has little or no history of generating earnings or cash flow. Debt use is higher. These companies may be in start-up mode or in a turnaround situation. These companies should be considered speculative.

5 (Highly Speculative) - The company has no history of generating earnings or cash flow. They may operate in a new industry with new, and unproven products. Products may be at the development stage, testing, or seeking regulatory approval. These companies may run into liquidity issues, and may rely on external funding. These stocks are considered highly speculative.

Disclaimers and Disclosure

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