

Western Energy Services Corp (TSXV: WSV) – Continuing to focus on production optimization; Significant debt due in 2008

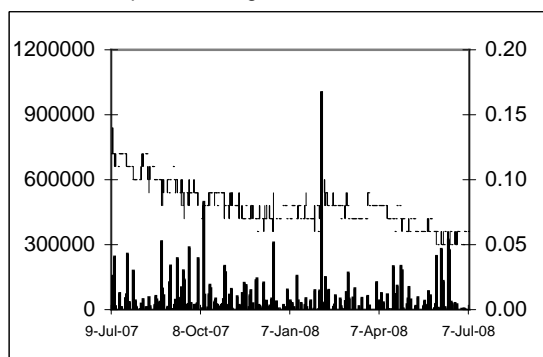
Sector/Industry: Oilfield Services

www.wesc.ca

Market Data (as of July 07, 2008)

Current Price	\$0.045
Fair Value	\$0.06 (↓)
Rating*	HOLD
Risk*	4 (Spec)
52 Week Range	\$0.045 - \$0.140
Shares O/S	168.0MM
Market Cap	\$7.6MM
Current Yield	N/A
P/E (forward)	N/A
P/B	0.87x
YoY Return	-62.5%
YoY TSX-V	-23.7%

*See back of report for rating and risk definitions



Q1 2008 and 2007 Highlights

- The company reported revenues of \$15.2 million in 2007 compared to \$14.1 million in 2006. However, revenues in Q1 2008 dropped YOY, from \$5.3 million, to \$3.3 million, primarily due to sales declines from the company's non-core businesses.
- Operating Margins declined to 12.7% in 2007, from 15.0% in 2006, due to higher COGS. G&A expenses/revenues improved to 8.6% in 2007, down from 13.2% in 2006.
- The company has reinvested the sales proceeds of its non-core assets in new equipment to support its core business.
- Strong oilfield activity levels were seen in the U.S. due to high oil & gas prices. However, weak drilling data shows the industry condition in Canada has not yet improved in 2008.
- The company recorded a net loss of \$4.5 million in 2007 (EPS: -\$0.04) versus \$4.7 million in 2006 (EPS: -0.05). In Q1 2008, the company recorded a net loss of \$0.98 million (EPS: -\$0.01), versus \$0.48 million in Q1 2007 (EPS: -\$0.00).
- At the end of Q1 2008, debt represented 55.1% of the company's total assets. In 2008, we estimate the company has to repay at least \$6 million in debt, and believe the company could run into liquidity problems if it cannot finance the repayments.
- We have maintained our HOLD rating, and lowered our fair value estimate to \$0.06 per share.

Key Financial Data and Statistics

(C\$ 000's)	2007	2008E	2009E
Revenues	15,201	17,003	23,642
EBITDA	410	751	1,727
Net Income	(4,526)	(1,898)	(940)
Assets	26,902	26,760	27,207
Debt	14,109	8,260	6,907
Equity	9,506	16,120	17,093
EPS	\$ (0.04)	\$ (0.01)	\$ (0.01)
EBITDA Margin	2.7%	4.4%	7.3%

Western Energy Services Corp. (WSV) is a Canadian based oilfield services company. It operates primarily in West Texas and Canada. It has shifted its business away from new drilling activity to stimulation and production optimization services in order to reduce exposure to drilling cycles and gas prices.

Industry Outlook

Drilling rig utilization in Alberta was 34.5% in 2007, versus 59.7% in 2006, and the decline in oilfield activities continued into 2008. As shown in the table below, the drilling utilization rate in Q1 2008 was 52.9%, down from 58.9% in Q1 2007, and 89.9% in Q1 2006. This was disappointing as Q1 is typically the strongest season for oilfield activities in Alberta and Canada. Drilling utilization rates in Q2 2008 were 13.0%, down from 13.3% in Q2 2007, and 36.2% in Q2 2006. The year to date rig utilization rate is at 32.9%.

		Alberta Rigs									
		Q1		Q2		Q3		Q4		YTD	
		AVG	Utilization	AVG	Utilization	AVG	Utilization	AVG	Utilization	AVG	Utilization
2008 Available		683		689						686	
2008 Drilling		362	52.9%	90	13.0%					226	32.9%
2007 Available		663		723		708		704		700	
2007 Drilling		391	58.9%	97	13.3%	239	33.8%	238	33.8%	241	34.5%
2006 Available		580		643		624		641		622	
2006 Drilling		522	89.9%	233	36.2%	384	61.5%	348	54.3%	372	59.7%

Source: CAODC, FRC

On the positive side, in April 2008, the Alberta government announced two new royalty programs to encourage the development of deep oil and gas wells. The new programs will provide royalty breaks for the high-cost and high productivity wells hit hard by the royalty rate increases announced last year.

In contrast, due to strong oil and gas prices, drilling activities in the U.S. have shown significant improvement year to date. According to the Oil & Gas Journal (OGJ), US drilling activities reached a 23-year record in the week ended July 4, 2008 (with a total rig count of 1,921, versus 1,752 in the same period in 2007), and Texas (where most of the company's U.S. operations are based) recorded a rig count of 923. We believe the industry conditions in Canada will eventually catch up in Q4 2008. Overall, we have a bullish outlook on the industry for the following reasons.

Strong Capital Spending – The performance of the oilfield services industry is heavily dependent on the capital spending of E&P companies. According to a midyear survey of 398 companies by Lehman Brothers, global exploration and production expenditures will increase 20% to \$418 billion in 2008. The survey indicates that E&P expenditures are expected to increase 15% to \$98 billion in the U.S., 11% to \$27.5 billion in Canada, and 22% to \$293 billion in all other countries in 2008 (versus growth of 3.5% in the U.S., a 12% spending reduction in Canada, and growth of 16% elsewhere in Lehman's December 2007 survey). The survey also suggests that E&P spending will continue to grow at least 10% in 2009.

Strong Oil & Gas Prices – Capital spending by E&P companies is largely dependent on oil and natural gas prices, since the companies want to capture higher potential revenues resulting from the higher commodity prices, and cut back production when prices are not economic. Oil is currently trading at record highs (above US\$140/bbl). Natural gas prices also improved significantly in the year so far (currently trading above US\$12/mmbtu). We believe the current high commodity prices and strong short to mid term price forecasts

support the projected increase in E&P spending, which in turn, is expected to increase oilfield activities. Average oil and natural gas prices were US\$72.47/bbl and US\$6.98/mmbtu respectively in 2007. The following table shows that most recent short term oil and natural gas prices forecasts represent significant increases over the average prices in 2007.

Oil & Gas Price Forecasts		
	2008	2009
Sproule		
Oil (\$US/bbl)	132.01	131.09
Natural Gas (\$US/mmbtu)	12.92	11.82
GLJ		
Oil (\$US/bbl)	122.80	125.00
Natural Gas (\$US/mmbtu)	11.22	11.25
EIA		
Oil (\$US/bbl)	122.15	126.00
Natural Gas (\$US/mmbtu)	11.05	10.99
Average		
Oil (\$US/bbl)	125.65	127.36
Natural Gas (\$US/mmbtu)	11.73	11.35

Source: Sproule, GLJ, EIA

In the long term, the Energy Information Administration (EIA) expects natural gas supplies to be in a deficit in both North America and China as shown in the table below. We also believe the global movement toward reducing greenhouse gases will increase demand for LNG. Therefore, we have a positive outlook on natural gas prices in the long run.

World Natural Gas Supply and Demand - in trillion cu. feet							
	2003	2010	2015	2020	2025	2030	Average 2003-30
North America							
Production	27.1	28.1	28.2	29.3	29.2	29.6	0.4%
Consumption	27.4	29.6	32.7	34.7	35.7	36.6	1.1%
Deficit	-0.3	-1.5	-4.5	-5.4	-6.5	-7.0	
China							
Production		2.5	3.1	3.5	4.0	4.3	4.1%
Consumption	1.2	3.0	3.9	5.1	6.2	7.0	6.8%
Deficit		-0.5	-0.8	-1.6	-2.2	-2.7	

Source: EIA

Although the International Energy Agency (IEA) forecasts global oil demand to grow at a faster pace than supply (1.8% per year versus 1.3% per year), the agency does not expect the oil market to be in deficit going forward. Therefore, we expect oil prices to soften going forward from the current high levels. However, based on the fundamentals of the oil industry, such as increased finding costs, we believe oil prices will stay above historical averages (\$35.5/bbl during 1996-2007). Both GLJ and Sproule expect oil prices (inflation adjusted) to stay above US\$80/bbl for the period 2008 – 2018 in their most recent forecasts.

Update on Strategic Direction and Activity

In 2007, the company implemented a number of activities as part of its strategy to focus on its core business of production optimization. The company has sold its Plata-Inca mining property in the Yukon Territories, and purchased the operating assets of the Grenville Energy Partnership. Particularly, the company has eliminated several low margin service lines as summarized below.

- Well testing services (all well service assets were sold)
- Canadian shallow coiled tubing services (due to its dependence on natural gas drilling activities)
- Fraction fluid
- Tool operation in Texas

In 2008, the company has set goals to increase revenues and profitability, and maintain cost measures achieved in 2007. It remains the company's strategy in 2008, to focus on its core business of production optimization through remedial stimulation services, and continue to rationalize other non-core assets.

In Q1 2008, the company opened a new operations center in Ashdown, Arkansas, and purchased nitrogen pumping and transport assets to equip the new center. According to the company, the purchase of nitrogen pumping and transport equipment (in the amount of US\$1.5 million financed by a new demand term loan) increased the size of the company's U.S. based nitrogen fleet by 50%. The new operation center is expected to give the company the opportunity to fully utilize its acid pumpers, and generate additional third party nitrogen revenues.

Based on our discussions with management, the company's operations are now more weighted to the U.S., and we believe the company will benefit from the current strong oilfield activity levels in the U.S. going forward. The company has plans to continue to expand geographically in both the U.S. and Canada.

Financial Analysis

Revenues: The company recorded revenues of \$15.2 million in 2007, versus \$14.1 million in 2006, reflecting growth in the company's production optimization business (e.g., simulation services), offset by revenue declines from well testing and Canadian shallow coiled tubing services (about \$1.9 million and \$1.6 million, respectively).

In Q1 2008, the company reported revenues of \$3.3 million versus \$5.2 million in Q1 2007. According to the company, revenues in Q1 2008 reflect stable revenues from the core business of remedial stimulation services, and were offset by revenue declines of \$0.44 million from well testing, \$0.80 million from Canadian shallow coiled tubing services and \$0.60 million from tool rental revenues. Based on our discussion with management, the revenue decline was also negatively affected by the strong Canadian dollar.

We believe remedial services are less sensitive to industry conditions and we are glad to see the company has been able to maintain revenues from its core business of remedial services in light of weak industry conditions during Q1 2008.

The total decline in revenues from the company's well testing and coiled tubing businesses was about \$1.2 million in Q1 2008. We believe these businesses are more sensitive to oilfield activity levels than remedial services, and therefore, are more volatile. Since the company had sold all of its well testing assets, and certain coiled tubing units in 2007, we predict the company's revenues will stabilize in the future. At the same time, we are concerned that the company will not receive as much revenue from these businesses when the industry fully recovers. However, based on our discussion with management, the company has reinvested most of the proceeds from the sales of the non-core assets in new equipment to support its core business as summarized in the list below.

- \$2 million in pumping equipment in Canada in 2007
- Nitrogen pumping equipment in the U.S. in 2007, and in Q1 2008
- Deep hole coiled tubing units, fluid pumping units, and transport and storage facilities in the U.S. in 2008
- A new operations centre in Ashdown AK

Although we have not seen revenues improve in Q1 2008, we believe these new investments in the company's core business present good upside potential to the company's revenues and bottom line for the rest of 2008, particularly in light of strong U.S. oilfield activity levels.

Lastly, the company recorded significant revenue declines in the tool rental business from \$0.70 million in Q1 2007, to \$0.11 million in Q1 2008. Based on our discussion with management, the customers of the company's tool rental business were not active during Q1 2008. Management expects the drilling programs of its customers to recommence in Q3 2008, and revenues from its tool rental business to improve significantly during the second half of 2008.

Revenues from the company's U.S. operations increased 12% in US\$ (4% decrease in C\$) in Q1 2008 versus Q1 2007, reflecting strong demand for the company's nitrogen pumping and transportation services. In comparison, revenues from Canada (excluding well testing and coiled tubing services) were 92% of the value of Q1 2007, reflecting weak Canadian industry conditions.

As shown in the table below, we forecast revenues of **\$17.0 million in 2008, compared to \$27.6 million in our previous report. In 2009, we estimate the company to record revenues of \$23.6 million.**

(in \$000s)	2006	2007	2008E	2009E
Revenue				
Well Service	12,385	13,619	16,305	22,012
Tool Rental	1,734	1,583	698	1,630
Total	14,119	15,201	17,003	23,642

Margins: In 2007, the company had segmented operating margins of 11.5% for the well service segment and 23.1% for tool rental segment. Overall, operating margins decreased to

12.7% in 2007, compared to 15.0% in 2006, reflecting higher cost of goods sold. Operating margins improved to 16.8% for the well service segment in Q1 2008, but was only 1.2% for the tool rental segment. We expect the company to improve its operating margins for the well service segment as the company continues to focus on its core business. We have forecasted operating margins of 18.0% and 10.0% for the well service and tool rental segments in 2008, respectively. In addition, G&A/Sales was 8.6% in 2007, an improvement from 13.2% in 2006. The company expects to maintain G&A expenses at 12% or less of revenues. The ratios are summarized in the table below

					3MO	3MO
Operating Margin %	2006	2007	2008E	2009E	2007	2008
Well Service	15.0%	11.5%	18.0%	20.0%	22.9%	16.8%
Tool Rental	14.6%	23.1%	10.0%	23.0%	33.1%	1.2%
Total	15.0%	12.7%	17.7%	20.2%	24.2%	16.3%
G&A/Sales	13.2%	8.6%	12.0%	12.0%	8.2%	9.2%

Capital Structure and Cash Flows: Total debt (including capital leases) was \$15.3 million at the end of Q1 2008, representing 55.1% of the total assets of the company. The company had a working capital deficit of \$14.4 million at the end of March 2008. We estimate the company will have to repay at least \$6.0 million of its debt in 2008, specifically, \$2 million in short term borrowings, \$0.41 million in long term debt, and \$3.4 million in convertible notes (we do not believe the note will be converted under the terms of the agreement), and \$0.18 million in capital leases. Based on our discussion with management, the company also has a capital expenditure budget of US\$3.5 million in 2008 (including the purchase of US\$1.5 million in new nitrogen equipment during Q1 2008).

We expect that free cash flow in 2008 will be insufficient to repay the debts coming due and finance the proposed capital expenditures, and have estimated that the company will have to raise an additional \$8.3 million in equity. However, we do note that the company has demonstrated good ability to refinance debt in the past. According to management, the company's capital expenditure budget may also change depending on financing and available resources. Therefore, we believe the actual amount of equity financing required in 2008 may vary from our estimate based on the results of debt renegotiations and actual capital expenditures.

EPS forecasts: The company recorded a net loss of \$4.5 million in 2007 (EPS: -\$0.04) versus a net loss of \$4.7 million in 2006 (EPS: -0.05). For the 3 months ended March 2008, the company recorded a net loss of \$0.98 million (EPS: -\$0.01), versus a net loss of \$0.48 million in Q1 2007 (EPS: -\$0.00). Given the assumptions discussed above, **we have forecasted a net loss of \$1.9 million (EPS: -\$0.01) in 2008, and a net loss of \$0.9 million (EPS: -\$0.01) in 2009.**

Valuation

Our revised DCF model (shown below) values the company at \$0.06 per share, compared with a fair value estimate of \$0.08 per share in our previous report.

Western Energy - Discount Cash Flow Model (\$000s)

	2008E	2009E	2010E	2011E	2012E	2013E	2014E	2015E	2016E	Terminal
Funds From Operations	1,016	2,070	2,739	3,248	3,665	4,151	4,751	4,830	4,918	5,014
Investment in Working Capital	(170)	(222)	(280)	(240)	(208)	(249)	(299)	(55)	(57)	(59)
Cash From Operations	846	1,848	2,459	3,009	3,457	3,902	4,452	4,775	4,861	4,956
Capex	(3,500)	(2,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)
Free Cash Flow	(2,654)	(152)	1,459	2,009	2,457	2,902	3,452	3,775	3,861	3,956
PV	(2,508)	(128)	1,099	1,351	1,475	1,556	1,653	1,613	1,474	16,773
Discount Rate	12%									
Terminal Growth	3%									
Sum PV (MM)	24,358									
Debt (MM)	14,109									
Cash	211									
Equity Value (MM)	10,460									
Share O/S (MM)	168,007									
DCF Value/Share	0.06									

Rating

Based on a review of the company's operating and financial results, **we maintain our HOLD rating and decrease our fair value to \$0.06 per share from \$0.08 per share in our previous report.**

With continued focus on production optimization, the company rationalized several non-core service lines, and invested the proceeds from the sales of non-core assets to new equipment to support its core business. Although Q1 2008 results were negatively affected by revenue declines due to the sales of their non-core assets, we think the new investments present good upside potential for the rest of 2008, particularly given the strong drilling activity levels in the U.S. and high commodity price forecasts. However, the company has a relatively significant amount of debt coming due in 2008. Overall, we believe the company has yet to show an improvement in its operations from the new investments, and resolve the maturing debt issue. Therefore, at this time, we recommend investors to continue to take a wait and see approach.

Risks

- Although the company has taken steps to reduce exposure to drilling activity, it is still exposed to overall oilpatch activity;
- The company has a relatively high debt to capital and what we believe to be an unfavorable debt maturity schedule relative to cash on hand and cash flow. If the company is unable to raise new equity or refinance debt, we believe it could be subject to credit problems.
- The company is indirectly exposed to commodity prices.
- The company is subject to foreign exchange rate risk.

We rate the company a **RISK** of 4 (Speculative).

APPENDIX:**Western Energy Services Corp - Income Statement**

(\$000s)

	2007	2008E	2009E
Revenue	15,201	17,003	23,642
Expenses			
Operating	13,266	13,998	18,865
G&A	1,311	2,040	2,837
Stock Compensation	213	213	213
Total	14,791	16,251	21,915
EBITDA	410	751	1,727
gain on sale of assets	(786)	-	-
Gain from partial payment of convertible note	36		
FX	194	-	-
Restructuring costs	(30)		
Depreciation	2,721	2,701	2,797
EBIT	(2,896)	(1,950)	(1,070)
Interest	1,653	971	377
Accretion	74		
EBT	(4,623)	(2,921)	(1,447)
Tax	898	(1,022)	(506)
Net income from continuing operations	(5,521)		
Net gain (loss) from discontinued operations	995		
Net Income	(4,526)	(1,898)	(940)
EPS	\$ (0.04)	\$ (0.01)	\$ (0.01)

Western Energy Services Corp - Balance Sheet

(\$000s)

	2007	2008E	2009E
Assets			
Current			
Cash	211	8	203
AR	2,422	1,972	2,742
Inventory	640	420	566
Prepaid Expenses	408	340	473
Total Current Assets	3,681	2,740	3,984
PPE	22,510	23,308	22,511
Deferred Charges	-	-	-
Goodwill	712	712	712
Future Income Taxes	-	-	-
Total Assets	26,902	26,760	27,207
Liabilities			
Current Liabilities			
AP	3,288	2,380	3,207
Revolving credit facilities	722	858	858
ST Debt	2,000	-	-
Demand Term Loans	6,401	6,401	5,401
Convertible Note	3,392	-	-
Current Capital Lease	180	0	0
Current LT Debt	413	353	313
Total Current Liabilities	16,396	9,993	9,780
Asset Retirement Obligations	-	-	-
Capital Lease	21	21	21
LT Debt	980	626	313
Total Liabilities	17,396	10,640	10,114
Common Shares	10,909	19,209	20,909
Contributed Surplus	1,662	1,875	2,088
Equity portion of convertible note payable	31	31	31
Retained Earnings	(3,096)	(4,994)	(5,935)
Equity	9,506	16,120	17,093
Equity and Liabilities	26,902	26,760	27,207

Western Energy Services Corp - Cash Flow
(\$000s)

	2007	2008E	2009E
Operating			
Net Income	(5,521)	(1,898)	(940)
Plus			
Depreciation	2,721	2,701	2,797
Stock Compensation	213	213	213
Accretion	74		
Gain on Sale	786	-	-
Gain from partial payment of c	(36)		
Future Income Taxes	650	-	-
Funds From Operations	(1,114)	1,016	2,070
Investment in W/C			
A/R		450	(770)
AP		(908)	827
Inventory		220	(146)
Prepaid Expenses		68	(133)
Total Investment in W/C	(525)	(170)	(222)
Cash From Operations	(1,639)	846	1,848
Investing			
Capex	(6,872)	(3,500)	(2,000)
Sale of Assets	4,179		
Cash Used in Investing	(2,694)	(3,500)	(2,000)
Financing			
Revolving Credit	(1,147)	137	-
ST Debt	-	(2,000)	
Demand Term Loans	4,846	-	(1,000)
LT Debt	(179)	(413)	(353)
Convertible	(5,303)	(3,392)	
Capital Leases	(146)	(180)	-
Equity	6,033	8,300	1,700
Cash From Financing	4,104	2,452	347
Change in Cash	(229)	(203)	195
Cash BOP	439	211	8
Cash EOP	211	8	203

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.

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