



BLACKMONT CAPITAL™

CHALLENGER ENERGY CORP.

CHQ-TVX \$2.15
 Recommendation **Speculative BUY**
 Target Price (from \$8.25) **\$6.00**
 Projected Return 179.1%

Market Data

52-Week Trading Range \$6.64 - \$1.45
 Shares Outstanding, Basic (mm) 57.8
 Shares Outstanding, FD (mm) 75.4
 Market Capitalization (mm) \$124.2
 Enterprise Value (mm) \$128.2

Financial Data

Net Debt (mm) \$6.2

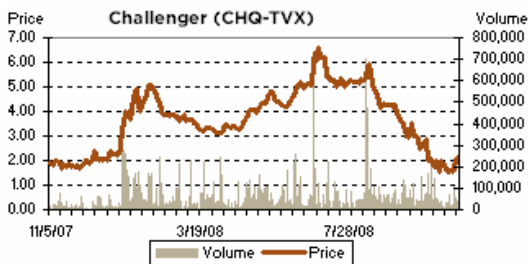
Forecasts

FYE: December	2007A	2008E	2009E
EBITDA (mm)	(\$4.3)	(\$3.7)	(\$4.1)
CFPS, FD	(\$0.02)	(\$0.03)	(\$0.04)
Oil and Liquids (bbls/d)	n/a	n/a	n/a
Natural Gas (mcf/d)	n/a	n/a	n/a
Total Production (BOE/d)	n/a	n/a	n/a

Valuation

NAV/sh, FD		\$5.89	
EV/DACF (x)	n/m	n/m	n/m
P/CF, FD (x)	n/a	n/a	n/a
P/NAV, FD (x)	n/a	n/a	n/a

Source: Reuters, company reports, Blackmont Capital Inc.



Source: Reuters

Company Profile

Industry: Energy: Exploration & Production
Description: Challenger is a Calgary-based junior E&P focused on exploration activities offshore Trinidad & Tobago. The company has successfully drilled & tested Victory & Bounty and is currently drilling the Endeavour prospect on Block 5(c).

Changes at a Glance

Target Price	↓	\$6.00	
2008 CFPS	↑	(\$0.03)	2009 CFPS ↑ (\$0.04)

See important disclosure statements at the end of this report.

Energy: Exploration & Production

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Global Credit Crisis Increases Risk Profile - Reducing Target Price

Executive Summary

- The geological and project economic risk for Block 5(c) has been reduced by the Bounty discovery, but this has been offset by the global credit crisis and recessionary fears that have increased the cost of capital as well as the future financing risk for Challenger Energy (CHQ-TVX).
- We have performed a scenario analysis that shows that if a corporate sale does not take place in 2009, Challenger will require \$44-70 million of new capital to fund its 2009 obligations; a rather daunting task in the current environment.
- We therefore view a corporate sale within the next six months as being imperative.
- We have made a number of adjustments to our valuation model, both positive and negative, with the result being a reduction in our target price to \$6.00/share, down 27% from our previous target of \$8.25. However, this still represents a potential 170% return on the current stock price of \$2.20/share.

Financing Completed in a Difficult Environment

Shortly after our initiating report on Challenger Energy, the company announced a best efforts equity financing on August 21, 2008, of which Blackmont was the lead underwriter. We have been research restricted as a result.

The company's efforts to raise capital could not have come at a more unfortunate time given the global credit

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crisis and the recessionary fears that have negatively impacted equity values across the entire investment spectrum. That said the financing closed on October 2, 2008, with Challenger issuing 10 million units at \$3.00/unit, with each unit consisting of one common share and one half of one common share purchase warrant with an exercise price of \$3.50/share and an expiry 12 months hence. Challenger hoped to raise a minimum \$44 million but fell short. The difference of \$14 million was obtained through a short-term bridge loan from Canadian Superior Energy (SNG-TSX); a related company.

Challenger cannot be faulted for the timing of the equity raise. The strategy since inception has been to raise separate tranches of capital for the drilling of each of the three exploratory wells on Block 5(c) offshore Trinidad. With Victory and Bounty having been drilled as successful discoveries, Challenger required capital to pay the Bounty testing costs and to drill the third and final commitment well, Endeavour, which spud August 28, 2008, and has reached approximately 15,000 feet towards the 18,000 foot target depth.

Without participation in Endeavour, Challenger's right to a 25% interest in Block 5(c) would have been at risk. That risk has now been substantially eliminated and we expect that legal title for a 25% interest in Block 5(c) is in the process of being transferred to the company.

The short-term bridge loan through Canadian Superior bears interest at 10% per annum compounded, funds drawn can only be used for expenses incurred on Block 5(c), and interest and principal are due no later than December 31, 2008. Furthermore, Challenger has agreed to pay Canadian Superior up to 500,000 warrants on the same terms as the unit offering if the full \$14 million is drawn. In our forecasts, we are assuming this to be the case. Additionally, Canadian Superior has the option, at its sole discretion, to convert the loan into units rather than receiving cash.

Improved Geological & Project Economic Risk Profile Offset by Global Credit Crisis

When we initiated research coverage of Challenger (August 6, 2008) the Victory well had been successfully drilled with an internally estimated recoverable resource of between 0.63 Tcf and 1.12 Tcf. Bounty had been drilled but not tested. Since then the Bounty well tested at restricted rates of over 60 mmcf/d and internal estimates are that the well can initially produce at 200 mmcf/d, making it one of the best wells offshore Trinidad. Preliminary internal estimates of the Bounty resource are 2.6 Tcf. If correct, the upside case for Victory plus Bounty amounts to approximately 3.7 Tcfe, which is close to the initial 4.0 Tcf estimate for the entire Block 5(c) and this is before results from Endeavour are included.

Thus the geological and project economic risk for Block 5(c) has been reduced by the Bounty discovery but this has been offset by the global credit crisis and recessionary fears that have increased the cost of capital as well as the future financing risk for the company. Challenger's plan was to monetize its Block 5(c) interest immediately after the drilling of Endeavour and this objective remains in place. **That said, the timing of a transaction and the potential value a buyer is willing to pay for the asset remains anyone's guess at this time.**

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A potential risk is that BG Group (BG-L), operator of the Block after the drilling of Endeavour and 45% working interest holder, turns out to be the only interested suitor. This would put Challenger in a weak negotiating position given its lack of financial resources. However, we believe Challenger is holding preliminary talks with a number of companies interested in LNG, including upstream as well as midstream players, and this could result in a competitive bidding process.

Scenario Analysis of Financing Risk

Before discussing our updated valuation of Block 5(c) we need to review the potential scenarios should an asset (or corporate) sale be delayed, or in a worst case scenario, not occur. We understand that BG Group is already sourcing a rig for the drilling of two development wells on the Block in 2009. Given the logistics of sourcing steel pipe and other supplies in conjunction with timing of rig availability and mobilization, we don't believe the two development wells will be drilled until H2/09.

We estimate average drilling and completion costs for Victory, Bounty, and Endeavour at approximately C\$90 million gross (\$22.5 net), thus Challenger's minimum drilling capital commitment in 2009 would be in the range of C\$45 million if a corporate sale does not occur and the company remains a going concern.

Figure 1 summarizes Challenger's Financing risk by illustrating five scenarios that may play out over the next year. Scenario A through C assume that a corporate sale takes place sometime in H1/09; the timing of which would have some bearing on Challenger's financing risk. A sale in January 2009 would result in no additional capital being required, whereas a sale later in the quarter might require some temporary funding until the sale closes.

Figure 1: Challenger Energy 2009 Financing Risk

	Scenario A	Scenario B	Scenario C	Scenario D	Scenario E
Uses of Cash					
Working capital deficiency June 30/08	\$7.3	\$7.3	\$7.3	\$7.3	\$7.3
Administration & other	2.0	2.0	2.0	3.5	3.5
Remaining Bounty costs not accrued	7.5	7.5	7.5	7.5	7.5
Drilling Endeavour	24.8	24.8	24.8	24.8	24.8
Testing Endeavour	0.0	6.0	6.0	6.0	6.0
Disputed Victory costs	0.0	5.0	5.0	5.0	5.0
Repayment of Canadian Superior bridge loan	0.0	0.0	14.0	14.0	14.0
2009 Development drilling	0.0	0.0	0.0	45.0	45.0
Total	\$41.6	\$52.6	\$66.6	\$113.0	\$113.0
Sources of Cash					
Net proceeds from October/08 equity financing	\$28.2	\$28.2	\$28.2	\$28.2	\$28.2
Bridge loan from Canadian Superior	14.0	14.0	14.0	14.0	14.0
Warrant proceeds Q4/09	0.0	0.0	0.0	27.4	0.0
Total	\$42.2	\$42.2	\$42.2	\$69.6	\$42.2
Cash Surplus (Shortfall)	\$0.6	(\$10.4)	(\$24.4)	(\$43.4)	(\$70.8)

Source: Company documents, Blackmont Capital Inc.

Scenario D and E assume that a corporate sale does not occur and Challenger remains a going concern. Obviously a greater amount of financing risk is associated with these two scenarios given the larger amount of cash required to fund ongoing operations.

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We view Scenario B or C as the likely outcomes and believe that a corporate sale in Q1/09, or Q2/09 at the latest, has a high probability of occurring despite the global credit crisis. We maintain this view because Victory and Bounty have established a significant resource on the Block, worldwide LNG demand is growing, and now is the time for companies with healthy balance sheets to be on the prowl for quality assets at reasonable valuations.

In fact, the argument could be made that a transaction has a higher probability of being consummated today than it would be if gas prices were sky-high and valuations at historically high levels. As an example, BG Group recently announced (October 28, 2008) a friendly takeover offer for Queensland Gas Co. of Australia (QGC-AX) for US\$3.4 billion in a strategy to boost its presence in the lucrative Asian LNG market. BG expects global demand for LNG to grow threefold by 2020.

Following is a brief description of the assumptions underlying each scenario.

Scenario A

Scenario A assumes that the Endeavour well is dry and therefore no testing costs are incurred. Also, the dispute between the drilling contractor and the partners is resolved in favour of the partners and no additional payments are required with regard to the Victory well. Finally Canadian Superior converts the short-term bridge loan to units thus relieving Challenger of its obligation to repay this debt in cash. Challenger is sold in Q1/09 before any further capital obligations on Block 5(c) are incurred.

Scenario B

The only differences in scenario B are that Endeavour is assumed to be a successful discovery resulting in additional well testing costs and it is assumed that the dispute with the drilling contractor is resolved in favour of the contractor, adding an additional \$5 million of costs. We estimate that Challenger would be short just over \$10 million, but this may not be problematic if the sale of the company is negotiated early in the quarter and creditors are willing to provide some leeway with regard to re-payment.

Scenario C

Scenario C is the same as B except that it is assumed that Canadian Superior demands repayment of the \$14 million short-term bridge loan in cash rather than exercising its option to convert the loan to units. We estimate that Challenger would require just over \$24 million to satisfy its obligations under this scenario. Again, if a corporate sale is imminent (binding agreements signed etc.) then creditors may be lenient with regard to repayment but if this is not the case, then Challenger will be forced to raise sufficient capital to repay its debts through alternative financing. This could be difficult if current market conditions and negative sentiment persist into H1/09.

Scenario D

Scenario D includes all the other assumptions described so far but also assumes that no corporate sale takes place in 2009 and Challenger remains a going concern. We estimate that the company would have a minimum capital commitment of C\$45 million for the drilling of two appraisal/development wells on Block 5(c). In this best case scenario, Challenger's stock price is in excess of \$3.50/share and the company receives \$27.4 million of exercised

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warrant proceeds in Q4/09. We estimate Challenger would require \$44 million of additional funds if these assumptions prove correct.

Scenario E

This scenario is the same as D but assumes no warrant proceeds are received. Thus, Challenger would require slightly more than \$70 million to fund its going concern obligations through 2009.

To conclude; due to the lack of any cash-flowing assets that could help internally fund on-going obligations, Challenger's financial situation is less than ideal, making a corporate sale imperative in the next six months.

Revised Block 5(c) Valuation and CHQ Target Price

With Bounty now drilled and tested, we have updated our valuation model to reflect a higher probability weighting for the resources on the block. We have also adjusted our production profile assumptions to reflect potentially higher IP rates from wells based on Bounty's test results. We have lowered our project capital cost assumptions marginally. These are positive adjustments.

On the negative side, we believe it is appropriate to increase the discount rate in our DCF model to reflect increased risk from the global credit crisis and the resulting increase in the cost of capital. Our valuation was based on a 10% discount rate previously and we are increasing this to 12%.

Another adjustment is a change to our gas price probability weighting. We argued previously that a gas price assumption for Challenger should be based more on a world LNG price rather than a North American price and this still remains our belief. We also continue to believe that long-term gas prices will increase along with global demand. That said, we cannot ignore the fact that the global credit crisis and looming recession have changed the near-term demand and price outlook and it is likely that a potential buyer for Challenger will put a higher weighting on the near-term outlook and less emphasis on longer-term projections.

The result of all of these adjustments is shown in Figure 2, which summarizes our approach to arrive at a target price. This approach is unchanged from when we initiated on Challenger. We have assigned probability of success to both potential recoverable reserves and to future natural gas prices, with the product of these probabilities applied to the estimated after-tax fully diluted NAVPS amounts from our sensitivity analysis, shown in Figure 3. The results are summed to arrive at the probability weighted target price.

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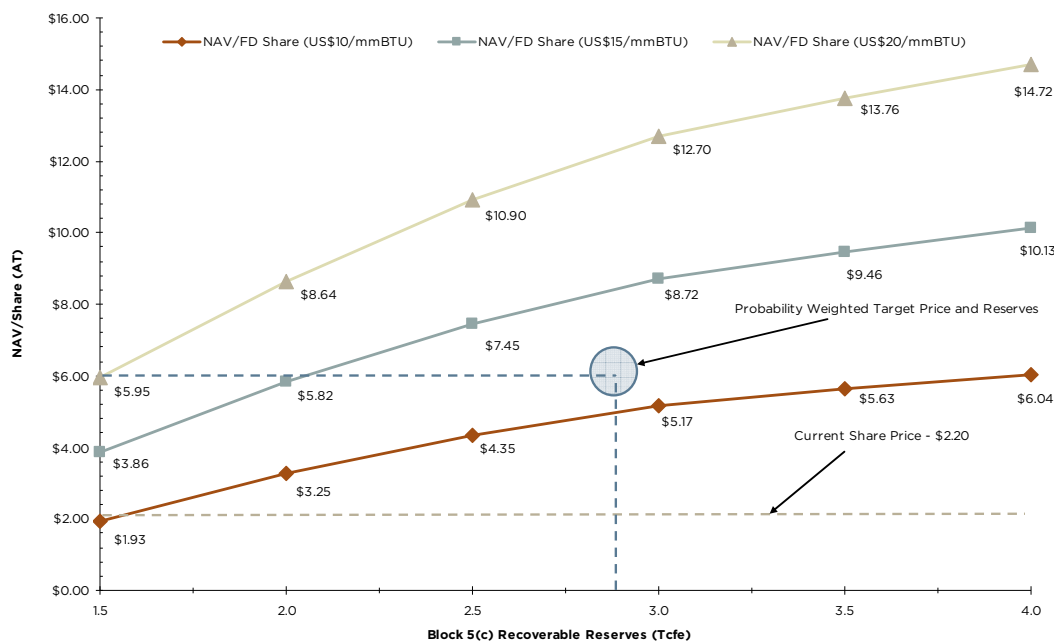
Figure 2: Probability Weighted Target Price (C\$)

Reserves Tcfe	GAS US \$/mmBTU					
	Probability (OLD)	Probability (NEW)	\$10.00	\$15.00	\$20.00	
			40% 70%	50% 30%	10% 0%	
4.0	10%	15%	\$6.04	\$10.13	\$14.72	\$1.09
3.0	20%	25%	\$5.17	\$8.72	\$12.70	\$1.56
2.5	40%	50%	\$4.35	\$7.45	\$10.90	\$2.64
2.0	20%	15%	\$3.25	\$5.82	\$8.64	\$0.60
1.0	10%	0%	\$0.00	\$0.00	\$0.00	\$0.00
			\$3.40	\$2.49	\$0.00	\$5.89

Source: Blackmont Capital Inc.

Our new target price for Challenger is \$6.00/share down 27% from our previous target price of \$8.25/share. However, this still represents a potential 170% return on the current stock price of \$2.20/share.

Figure 3: Estimated PV_{12%} NAVPS (C\$) at Various Different Gas Price and Reserve Assumptions

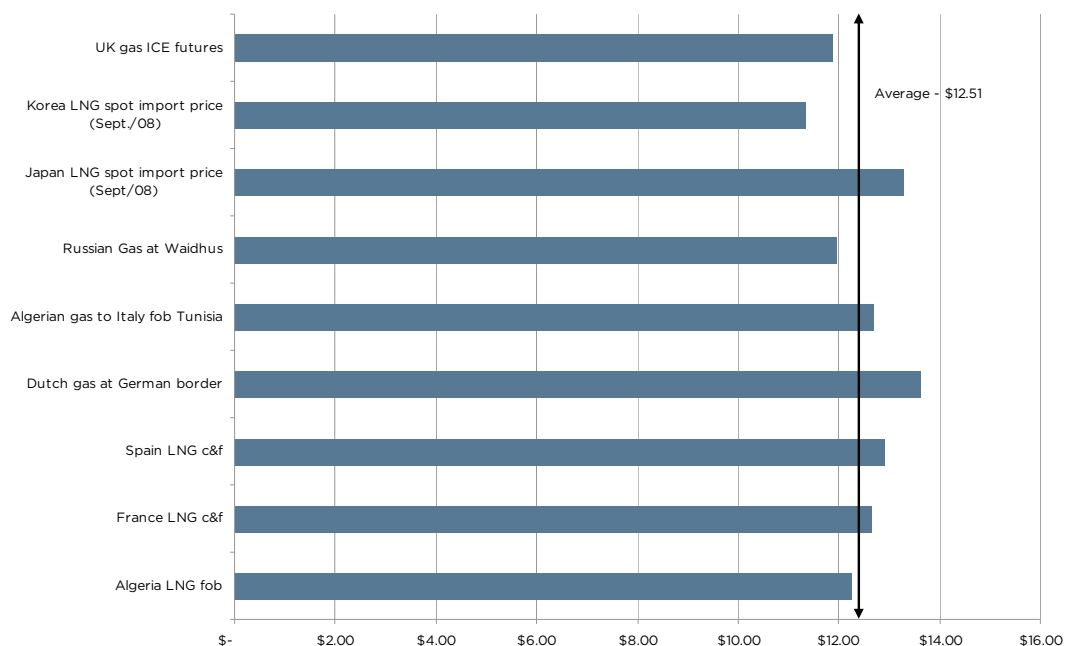


Source: Blackmont Capital Inc. estimates

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Our target price implies probability weighted reserves of 2.9 Tcfe for Block 5(c) and a probability weighted landed gas price of US \$11.50/mmBTU or US \$7.83/mmBTU net to the JV partners after estimated transportation and LNG tariffs and fees. This landed gas price assumption is not unreasonable in the context of currently forecasted short-term global gas prices, as illustrated in Figure 4, as well as the estimated timing of first production, which we assume to be 2013.

Figure 4: Currently Forecasted December/08 Global Gas Prices (US \$/mmBTU)



Source: Bloomberg, Blackmont Capital Inc.

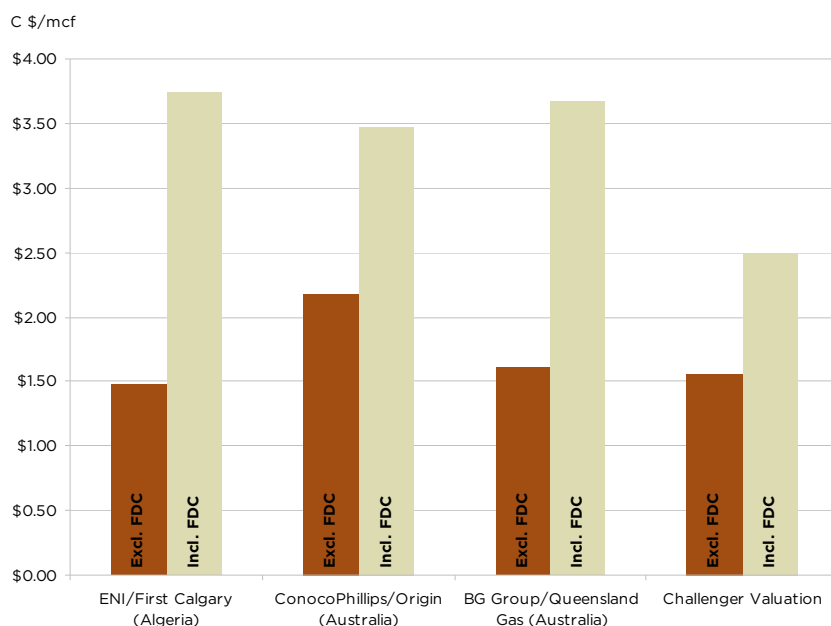
Our target price also implies a value for Challenger amounting to C\$452 million or \$1.56/mcf of reserves excluding future development capital (FDC); this is reasonable relative to recent 3P acquisition transaction metrics for large gas/LNG projects around the world (Figure 5). **That said, we must caution that these comparisons are difficult at the best of times given wide-ranging differences between the location and type of assets. Furthermore, these acquisitions often have a strategic intent, which is impossible to quantify.**

For example both Queensland Gas Corp. and Origin Energy are Australia-based companies with vast on-shore coal seam gas assets that differ significantly from off-shore Trinidad gas assets, although the scope of the projects in terms of dollars are similarly large. Queensland's CSG to LNG project encompasses 3,000 wells, a 380 km pipeline to supply gas to two LNG trains, 200 km of collection pipeline to bring the gas to the main supply pipeline, and a further 220 km of interconnection pipeline for both gas and water; total estimated cost A\$8 billion (US\$5.1 billion).

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Queensland's project cost dwarfs our revised capital estimate for developing Block 5(c) of US \$1.6 billion, including nine wells, subsea tie-backs, a production platform and pipeline to the mainland and excluding any costs for LNG trains which we assume will have available capacity by the time Block 5(c) production comes on-stream in 2013.

Figure 5: Recent 3P Acquisition Metrics for Large Gas/LNG Projects



Australia government take (royalties/taxes) assumed at 50%

Source: Company documents, Blackmont Capital Inc.

Conclusion and Recommendation

An investment in Challenger Energy is a bet on whether the company can find a buyer willing to acquire its Block 5(c) interest in the next six months at a substantial premium to the current share price. Without a sale and assuming the company fully participates in the development drilling likely to take place on the block in 2009, we estimate Challenger would require about \$70 million of capital; a rather daunting task in the current environment.

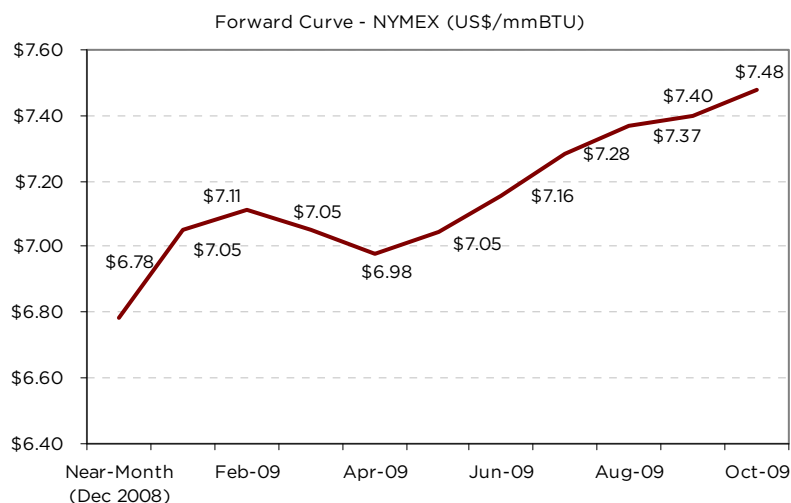
That said, the Victory and Bounty wells have established a substantial resource on Block 5(c) and the Endeavour well has the potential to add further value. Global LNG demand is projected to grow significantly over the next decade and Trinidad continues to be one of the largest providers of spot LNG on world markets, making its gas resources very desirable. **Thus, there should be no lack of buyer interest in Challenger's assets and we believe a corporate sale has a high probability of taking place.**

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Assuming a recoverable resource of 4.0 Tcfe on the Block and a 12% DCF rate, we estimate the market is discounting a long-term constant gas price of approximately US\$6.75/mmBTU to substantiate Challenger's current stock price of \$2.20/share. This is in-line with current NYMEX prices but low relative to the 2009 forward curve (Figure 6), and very low relative to world LNG prices.

We can only conclude two things: (1) Investors have completely abandoned the stock (like many other junior E&P stocks) and are not interested in the potential upside because many other less risky junior E&P companies are also "cheap" or (2) Investors are betting against a corporate sale and believe a "going concern" option is not likely. Whatever the case, **we believe the near-term catalysts, including results from the drilling of Endeavour and a potential corporate sale, outweigh the downside risks and therefore we are maintaining our Speculative BUY recommendation with a new target price of C\$6.00/share.**

Figure 6: October 31/08 NYMEX Forward Curve



Source: Bloomberg, Blackmont Capital Inc.

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Blackmont Research Disclosure

Company Name	Ticker	Disclosure
Challenger Energy Corp.	CHQ - TVX	1, 2

Distribution of Research Ratings (# of Stocks)		
BUY	75	54%
Speculative BUY	14	10%
HOLD	39	28%
SELL	4	3%
Other	6	4%
Total	138	100%

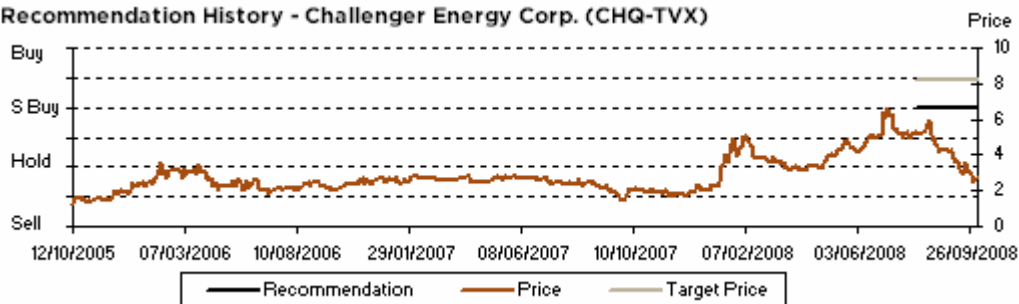
Investment Banking Services Provided*	
BUY	33%
Speculative BUY	43%
HOLD	28%
SELL	0%

* Percentage of subject issuers within each of the research ratings for which Blackmont Capital Corp. has provided investment banking services within 12 months.

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Recommendation History - Challenger Energy Corp. (CHQ-TVX)



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- BUY:** The stock's total return is expected to exceed a minimum of 15% over the next 12 months.
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- HOLD:** The stock's total return is expected to be between 0% and 15% over the next 12 months.
- SELL:** The stock's total return is expected to be negative over the next 12 months.
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