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Bullish and Fully Fueled

Interview with Kurt Wulff, Founder, McDep Associates

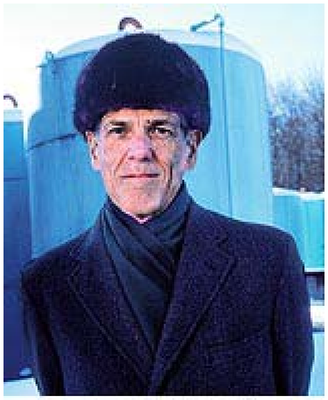
By SANDRA WARD

IT MAY NOT SPORT the catchiest name, but Needham, Mass.-based McDep Associates and its founder, Wulff, have built a big following among investment banks and individuals for in-depth, independent research on the energy industry. That's partly because he makes his research available on the World Wide Web, at www.mcdep.com. But partly, too, because he is an enormously insightful and creative thinker. McDep is named for a ratio Wulff devised in the 1980s, while he was a top-ranked oil analyst at the former Donaldson Lufkin & Jenrette, to better appraise the value of energy companies: McDep = market cap and debt (McDe) to present value of energy (p). Last year in these pages ("Drilling for Value," December 2004), Wulff forecast a value of Burlington Resources stock of $86 a share on $50 oil, and fantasized about a ConocoPhillips takeover of Burlington. Now he makes the case that natural gas isn't expensive at current levels, and that it one day could be worth more than oil.

Barron's: Have the prospects for energy changed since we spoke a year ago?

Wulff: It has been a great year for the stocks, so automatically you have to be a little cautious about anticipating another great year. But the long-term outlook is still pretty powerful. Demand is strong, and higher energy demand means more economic activity. The supply picture, obviously, has changed. Last year we learned Saudi Arabia could no longer produce additional light oil. That hasn't changed. We were happy when oil prices dropped back to $55 a barrel because they had gone up a little too much too soon, but they are in an upward trend. We think $60 a barrel is close to the 40-week moving average. Maybe the higher limit for now might be $80 a barrel rather than $60. We don't ever know what is going to happen in the future, but the momentum is good: Oil prices are above the 200-day moving average, the gas price is above the 200-day moving average, refining margins are above the 200-day moving average and the underlying long-term expectation is that oil could still be a lot higher. So it is better to bet on it going higher than not going higher. My vision for oil is $150 a barrel by 2010. We've only gone up threefold so far this decade and we went up 10 times in the 'Seventies, so who knows what's ahead for us? The upside is still pretty powerful.

What of the relationship between stock prices and the price of the commodity in the futures market?


Christopher Fitzgerald

Wulff fantasized last year about ConocoPhillips buying Burlington Resources. He still recommends both stocks.

The McDep ratio I use to calculate present value includes a denominator that is the value of the company's oil and gas resources depending on some oil price and gas price. Last December we were using $35 a barrel as our long-term expectation. In January I raised my long-term number to $40 a barrel and in August I went to $50 a barrel. That didn't take a lot of imagination because the six-year price of crude oil was going up at the same time. So today my values for companies are tied to $50 oil. The futures market is at $61 a barrel for six-year oil. The market is at about $60, I'm at $50 and stocks are at $40 and will probably go a lot higher yet.

ConocoPhillips buying Burlington Resources was on your wish list a year ago. What do you think of this deal?

Burlington Resources [ticker: BR] has been one of my favorite stocks for a long time, and my present value on Burlington is $86 on $50 oil. The current stock price is right at my present value. I've been looking for this deal for a long time, and so I'm delighted that ConocoPhillips [COP] bid for Burlington Resources. It obviously demonstrates confidence in natural gas on the part of ConocoPhillips because Burlington Resources is about 70% natural gas. While I quote the price for Burlington in oil terms, it is really a natural-gas value. Burlington Resources is the largest gas producer in the San Juan Basin, and Phillips was about the third-largest producer. The two together will now be the largest producer in the San Juan Basin, which is the largest gas field in the U.S. It has been a wonderful long-term property, and it just gets better and better.

What now? Should investors continue to hold these stocks?

I continue to recommend both. The deal does change the picture a little. Obviously, if you have a lot of Burlington and you want to cash in, this is the time to do it. You will get cash for half of your Burlington. Part of the rationale would be to take the cash and recycle it in something else. The rationale for holding Burlington would be to get ConocoPhillips, which was a cheap stock before the deal and is a cheap stock after the deal. If you are a taxable investor, you don't pay taxes on the ConocoPhillips part of the transaction, so you may as well buy Burlington. But, of course, Burlington isn't the best buy out there, while ConocoPhillips could be one of the best buys. You could rationalize you are buying ConocoPhillips at a slight discount if you buy Burlington Resources, because of the arbitrage discount. ConocoPhillips is my favorite among the megacaps.

What is your favorite part of the energy market?

From a commodity point of view, natural gas has to be a favorite. It has always been my favorite.

But is natural gas too high at $15?

Most people think it is, but I don't. The one-year natural-gas-price for the next 12 months is $12 per million BTU [British thermal unit]. For oil it is $63. The conversion rate of oil to gas is 5 to 1, roughly the price of heating oil. At $15 you are paying a little bit of a wintertime premium. But for the full year, at $12, you are not paying any more for natural gas than for heating oil, and natural gas is a cleaner fuel than heating oil.

What's changing is that in former years, natural gas would compete with heavy fuel oil and the high-polluting fuels. But increasingly, with the new electrical-generation capacity that runs on gas, gas competes with jet fuel or heating oil, which can also run those turbines. So, the competitive interface is heating oil. If natural gas goes to $12, or $13 or $14 or $15, that means all of it is being used as competitively as possible. In the U.K. the gas price has been around $18 per million BTU, which is really quite amazing.

But there are big shortages in the U.K.

It's a classic case. The U.K. converted to natural gas in the last 30 years and it has been wonderful for the country. But they have been relying on the North Sea fields, which are now running down, and the substitutes of LNG [liquefied natural gas] are not coming in fast enough. The LNG market is making a point on natural gas very well, because now we have Spain and the U.K. and the U.S. and Japan all bidding against each other for the incremental LNG supplies. There aren't very many available. A tanker might set out for one of these places and change direction midstream.

The competitive equivalent for LNG, again, is oil, not coal. At $18 a million BTU, natural gas is at a premium, but there are some places where you can't burn oil as a substitute for gas. Eventually, gas will be worth more than oil.

What are you referring to?

California is bringing on new gas power plants as we speak. Some of California's electricity comes from coal-fired plants, and environmentally conscious people are objecting to importing electricity from Wyoming that might be generated by a new coal plant.

Everyone's focus has been on $100 oil. Maybe the focus should be on how high natural gas can go. What's your view?

The one-year futures price, or 12-month strip, which is the quote for the next 12 months averaged, is higher than the six-year futures. The six-year average price for gas in the futures market is $9, not $12. That would indicate most people think the price of gas is going to come down. Maybe it will for a while, but in the end there is no reason why natural gas should be any cheaper than oil, and $9 on gas should move up to $12. That's a big, unexploited inefficiency.

An increase in natural-gas prices would be more of a surprise to investors than an increase in oil prices. ConocoPhillips will say they didn't bet on these high prices, but six-year gas going from $9 to $12 makes the Burlington Resources acquisition look a lot better. Burlington Resources is selling at a full net present value, yet it is only 4.6 times unlevered, based on cash flow. So in only two to three years, Conoco gets half its investment back. It all boils down to where the price of the commodity is going. If the price of the commodity stays anywhere near the same level, it is a wonderful deal. The knock on the deal is that Conoco could have bought its own stock back because it is cheaper than Burlington Resources'. I calculate ConocoPhillips' present value before the deal was $100, and its stock was only around $60 or so. After buying Burlington Resources, I put Conoco's present value at 93. If you give them credit for synergies and cost savings, it might be 95. So there are a few dollars a share of value dilution.

What are some takeover candidates?

Close peers to Burlington are Anadarko Petroleum [APC], Devon Energy [DVN] and EnCana [ECA]. I don't cover Apache [APA] but you could probably include it, though it is a different kind of company. XTO Energy [XTO] is also among the large-cap independents I cover.

What's the most appealing?

I'm recommending all of them, but Anadarko is a more obvious takeover candidate because it is out of favor with investors. It was the favorite for most of the 'Nineties, and then investors became disenchanted and the company went through a management change. In the end they couldn't grow production and have retrenched to an asset play from a growth play. Not long ago they sold off their short-life properties to concentrate on their long-life properties, and that reduced their cash flow. It should have increased their multiples, though they haven't gotten the increase in the stock market yet. They put themselves up for sale a few years ago and nobody was interested.

Who would be a likely buyer?

Any megacap. The most likely is Royal Dutch Shell. They've gone through their own troubles and now they are ready to roll. They've been quiet. They haven't been doing deals. They had a controversial cost overrun at their LNG plant in Russia. It's going to cost $20 billion instead of the estimated $10 billion, which is often what happens when we are in this kind of a trend: Everybody tries to build something and it is always much more expensive to build than people think. That contributes to the rising commodity price.

How are you playing the LNG market?

I am paying very close attention to the linking of the global gas markets through LNG, but in the end you play it through natural-gas producers, and that leads to my ultimate natural-gas stock. My most interesting recommendation now is Gazprom. This month the Russian parliament has approved the lifting of ownership restrictions on Gazprom, and President Vladimir Putin should be signing off on that before the end of the year. Before, only 20% of Gazprom shares could be owned by non-Russians, and the stock could only be traded on certain exchanges. There was a little bit of a premium between the Russian shares and the non-Russian shares. Once the restrictions are lifted there should be so much demand for the stock that that premium will easily be absorbed.

What's your target for the stock?

It's $120 a share, and the stock is trading at $77. What's interesting about the present value is that it is tied to what they get for their gas, and that's only about one-fourth of world levels. The Russians are getting only 2.50 rubles per cubic meter -- coincidentally, rubles per cubic meter is the same as dollars a million BTU, or close enough. That's about $2.50 a million BTU based on $15 on a near-month basis, $12 on the next 12 months and $9 on the next six years. But we think the $9 is low, so there is a four-fold-type potential gain for Gazprom.

What are they doing to get the price to the world level?

It is controversial. Gazprom's pipeline to Europe goes across other countries, including Ukraine, and Ukraine apparently steals gas from the pipeline. They are arguing right now over transit fees. Gazprom wants to get the price up and Ukraine wants to get a big chunk of it. Gazprom is building a pipeline under the Baltic Sea that won't pass through Ukraine and other countries. They also built one under the Black Sea to Turkey and southern Europe. They'll have LNG going across the Arctic, and they will be part of an LNG project in far eastern Russia.

What about Russian price controls?

They are being relaxed gradually. There is no assurance they are going to go away, but I think they will. In Gazprom's case there is one oligarch who might own 10% or so. The Russian government now owns 50% of it, and presumably a million Russians own the stock. Twenty percent is owned outside of Russia by people in the global capital markets. So the interests are aligned, and if Gazprom makes a lot of money, the Russian government gets half of it and Russian citizens make a lot of money. The international guys can help drive up the price, and if Gazprom becomes a trillion-dollar stock eventually, it is a great flagship for the whole country. There is talk about Gazprom being bigger than Exxon some day.

Kurt Wulff's Picks

Company	**Ticker**	**Recent Price**
ConocoPhillips	COP	$59.35
Anadarko Petroleum	APC	96.26
Gazprom ADR	OGZPF	77.60
Penn West Energy Trust ADR	PWTFF	31.94
Cimarex Energy	XEC	41.26

source: Bloomberg

Gazprom does have an ambitious energy strategy. They want to export LNG to the U.S. Russia has more natural gas than Saudi Arabia has oil. Gazprom has 90% of the production in Russia, and it is not hard to make the case they already own or have access to more resources than any other company. They are bent on marketing those resources, so it should follow they get more recognition in the stock market. It has the lowest McDep ratio of all the major companies at 0.64 on a net present value of $120. They generate $23 billion in cash flow a year. Put a multiple of 11 times on the unlevered cash flow, which is a little higher than normal because Gazprom has very, very long-lived reserves, and you get to $120 present value.

How about an income stock?

In the income category, the Canadian Oil Sands Trust is still one of my favorites. They doubled the dividend, but the yield is still 3.1%. If you want a 10% yield or so, my recommended stock is Penn West Energy Trust, another Canadian company. It is a new trust formed this year, the largest in Canada after Canadian Oil Sands. You can't buy it on a U.S. exchange, though they expect to list in the U.S. next year. The yield is 9.82%, but that will probably increase in the next year to more than 10%. The distribution is only 50% of the equity cash flow, so they are still reinvesting 50% of their cash flow, which will help keep that distribution going indefinitely. Reserve life is about eight years.

The McDep ratio on Penn West, at 1.16, is not very low compared with most income stocks, but they have a long-term project I don't count in my McDep ratio yet. They own a major portion of a giant old oil field in Canada. They will be applying tertiary recovery techniques and injecting carbon dioxide to extract the oil in the next two years. That will add a lot of cash flow. It is actually kind of a miraculous project because, as Canada is a signatory to the Kyoto Treaty, there are companies in Canada that have to get rid of their CO_2 emissions. CO_2 is a useful product to help get the last bit of oil out of old fields in a clean way.

What's your pick in the small-cap category?

Among small-cap independents, Cimarex Energy [XEC] is a real laggard. It is the only one of my stocks that hasn't gone up much this year. It is run by a fellow by the name of Mick Merelli, who was an officer at Apache in the late 1980s and who has had a 10-bagger-type experience in a company called Key Production. Cimarex acquired Magnum Hunter this year, and I thought it was a good acquisition that added value. But the stock has gone nowhere.

Some years ago Cimarex made an acquisition and it took a few quarters to absorb the new company. They lost momentum in their business. Investors might be concerned about a replay here. Cimarex has a low McDep ratio, 0.69, and has a shorter reserve life, seven years. It is 71% gas and it is selling at 2.8 times unlevered cash flow. They are drillers. They look for wells that will produce a lot of production initially and then drop off. It is a rate-of-return business, and if they can make a 20%-25% rate of return on it, they do it. They've been successful for a long time doing just that, as opposed to somebody who just sits on assets and watches them grow in value.

Thanks, Kurt.