

Rating: Buy
S&P 500: 1284

Encore Acquisition Company Long Life, Low Stock Price

<i>Symbol</i>	EAC	<i>Ebitda Next Twelve Months ending 12/31/06 (US\$m)</i>	484
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	33
<i>Price (\$/sh)</i>	34.66	<i>Natural Gas and Oil Production/Ebitda (%)</i>	100
<i>Pricing Date</i>	1/27/06	<i>Adjusted Reserves/Production NTM</i>	14.3
<i>Shares (mm)</i>	50	<i>EV/Ebitda</i>	4.9
<i>Market Capitalization (\$mm)</i>	1,720	<i>PV/Ebitda</i>	6.5
<i>Debt (\$mm)</i>	670	<i>Undeveloped Reserves (%)</i>	29
<i>Enterprise Value (EV) (\$mm)</i>	2,390	<i>Natural Gas and Oil Ebitda (\$/boe)</i>	43.20
<i>Present Value (PV) (\$mm)</i>	3,150	<i>Present Value Proven Reserves(\$/boe)</i>	16.80
<i>Net Present Value (\$/share)</i>	50	<i>Present Value Proven Reserves(\$/mcf)</i>	2.80
<i>Debt/Present Value</i>	0.21	<i>Earnings Next Twelve Months (US\$/sh)</i>	3.35
<i>McDep Ratio - EV/PV</i>	0.76	<i>Price/Earnings Next Twelve Months</i>	10
<i>Dividend Yield (%/year)</i>	0.0	<i>Indicated Annual Dividend (US\$/sh)</i>	0.00

Note: Estimated cash flow and earnings tied to one-year futures prices for oil and natural gas.

Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

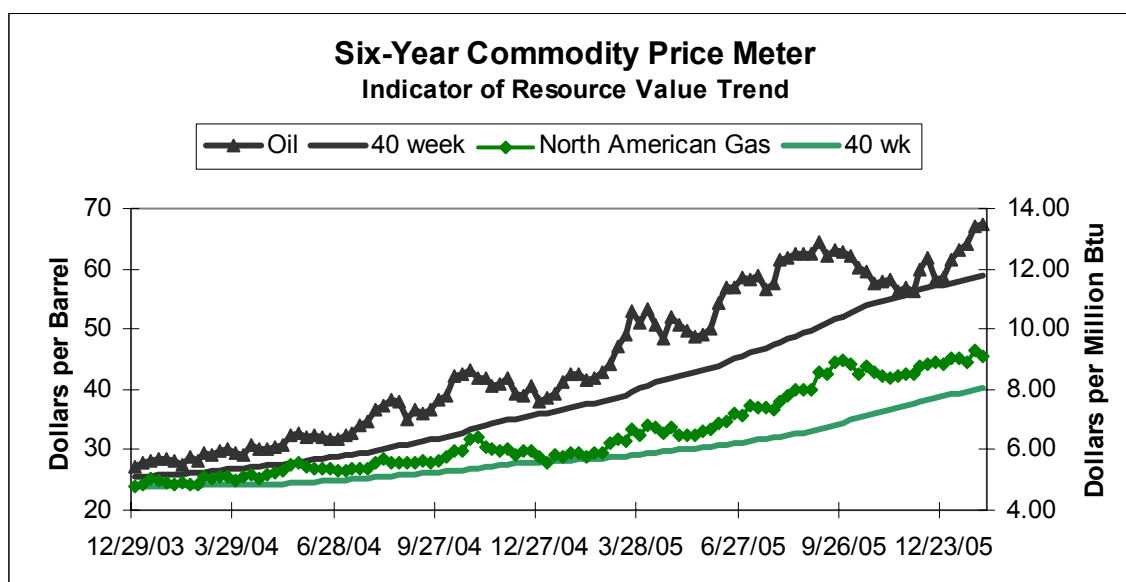
Summary and Recommendation

With a few more weeks before fourth quarter results are reported buy-recommended **Encore Acquisition (EAC)** offers 44% appreciation potential to estimated net present value of \$50 a share that presumes a long-term oil price of \$50 a barrel. Futures investors price Light, Sweet Crude Oil at \$67 a barrel for the next six years. Among independent producer peers, EAC's near lowest McDep Ratio suggests that investors may not be giving the stock as much credit for long life as might be justified. Adjusted reserve life at 14.3 years is the highest in our large cap and small cap independent group. The value of the company is more concentrated on oil, 75%, than on natural gas. Enhanced recovery underway on a large oil field in Montana and North Dakota has the potential to double company reserves. Chairman Jon Brumley is one of investors' favorite long-term money makers in oil and gas.

McDep Ratio Relates Oil Price to Opportunity

A McDep Ratio below 1.0 tells us that EAC's market cap and debt, or enterprise value, is less than the estimated present value of its energy resources. The estimate has been increasing with six-year oil futures. Futures price momentum has been positive for more than three years as the current quote stays above the 40-week average (see chart [Six-Year Commodity Price Meter](#)). Six-year oil has tripled in the four years we have been calculating it on a weekly basis. We do not need further gains in oil price to make money in buy recommendations. Yet our vision of \$150 oil in 2010 implies additional scope to exceed common expectations. Meanwhile the McDep Ratio for EAC appears low among peers (see table [Rank by McDep Ratio](#)).

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Rank by McDep Ratio: Market Cap and Debt to Present Value

	Symbol/ Rating	Price (\$/sh) 27-Jan 2006	Shares (mm)	Market Cap (\$mm)	Net Present Value (\$/sh)	Debt/ Present Value	McDep Ratio
Independent Natural Gas and Oil - Large Cap and Mid Cap							
CNOOC Limited (29%)	CEO B	85.23	119	10,160	84.00	0.00	1.01
XTO Energy Inc.	XTO B	47.99	370	17,760	48.00	0.20	1.00
Encana Corporation	ECA B	47.11	876	41,300	51.00	0.20	0.94
Burlington Resources	BR B	91.63	378	34,700	115.00	-	0.80
Devon Energy Corporation	DVN B	65.46	454	29,700	86.00	0.15	0.80
Anadarko Petroleum Corp.	APC B	107.14	238	25,500	140.00	0.12	0.79
Occidental Petroleum Corp.	OXY B	91.21	432	39,400	120.00	0.12	0.79
<i>Total or Median</i>				<i>199,000</i>		<i>0.12</i>	<i>0.80</i>
Independent Natural Gas and Oil - Small Cap							
Berry Petroleum Company	BRY B	75.24	23	1,690	65.00	0.11	1.14
Energy Partners Ltd.	EPL B	27.61	41	1,130	38.00	0.19	0.78
Encore Acquisition Company	EAC B	34.66	50	1,720	50.00	0.21	0.76
Cimarex Energy Company	XEC B	45.11	85	3,830	64.00	0.11	0.74
<i>Total or Median</i>				<i>8,400</i>		<i>0.15</i>	<i>0.77</i>

Low Cash Flow Multiple

Unlevered cash flow multiples in single digits attest to low valuation (see table [Rank by EV/Ebitda](#)). Cash flow estimated for the next twelve months, Ebitda NTM, reflects latest futures prices. Reserve life is measured as adjusted reserves divided by next twelve months production. EAC's adjusted reserve life index of 14.3 years is the highest of peers. Just as long-life ought to be worth a higher cash flow multiple, EAC's unlevered multiple, EV/Ebitda, is near the highest, but could be higher, we believe.

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Rank by EV/Ebitda: Enterprise Value to Earnings Before Interest, Tax, Deprec.

	Symbol/ Rating		Price (\$/sh) 27-Jan 2006	Adjstd Resrvs/ Prod NTM	PV/ Ebitda NTM	EV/ Ebitda NTM	P/E NTM	Divd or Distrib NTM (%)
Independent Natural Gas and Oil - Large Cap and Mid Cap								
XTO Energy Inc.	XTO	B	47.99	10.8	6.6	6.6	12	0.4
Encana Corporation	ECA	B	47.11	7.1	5.8	5.4	11	0.6
Anadarko Petroleum Corp.	APC	B	107.14	12.5	6.4	5.1	10	0.7
CNOOC Limited (29%)	CEO	B	85.23	9.2	5.0	5.1	9	2.7
Occidental Petroleum Corp.	OXY	B	91.21	11.3	5.7	4.5	8	1.6
Devon Energy Corporation	DVN	B	65.46	7.8	5.0	4.0	7	0.5
Burlington Resources	BR	B	91.63	-	-	-	-	-
		<i>Median</i>		9.2	5.7	5.1	9	0.6
Independent Natural Gas and Oil - Small Cap								
Berry Petroleum Company	BRY	B	75.24	10.1	5.1	5.8	11	0.8
Encore Acquisition Company	EAC	B	34.66	14.3	6.5	4.9	10	-
Cimarex Energy Company	XEC	B	45.11	7.4	4.9	3.6	7	-
Energy Partners Ltd.	EPL	B	27.61	5.7	4.4	3.4	10	-
		<i>Median</i>		8.8	5.0	4.3	10	-

Concentrated on Oil

Each oil and gas stock has its own unique mix of energy resources (see table Business Segments). EAC's concentration on oil is unusual as most independent producers are concentrated on natural gas. Stocks respond to near-term developments differently depending in part on concentration of the underlying businesses. We recommend both oil exposure and natural gas exposure in a portfolio of oil and gas investments.

Home Country and Business Segments

	Symbol/ Rating		Non- U.S. Domicile	North Amer. Gas (%)	Rest of World Gas (%)	Oil Prod'n (%)	Down- stream (%)	Total Present Value (US\$m)
Independent Natural Gas and Oil - Large Cap and Mid Cap								
Occidental Petroleum Corp.	OXY	B		14	1	75	11	59,000
Encana Corporation	ECA	B	Canada	83	-	17	-	55,600
Devon Energy Corporation	DVN	B		64	-	36	-	46,000
Anadarko Petroleum Corp.	APC	B		60	-	40	-	37,700
CNOOC Limited	CEO	B	China	-	12	88	-	34,600
XTO Energy Inc.	XTO	B		83	-	17	-	22,100
Burlington Resources	BR	B						
		<i>Median</i>		62	-	38	-	255,000
Independent Natural Gas and Oil - Small Cap								
Cimarex Energy Company	XEC	B		71	-	29	-	6,080
Encore Acquisition Company	EAC	B		25	-	75	-	3,150
Berry Petroleum Company	BRY	B		15	-	85	-	1,950
Energy Partners Ltd.	EPL	B		54	-	46	-	1,930
		<i>Median</i>		40	-	60	-	13,110

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Correlation Verifies Present Value in Real Time

Our underlying quantitative method for estimating present value projects cash flows years into the future and brings them to the present by applying a real discount rate, currently 7% a year. Around that traditional discounted cash flow analysis (DCF) we deal with uncertainty on a qualitative basis. “Option value” to us, for example, is “upside potential”. After awhile DCF analyses fall into a pattern where differences among companies depend mostly on first year cash flow and reserve life. Meanwhile input information is continually changing as companies make new disclosures, each on a different day or at a different hour and commodity prices fluctuate. We aggregate latest information into a correlation analysis that determines a real-time present value approximation. When that approximation deviates too much from our steady, official estimate of present value and we cannot justify the difference with company-specific explanation, we change the official estimate. Net present value indicated by the current correlation is about \$8 a share higher than our ongoing standard estimate for the company (see table Functional Cash Flow and Present Value).

Encore Acquisition Company					
Functional Cash Flow and Present Value					
	<i>NTM Ebitda</i>	<i>Adjusted</i>	<i>PV/</i>	<i>Present</i>	
	<i>(US\$mm)</i>	<i>R/P</i>	<i>Ebitda</i>	<i>Value</i>	
				<i>(US\$mm)</i>	
North American Natural Gas	161	8.8	5.0	800	25%
Oil	324	17.6	7.3	2,350	75%
	484	14.3	6.5	3,150	100%
Debt (US\$mm)					670
Net Present Value (US\$mm)					2,480
Shares (mm)					50
Net Present Value - Standard Estimate (US\$/sh)					50
Net Present Value - Approximation by Correlation (US\$/sh)					58

Futures Prices and Company Disclosures Propel Estimated Cash Flow by Quarter

Cash flow for the next year is projected from a base through the latest reported quarter (see table Next Twelve Months Operating and Financial Estimates). Company disclosures provide the clues for future volumes and costs as well as geographic and quality differences in price. Futures prices from the New York Mercantile Exchange determine industry benchmarks for the next year in our model.

Kurt H. Wulff, CFA

Encore Acquisition Company
Next Twelve Months Operating and Financial Estimates

	<i>Q4</i>	<i>Q3</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Next Twelve Months</i>
	<i>12/31/04</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>2005E</i>	<i>3/31/06</i>	<i>6/30/06</i>	<i>9/30/06</i>	<i>12/31/06</i>	<i>12/31/06</i>
Volume									
Natural Gas (mmcf)	46.7	59.7	70.0	58.4	70.0	70.0	70.0	70.0	70.0
Oil (mbd)	18.32	18.26	18.6	18.62	19.6	19.6	18.5	18.6	19.07
Total (mbd)	26.1	28.2	30.3	28.4	31.3	31.3	30.2	30.3	30.7
Price									
Henry Hub (\$/mmbtu)	7.10	8.56	13.00	8.65	9.45	8.75	9.02	10.05	9.32
Differential (\$/mmbtu)	0.41	0.09	2.00	0.42	0.66	0.61	0.63	0.70	0.65
EAC (\$/mcf)	6.69	8.47	11.00	8.23	8.80	8.14	8.40	9.35	8.67
WTI Cushing (\$/bbl)	48.31	62.52	60.02	56.31	67.11	68.97	69.80	70.12	69.00
Differential	4.46	4.43	4.25	4.81	4.25	4.89	4.95	4.97	4.90
EAC (\$/bbl)	43.85	58.09	55.76	51.50	62.36	64.09	64.86	65.15	64.10
Total (\$/bbl)	42.74	55.53	59.71	50.77	58.79	58.41	59.26	61.67	59.52
Revenue (\$mm)									
Natural Gas	29	46	71	175	55	52	54	60	222
Oil	74	98	95	350	110	114	110	111	446
Total	103	144	166	525	165	166	164	172	668
Expense									
Lease operating	13	18	22	71	23	23	22	22	90
Production taxes	9	13	15	46	15	15	15	15	60
General and administrative	5	7	8	29	8	9	8	8	34
Total	28	37	46	146	46	46	45	46	184
Ebitda	75	107	121	379	120	120	119	126	484
Exploration	2	5	5	16	5	5	5	5	19
Deprec., Deplet., & Amort.	15	24	28	88	28	28	28	28	112
Hedging and other	11	27	25	77	21	20	21	22	84
Ebit	47	51	68	203	71	71	71	75	288
Interest	7	9	9	32	9	8	8	8	33
Ebt	40	43	59	171	62	63	63	67	256
Income Tax	14	9	21	54	22	22	22	24	89
Net Income (\$mm)	26	33	38	117	40	41	41	44	166
Per Share (\$)	0.53	0.67	0.78	2.37	0.81	0.83	0.82	0.88	3.35
Shares (millions)	49	50	50	50	50	50	50	50	50
Lease operating (\$/bbl)	5.58	6.90	8.00	6.84	8.00	8.00	8.00	8.00	8.00
Production taxes (%rev)	9.0	8.7	9.0	8.8	9.0	9.0	9.0	9.0	9.0
General and admin (\$/bbl)	2.20	2.52	3.00	2.79	3.00	3.00	3.00	3.00	3.00
Deprec., D, & A (\$/bbl)	6.36	9.34	10.00	8.48	10.00	10.00	10.00	10.00	10.00
Ebitda Margin	73%	74%	73%	72%	72%	72%	72%	73%	73%
Tax rate	35%	22%	35%	32%	35%	35%	35%	35%	35%

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