



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

March 19, 2010

Price Pressure for Natural Gas

Summary and Recommendation

Rising stock market trends measured by prices compared to 200-day average are positive for accelerating demand for natural gas and gains for natural gas investments. Declining natural gas price trends by the same measure may have the best chance for reversing in the summer or fall when investors, producers and consumers look to seasonal strength in the winter of 2010-2011. Longer term, a steep, 60% discount for natural gas compared to oil offers the promise of strong appreciation in the commodity and the stocks. Quantitatively speaking, a median McDep Ratio of 0.94 for small cap and income stocks implies a long-term natural gas price of \$7.50 a million btu compared to a futures market price of \$6.05 for the next six years. Natural gas reserves backing stocks will last more than twice as long as the period for futures prices. Median distribution yield of 9% a year for 15 income stocks appears attractive in the context of a negative real rate on near-term treasury securities.

Demand Rising

Industrial and commercial use has been sensitive to a sharp down cycle and should be recovering. Accurate numbers describing the trend are generally late. By the time trustworthy data is available it will have already been reflected in price.

Supply Advancing Rapidly

At the same time, producers have had extraordinary success in developing new supply, especially from shale formations. At EnCana's Analyst Day in New York on March 18, Chief Executive Randy Eresman explains that his company has so much inventory that he believes it should be developed more rapidly to capture optimum value. Aware of the risk that too much new supply may drive down price, Mr. Eresman takes comfort in the belief that Encana will be the low cost producer and still be able to profit.

Seasonal Softness Immediately Ahead

The end of winter may not the best time of year to be bullish on natural gas for a few weeks. Yet, the seasonal trend is too short term to be worth much. At the same time, the market for stocks also looks ahead six months and more. Six months from now demand may remain quiet while sometimes a hurricane has a surprise impact on supply. Eight months from now the next winter heating season begins.

Price Adjusts to Lower Levels

New supply contributed to a reduction in our long-term assumption two years ago to \$8 from \$10. The futures market since then has readjusted to \$6 from \$8. We are staying at \$8



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recognizing that it is higher than futures. In other words we don't see much further downside. Yet, natural gas is still a volatile commodity and prices can surprise in both directions.

EnCana's long-term forecast is \$6-7 as of six months ago when six-year futures were about \$6.50. Offsetting some decline in the industry reference price since then, Encana management expect that regional discounts often 20% in the past have now disappeared.

Mr. Eresman characterizes the \$6-7 range, maybe \$5.50 to \$6.50 now, as the marginal cost of new supply for the industry. He believes Encana can make a moderate return, not counting overhead, at \$4. Bearish investors in the commodity point to those economics as pressure for lower price. Our perspective is that the best supply economics at a low point in the cycle are a misleading indicator of future price. We recall similar expectations for Middle East liquefied natural gas at the beginning of the last decade when bearish forecasters seized on \$2.50 as the long-term supply price. Sparing any discussion of more examples in between, we could go all the way back to a half century ago when Professor Adelman of MIT famously declared that the long-term price of oil was a dollar a barrel.

With the new shale gas we can get quicker adjustment to changing supply and demand because shale supply declines so rapidly. If drilling slows, supply drops fast. The main contradiction now is that shale gas is so new that the players have committed to a lot of drilling in order to secure leases acquired in a land rush. Once shale matures a bit, the response of supply to price should be faster.

Bet on the Surprise

The gap with oil is so wide that natural gas is in a market by itself for now. As a result, the relationship with oil is where we would look for a surprise in the years ahead. The oil trend is up now. We think a target of \$180 a barrel is reasonable for 2016 (see [Trending Up for the Tens, http://www.mcdep.com/rtweek91224.pdf](http://www.mcdep.com/rtweek91224.pdf)). On that basis the heating equivalent of natural gas is \$30 a million btu). Less than \$30 would be a good investment case and favorable case for users compared to any other fuel, renewable, nuclear or fossil.

Kurt H. Wulff, CFA



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Table 1										
McDep Income and Small Cap Energy Portfolio										
Debt, Business Segments and Income Yield										
						Present Value by Segment (%)				
Symbol/Rating	Price (US\$/sh)	EV/ Market	Enterprise Value (\$mm)	NAmer. Natural Gas	Oil Prod'n	Dist. NTM (\$/un)	Dist. Yield (%)	McDep Ratio		
B = Buy CB (see below)	18-Mar 2010	Cap								
Canadian Income Trusts (US\$)										
Penn West Energy Trust	PWE	21.43	1.45	13,100	22	78	1.77	8.3	1.08	
Peyto Energy Trust	PEYUF	13.46	1.26	1,960	71	29	1.42	10.5	1.03	
Pengrowth Energy Trust	PGH	11.25	1.45	4,700	35	65	0.83	7.3	0.96	
Enerplus Resources Fund	ERF	23.38	1.22	5,100	40	60	2.12	9.1	0.81	
Canadian Oil Sands Trust	COSWF	B	28.83	1.10	15,300	100	1.37	4.8	0.78	
<i>Total or Median</i>				40,200					0.96	
Small Cap Independent Producers										
Whiting Petroleum Corporation	WLL	79.07	1.33	6,180	15	85	-	-	1.01	
Cimarex Energy Company	XEC	B	58.96	1.14	5,570	62	38	0.32	0.5	
Berry Petroleum Company	BRY	28.62	1.90	2,450	31	69	0.30	1.0	0.90	
Birchcliff Energy Ltd. (US\$)	BIREF	8.83	1.20	1,420	77	23	-	-	0.83	
<i>Total or Median</i>				15,600					0.91	
Top Line Cash Payers										
Sabine Royalty Trust	SBR	44.83	1.00	650	39	61	3.66	8.2	1.00	
Freehold Royalty Trust (US\$)	FRHLF	16.93	1.16	1,130	27	73	1.65	9.8	1.00	
Permian Basin RT	PBT	17.04	1.00	790	27	73	1.33	7.8	0.95	
Cross Timbers Royalty Trust	CRT	30.33	1.00	180	78	22	2.75	9.1	0.89	
Dorchester Minerals, L.P.	DMLP	B	21.48	1.03	660	67	33	1.99	9.3	
<i>Total or Median</i>				3,400					0.95	
Bottom Line Cash Payers										
Linn Energy, LLC	LINE	27.05	1.48	4,570	44	56	2.52	9.3	1.33	
Encore Energy Partners, L.P. (52%)	ENP	20.00	1.29	600	23	77	2.15	10.8	1.13	
San Juan Basin Royalty Trust	SJT	B	20.97	1.00	980	100	-	1.70	8.1	
Mesa Royalty Trust	MTR	39.46	1.00	74	75	25	3.69	9.3	0.83	
Hugoton Royalty Trust	HGT	B	17.00	1.00	680	90	10	1.46	8.6	
<i>Total or Median</i>				6,900					0.91	
Composite (excl COSWF)										
<i>Enterprise Value Weighting</i>				50,800	38	62			0.99	
<i>Equal Weighting</i>					51	49			0.95	
<i>Equal Weighted Buys</i>					70	30			0.86	

CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.
 McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses.
 Present Value presumes long-term prices of \$75 a barrel for oil and \$8 a million btu for natural gas.
 Dist. = Income distribution. NTM = Next Twelve Months Ended March 31, 2011. Enterprise Value = Market Cap and Debt.



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			<i>Price</i>			<i>Net</i>		
	<i>Symbol/</i>		<i>(\$/sh)</i>	<i>Shares</i>	<i>Market</i>	<i>Present</i>	<i>Debt/</i>	
	<i>Rating</i>	<i>18-Mar</i>		<i>(mm)</i>	<i>Cap</i>	<i>Value</i>	<i>Present</i>	<i>McDep</i>
		<i>2010</i>			<i>(\$mm)</i>	<i>(\$/un)</i>	<i>Value</i>	<i>Ratio</i>
Canadian Income Trusts (US\$)								
Penn West Energy Trust	PWE		21.43	420.7	9,020	19.00	0.34	1.08
Peyto Energy Trust	PEYUF		13.46	114.9	1,550	13.00	0.21	1.03
Pengrowth Energy Trust	PGH		11.25	290.0	3,260	12.00	0.30	0.96
Enerplus Resources Fund	ERF		23.38	177.0	4,140	30.00	0.15	0.81
Canadian Oil Sands Trust	COSWF	B	28.83	484.0	13,960	38.00	0.07	0.78
<i>Total or Median</i>					<i>31,900</i>		<i>0.21</i>	<i>0.96</i>
Small Cap Independent Producers								
Whiting Petroleum Corporation	WLL		79.07	59.0	4,640	78.00	0.25	1.01
Cimarex Energy Company	XEC	B	58.96	82.6	4,870	65.00	0.12	0.92
Berry Petroleum Company	BRY		28.62	45.0	1,290	35.00	0.42	0.90
Birchcliff Energy Ltd. (US\$)	BIREF		8.83	134.0	1,180	11.00	0.14	0.83
<i>Total or Median</i>					<i>11,980</i>		<i>0.20</i>	<i>0.91</i>
Top Line Cash Payers								
Sabine Royalty Trust	SBR		44.83	14.6	650	45.00	-	1.00
Freehold Royalty Trust (US\$)	FRHLF		16.93	57.2	970	17.00	0.14	1.00
Permian Basin RT	PBT		17.04	46.6	790	18.00	-	0.95
Cross Timbers Royalty Trust	CRT		30.33	6.0	180	34.00	-	0.89
Dorchester Minerals, L.P.	DMLP	B	21.48	29.8	640	27.00	0.02	0.80
<i>Total or Median</i>					<i>3,230</i>			<i>0.95</i>
Bottom Line Cash Payers								
Linn Energy, LLC	LINE		27.05	114.0	3,080	17.00	0.43	1.33
Encore Energy Partners, L.P. (52%)	ENP		20.00	23.4	470	17.00	0.26	1.13
San Juan Basin Royalty Trust	SJT	B	20.97	46.6	980	23.00	-	0.91
Mesa Royalty Trust	MTR		39.46	1.9	74	48.00	-	0.83
Hugoton Royalty Trust	HGT	B	17.00	40.0	680	21.00	-	0.81
<i>Total or Median</i>					<i>5,280</i>			<i>0.91</i>
B=Buy; CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.								
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Present Value presumes long-term prices of \$75 a barrel for oil and \$8 a million btu for natural gas.								



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Table 3								
Oil and Gas Income and Small Cap Stocks								
Value Multiples - Rank by EV/Ebitda								
			Price (\$/sh)	Revenue	Dist/ Equity	Adjstd Resrvs/ Prod	PV/ Ebitda	EV/ Ebitda
	Symbol/ Rating		18-Mar 2010	Royalty (%)	Ebitda	NTM	NTM	NTM
Canadian Income Trusts (US\$)								
	PEYUF		13.46		1.39	18.3	12.8	13.2
	COSWF	B	28.83		0.43	21.5	12.0	9.3
	PWE		21.43		0.78	9.7	8.4	9.1
	PGH		11.25		0.57	9.8	8.3	7.9
	ERF		23.38		0.62	9.6	8.7	7.1
	<i>Median</i>					9.8	8.7	9.1
Small Cap Independent Producers								
	BIREF		8.83		-	12.0	15.7	13.0
	BRY		28.62		-	12.9	8.3	7.5
	WLL		79.07		-	10.9	7.0	7.1
	XEC	B	58.96		-	7.0	5.8	5.3
	<i>Median</i>					11.4	7.7	7.3
Top Line Cash Payers								
	SBR		44.83	100	1.00	9.4	12.3	12.3
	PBT		17.04	32	0.90	21.2	12.2	11.6
	CRT		30.33	84	0.96	13.0	11.9	10.6
	DMLP	B	21.48	64	0.97	7.9	13.1	10.5
	FRHLF		16.93	71	1.01	8.9	10.4	10.4
	<i>Median</i>					9.4	12.2	10.6
Bottom Line Cash Payers								
	LINE		27.05		1.76	19.3	11.9	15.9
	SJT	B	20.97		0.81	16.0	11.0	10.0
	MTR		39.46		0.91	-	11.8	9.8
	ENP		20.00		1.09	12.6	8.6	9.8
	HGT	B	17.00		0.77	12.3	11.0	8.9
	<i>Median</i>					12.6	11.0	9.8
B=Buy; CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.								
EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended March 31, 2011; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses								
Top Line Cash Payers defined as those having Revenue Royalty (see fifth column from right).								



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