



# Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

September 17, 2010

## Natural Gas Opportunity for the Tens Decade

### Summary and Recommendation

Out of favor with investors as a result of today's low price, natural gas offers the best energy investment opportunity of the decade on the basis of accelerating demand, environmental advantages and a supply breakthrough that radically changes the outlook for cleaner energy, we believe. While the potential reward is several fold gain, the main risk is timing, in our opinion. The immediate outlook depends on economic activity, political action, and weather, all of which no one can predict with much certainty. Because the current near-month futures price of about \$4 a million btu is down some 75% from the high of the past five years of about \$15, we think the downside risk is low. Strong upside, no cost to wait and minimal downside looks like a money-making combination for patient investors. Five of six buy recommendations are concentrated from 59% to 100% on the growth fuel (see [Tables 1-4](#) on pages 6-9). We like oil, too, as we see the current near-month price of about \$74 a barrel exceeding the \$145 high from the past five years in the next decade.

### Opportunistic Price Outlook

The U.S. Energy Information Administration probably spends more money than any other group to forecast energy price. Yet the product of their effort falls within a wide band of uncertainty. Forecasting a price of \$5.24 for December 2011, the actual price might be as high as \$10.04 or as low as \$2.79 and still be within the confidence interval (see chart [Henry Hub Natural Gas Price](#) on page 2). The oil price forecast for December 2011 is \$84 a barrel within a confidence interval of \$41 to \$164 (see chart [West Texas Intermediate \(WTI\) Crude Oil Price](#) on page 3). Natural gas price is at a low extreme at a third the energy equivalent of oil (see chart [Oil/Natural Gas Futures Ratio](#) on page 4).

### Accelerating Demand

At \$4 a million btu, natural gas is also cheaper than coal taking account of today's permissive environmental standards for coal burning. EIA expects U.S. natural gas consumption to be up 4% in 2010 over 2009. Helped by a hot summer requiring additional power generation for air-conditioning, the growth in natural gas for electric power may be 8 percent in the second half of 2010 compared to the same period in 2009.

Though the pace may subside depending on weather and other factors, the ultimate global demand for natural gas to replace coal in power generation is almost unlimited. Coal for



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power is about a third of global energy supply while all uses of natural gas account for another third. Environmentally it could be desirable to replace all coal burning implying a doubling of natural gas demand. At the same time electric power generation is usually the fastest growing source of energy demand. China, the world's largest energy economy and growing fast, gets 80% of its energy from coal.

## **Fuel of Choice for Power Generation**

New coal plant construction in developed countries is virtually grinding to a halt. Though the U.S. has not passed restrictions on carbon dioxide emissions, it hasn't passed subsidies for "clean coal" either. A costly carbon dioxide control program is probably not justifiable anyway, but increasing restrictions on obvious pollutants like sulfur, mercury, toxic metals and the like are common sense, we think. A prudent utility executive has to consider that restrictions on coal-fired generation will get progressively tighter one way or another. Not knowing for sure that such regulations could render a new coal plant uneconomic, the reasonable course of action is not to take a chance on the long lead time, high capital cost investment. James Rogers, the chief executive of Duke Energy, a major coal and nuclear utility, declared to an audience in Tianjin, China on September 13, "Gas-fired power plants will be built in lieu of coal plants because of uncertainty in the regulation of coal, on sulfur oxides and nitrogen oxides as well as carbon." according to Bloomberg.

## **Clean Fuel Technological Breakthrough**

It is an article of faith among optimistic Americans that technology will provide magical solutions to our problems. On that basis, political leaders and alternate energy promoters champion costly subsidies for uneconomic and impractical projects. To replace gasoline with ethanol, we would practically cover the whole country with corn fields! At least that might look better than wind towers. Would covering the whole country with solar panels be more appealing? In other words, those alternatives don't have scale and costs are prohibitive especially when government debt is exploding. Those who want more government in our economy might applaud the control that government retains with the ability to turn subsidies on or off at will.

The problem with natural gas, to be facetious, is that oil companies produce it. Environmental lobbyists, it seems, see the whole purpose of alternative energy to get rid of evil oil companies. Now in the irony of ironies, the energy cost breakthrough sought in nuclear, solar and wind has arrived in natural gas and has been developed primarily by oil and oil service companies!



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Horizontal multistage fracturing didn't arrive over night, but it has changed the supply equation in a major way since the financial panic of 2008. To the surprise of energy analysts, natural gas production did not decline much when rigs drilling for natural gas were cut by two-thirds in reaction to the financial disruption. The remaining one third were drilling highly productive horizontal wells with an increasing number of fracturing stages with better and better optimization. The technique has opened up hydrocarbon-rich shale formations that were always known, but couldn't be produced economically.

The advantages of natural gas for power generation have become increasingly obvious the past two decades with the combined cycle power plant that combines a jet engine with a conventional boiler to increase conversion efficiency. Since a jet engine can't use coal, the solid fuel became disadvantaged on efficiency in addition to cleanliness. The problem utility executives had with natural gas had been the fear that as soon as they committed to the better fuel its price would go up. That essentially happened to the natural gas merchant power generation pioneers in the past decade. Now with the supply breakthrough, the natural gas producing industry has the capacity to develop much more fuel at an economic price.

## **Income and Growth Stocks**

While the price of gas will likely not rise to make power generation uneconomic, it still has attractive potential to increase. Bloomberg reports that Mr. Rogers, the Duke chief and large future natural gas customer, conditions his conclusion on a price range of \$4 to \$7. Since we are at the bottom of that range now, the trend from here may be up. Next twelve months futures prices are about \$4.50, roughly where they have been for the past year. Futures for the next six years may have stopped declining at \$5.50. Our long-term price expectation is \$8 though we make year-ahead projections at the futures price, currently \$4.50.

Our long-term prospect anticipates that conditions will improve with moderate economic growth. Expectations now are generally low as they usually are after a steep economic downturn. Natural gas price confidence is also at a seasonal low point after peak summer demand and before peak winter demand. Stock market confidence is low before November mid-term elections. Seasonal tax selling may be in swing.

Despite all the economic and political gloom, most income and small cap oil and gas stocks are in an uptrend with current price above the 200-day average. Income stocks look good because distributions have continued to be attractive and our projected yields have remained strong using a \$4.50 one year price for gas. Nor is there much



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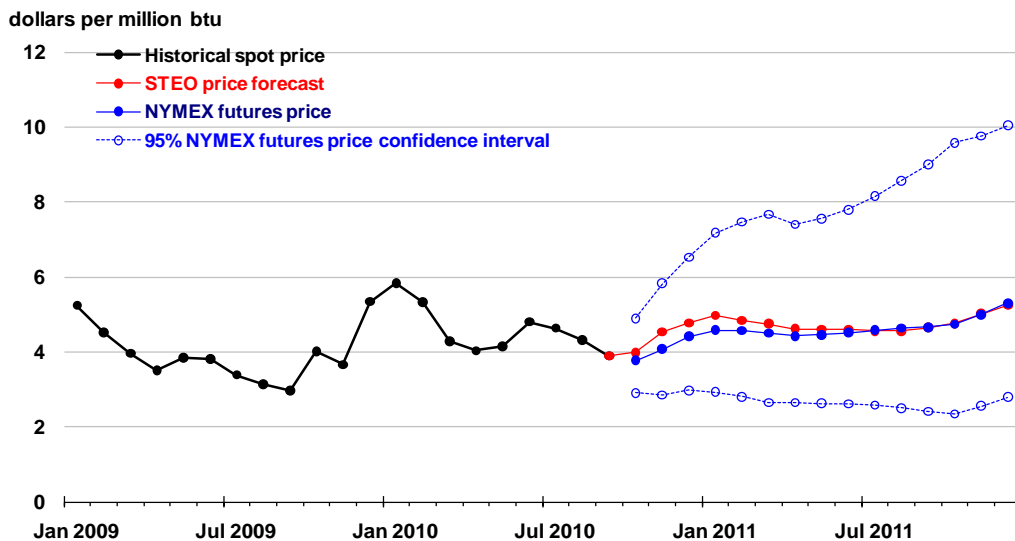
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competition from traditional savings and money market interest. Existing volumes from long-life producers is nearly always the most economic source of energy.

Our growth stock buys look good helped by strong current cash flow from oil. More important, natural gas drilling using latest technology has unlocked large new potential. Yet, because new production declines rapidly, new investment is in continuing demand to grow or maintain supply.

Kurt H. Wulff, CFA

## Henry Hub Natural Gas Price

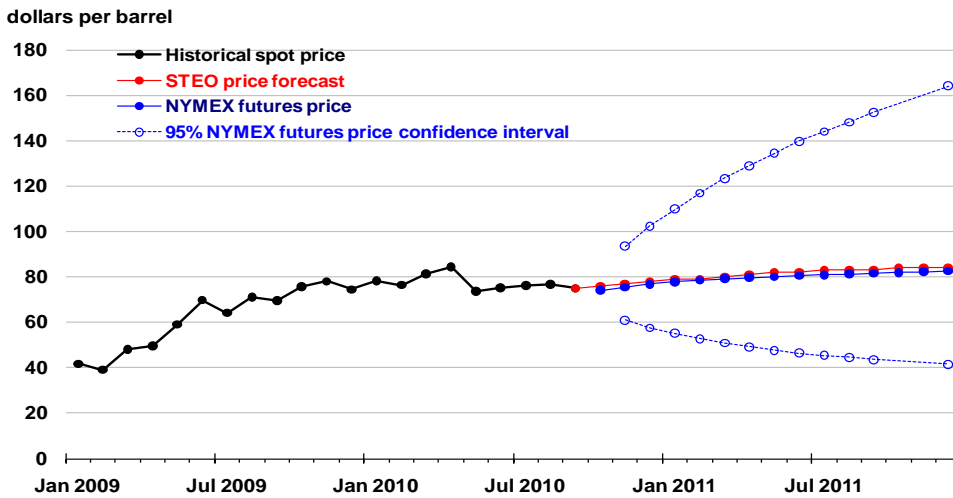


Note: Confidence interval derived from options market information for the 5 trading days ending September 2, 2010  
Intervals not calculated for months with sparse trading in "near-the-money" options contracts



Source: Short-Term Energy Outlook, September 2010; Reuters News Service; and CME Group

## West Texas Intermediate (WTI) Crude Oil Price

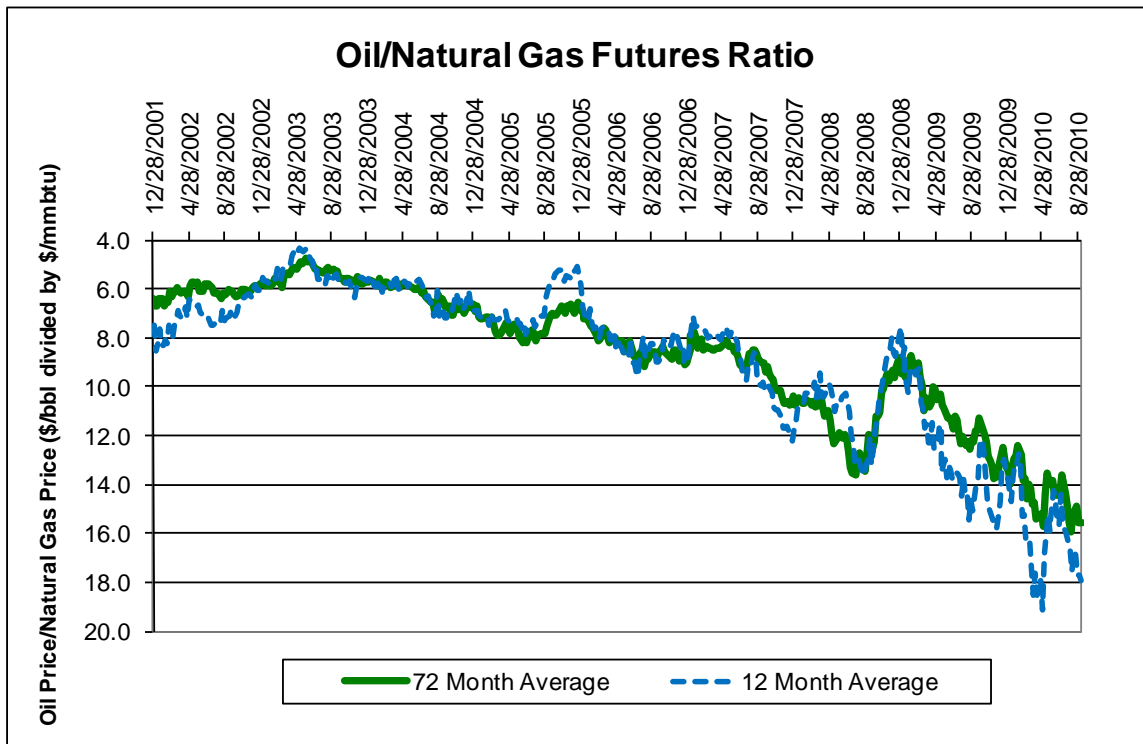


Note: Confidence interval derived from options market information for the 5 trading days ending September 2, 2010  
Intervals not calculated for months with sparse trading in "near-the-money" options contracts



Source: Short-Term Energy Outlook, September 2010; Reuters News Service; and CME Group

## Oil/Natural Gas Futures Ratio





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**Table 1**

## McDep Income and Small Cap Energy Portfolio Debt, Business Segments and Income Yield

Symbol/Rating	Price (US\$/sh)	EV/ Market	Enterprise Value (\$mm)	Present Value by Segment (%)			Dist. NTM (\$/un)	Dist. Yield (%)	McDep Ratio
				N.Amer. Natural Gas	Oil Prod'n				
B = Buy CB (see below)	16-Sep 2010	Cap							
<b>Canadian Income Trusts (US\$)</b>									
Pengrowth Energy Trust	PGH	10.72	1.41	4,400	36	64	0.81	7.6	0.98
Penn West Energy Trust	PWE	18.74	1.39	11,500	22	78	1.04	5.6	0.86
Enerplus Resources Fund	ERF	23.79	1.24	5,200	41	59	2.09	8.8	0.83
Peyto Energy Trust	PEYUF	14.00	1.24	2,070	78	22	1.39	9.9	0.81
Canadian Oil Sands Trust	COSWF CB	25.52	1.11	13,700		100	1.95	7.6	0.69
<i>Total or Median</i>				36,900					0.83
<b>Small Cap Independent Producers</b>									
Denbury Resources Inc.	DNR	15.71	1.54	9,710	16	84	-	-	1.03
Petrohawk Energy Corporation	HK	15.90	1.64	8,060	96	4	-	-	1.01
Whiting Petroleum Corporation	WLL	90.60	1.19	6,440	14	86	-	-	0.97
Range Resources	RRC	35.21	1.34	7,840	82	18	0.04	0.1	0.94
Berry Petroleum Company	BRY	29.82	1.63	2,640	31	69	0.30	1.0	0.90
Cimarex Energy Company	XEC B	69.09	1.10	6,510	59	41	0.32	0.5	0.87
Ultra Petroleum	UPL	39.28	1.22	7,460	94	6	-	-	0.83
Birchcliff Energy Ltd. (US\$)	BIREF CB	8.66	1.24	1,360	68	32	-	-	0.67
<i>Total or Median</i>				50,000					0.92
<b>Top Line Cash Payers</b>									
Sabine Royalty Trust	SBR	51.41	1.00	750	50	50	3.39	6.6	1.14
Cross Timbers Royalty Trust	CRT	36.49	1.00	220	75	25	2.24	6.2	1.07
Permian Basin RT	PBT	19.01	1.00	890	38	62	1.42	7.5	1.06
Freehold Royalty Trust (US\$)	FRHLF	15.91	1.09	1,010	25	75	1.62	10.2	0.94
Dorchester Minerals, L.P.	DMLP B	24.66	1.02	770	66	34	1.72	7.0	0.91
<i>Total or Median</i>				3,600					1.06
<b>Bottom Line Cash Payers</b>									
Linn Energy, LLC	LINE	30.39	1.45	6,460	47	53	2.52	8.3	1.27
Legacy Reserves LP.	LGCY	23.80	1.37	1,310	17	83	2.08	8.7	1.13
Encore Energy Partners, L.P. (52%)	ENP	18.42	1.29	560	25	75	2.00	10.9	1.06
Mesa Royalty Trust	MTR	45.99	1.00	86	75	25	3.60	7.8	0.96
Hugoton Royalty Trust	HGT B	19.19	1.00	770	90	10	1.38	7.2	0.91
San Juan Basin Royalty Trust	SJT B	22.61	1.00	1,050	100	-	1.23	5.4	0.90
<i>Total or Median</i>				10,200					1.01
<b>Composite (excl COSWF)</b>									
<i>Enterprise Value Weighting</i>				87,100	50	50			0.94
<i>Equal Weighting</i>					54	46			0.96
<i>Equal Weighted Buys</i>					67	33			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 September 30, 2011. Enterprise Value = Market Cap and Debt.



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			<i>Price</i>		<i>Market</i>	<i>Net</i>		
			<i>(\$/sh)</i>		<i>Cap</i>	<i>Present</i>	<i>Debt/</i>	
	<i>Symbol/</i>		<i>16-Sep</i>	<i>Shares</i>	<i>Cap</i>	<i>Value</i>	<i>Present</i>	
	<i>Rating</i>		<i>2010</i>	<i>(mm)</i>	<i>(\$mm)</i>	<i>(\$/un)</i>	<i>Value</i>	
							<i>McDep</i>	
							<i>Ratio</i>	
<b>Canadian Income Trusts (US\$)</b>								
Pengrowth Energy Trust	PGH		10.72	290.0	3,110	11.00	0.98	
Penn West Energy Trust	PWE		18.74	439.6	8,240	23.00	0.86	
Enerplus Resources Fund	ERF		23.79	177.5	4,220	30.00	0.83	
Peyto Energy Trust	PEYUF		14.00	119.4	1,670	18.00	0.81	
Canadian Oil Sands Trust	COSWF	CB	25.52	484.0	12,350	38.00	0.69	
<i>Total or Median</i>					29,600		0.16	0.83
<b>Small Cap Independent Producers</b>								
Denbury Resources Inc.	DNR		15.71	401.0	6,300	15.00	1.03	
Petrohawk Energy Corporation	HK		15.90	303.0	4,910	16.00	1.01	
Whiting Petroleum Corporation	WLL		90.60	59.2	5,400	95.00	0.97	
Range Resources	RRC		35.21	158.5	5,870	40.00	0.94	
Berry Petroleum Company	BRY		29.82	54.3	1,620	35.00	0.90	
Cimarex Energy Company	XEC	B	69.09	85.6	5,910	80.00	0.87	
Ultra Petroleum	UPL		39.28	154.0	6,120	50.00	0.83	
Birchcliff Energy Ltd. (US\$)	BIREF	CB	8.66	127.0	1,100	14.00	0.67	
<i>Total or Median</i>					37,230		0.20	0.92
<b>Top Line Cash Payers</b>								
Sabine Royalty Trust	SBR		51.41	14.6	750	45.00	1.14	
Cross Timbers Royalty Trust	CRT		36.49	6.0	220	34.00	1.07	
Permian Basin RT	PBT		19.01	46.6	890	18.00	1.06	
Freehold Royalty Trust (US\$)	FRHLF		15.91	58.3	930	17.00	0.94	
Dorchester Minerals, L.P.	DMLP	B	24.66	30.7	760	27.00	0.91	
<i>Total or Median</i>					3,550		1.06	
<b>Bottom Line Cash Payers</b>								
Linn Energy, LLC	LINE		30.39	146.5	4,450	21.00	1.27	
Legacy Reserves L.P.	LGCY		23.80	40.1	950	20.00	1.13	
Encore Energy Partners, L.P. (52%)	ENP		18.42	23.4	430	17.00	1.06	
Mesa RoyaltyTrust	MTR		45.99	1.9	86	48.00	0.96	
Hugoton RoyaltyTrust	HGT	B	19.19	40.0	770	21.00	0.91	
San Juan Basin Royalty Trust	SJT	B	22.61	46.6	1,050	25.00	0.90	
<i>Total or Median</i>					7,740		1.01	
B=Buy; CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.								
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Table 3								
McDep Income and Small Cap Energy Portfolio								
Value Multiples - Rank by EV/Ebitda								
			Price (\$/sh)	Revenue	Dist/ Equity	Adjstd Resrvs/ Prod	PV/ Ebitda	EV/ Ebitda
	Symbol/ Rating		16-Sep 2010	Royalty (%)	Ebitda	NTM	NTM	NTM
<b>Canadian Income Trusts (US\$)</b>								
	PEYUF		14.00		1.03	21.5	13.3	10.8
	PWE		18.74		0.45	9.9	9.9	8.5
	COSWF	CB	25.52		0.60	26.7	11.7	8.1
	ERF		23.79		0.60	9.7	8.6	7.1
	PGH		10.72		0.52	9.3	7.1	7.0
	<i>Median</i>					9.9	9.9	8.1
<b>Small Cap Independent Producers</b>								
	RRC		35.21		-	12.1	13.6	12.8
	UPL		39.28		-	13.2	12.9	10.6
	BIREF	CB	8.66		-	21.4	14.2	9.5
	HK		15.90		-	7.1	9.4	9.5
	DNR		15.71		-	12.8	8.4	8.6
	BRY		29.82		-	11.9	8.4	7.6
	WLL		90.60		-	9.6	6.7	6.5
	XEC	B	69.09		-	6.3	6.8	6.0
	<i>Median</i>					12.0	8.9	9.1
<b>Top Line Cash Payers</b>								
	CRT		36.49	84	0.96	13.7	14.5	15.6
	SBR		51.41	100	1.00	8.7	13.3	15.2
	DMLP	B	24.66	77	0.89	6.8	13.9	12.7
	PBT		19.01	42	0.95	13.1	12.0	12.7
	FRHLF		15.91	71	0.92	8.2	9.6	9.0
	<i>Median</i>					8.7	13.3	12.7
<b>Bottom Line Cash Payers</b>								
	LINE		30.39		1.64	18.4	13.6	17.3
	SJT	B	22.61		0.76	14.0	15.4	13.9
	HGT	B	19.19		0.88	12.7	13.5	12.3
	MTR		45.99		0.92	9.0	12.3	11.8
	LGCY		23.80		1.01	12.2	9.7	11.0
	ENP		18.42		1.08	13.2	9.2	9.7
	<i>Median</i>					12.9	12.9	12.1

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 September 30, 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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Table 4									
Oil and Gas Income and Small Cap Stocks									
Rank by Enterprise Value to 200 Day Average									
			Price (\$/sh)	Enterprise Value/					
	Symbol/ Rating		16-Sep 2010	52Wk High	52Wk Low	50 Day Avg.	200 Day Avg.	McDep Ratio	
<b>Canadian Income Trusts (US\$)</b>									
	Pengrowth Energy Trust	PGH	10.72	0.92	1.76	1.07	1.04	0.98	
	Enerplus Resources Fund	ERF	23.79	0.97	1.52	1.03	1.03	0.83	
	Peyto Energy Trust	PEYUF	14.00	0.91	1.37	0.98	1.03	0.81	
	Penn West Energy Trust	PWE	18.74	0.88	1.23	0.98	0.98	0.86	
	Canadian Oil Sands Trust	COSWF	CB	25.52	0.77	1.09	0.99	0.94	0.69
	<i>Median</i>			<i>0.91</i>	<i>1.37</i>	<i>0.99</i>	<i>1.03</i>	<i>0.83</i>	
<b>Small Cap Independent Producers</b>									
	Whiting Petroleum Corporation	WLL	90.60	0.98	1.55	1.04	1.12	0.97	
	Cimarex Energy Company	XEC	B	69.09	0.86	1.70	0.98	1.08	0.87
	Berry Petroleum Company	BRY	29.82	0.92	1.13	1.02	1.01	0.90	
	Denbury Resources Inc.	DNR	15.71	0.87	1.15	1.01	1.00	1.03	
	Birchcliff Energy Ltd. (US\$)	BIREF	CB	8.66	0.85	1.24	0.95	0.98	0.67
	Ultra Petroleum	UPL	39.28	0.73	1.06	0.95	0.88	0.83	
	Petrohawk Energy Corporation	HK	15.90	0.68	1.10	1.00	0.86	1.01	
	Range Resources	RRC	35.21	0.68	1.11	0.99	0.85	0.94	
	<i>Median</i>			<i>0.86</i>	<i>1.14</i>	<i>0.99</i>	<i>0.99</i>	<i>0.92</i>	
<b>Top Line Cash Payers</b>									
	Permian Basin RT	PBT	19.01	0.95	1.62	1.01	1.10	1.06	
	Sabine Royalty Trust	SBR	51.41	0.94	1.34	0.99	1.08	1.14	
	Cross Timbers Royalty Trust	CRT	36.49	0.92	1.29	1.04	1.05	1.07	
	Dorchester Minerals, L.P.	DMLP	B	24.66	0.88	1.23	0.97	1.03	0.91
	Freehold Royalty Trust (US\$)	FRHLF	15.91	0.89	1.20	1.00	1.01	0.94	
	<i>Median</i>			<i>0.92</i>	<i>1.29</i>	<i>1.00</i>	<i>1.05</i>	<i>1.06</i>	
<b>Bottom Line Cash Payers</b>									
	Linn Energy, LLC	LINE	30.39	0.97	1.68	1.02	1.08	1.27	
	Mesa RoyaltyTrust	MTR	45.99	0.85	1.56	1.03	1.07	0.96	
	Legacy Reserves L.P.	LGCY	23.80	0.93	1.36	0.99	1.05	1.13	
	Hugoton RoyaltyTrust	HGT	B	19.19	0.87	1.28	0.97	1.04	0.91
	San Juan Basin Royalty Trust	SJT	B	22.61	0.79	1.37	0.93	1.01	0.90
	Encore Energy Partners, L.P. (52%)	ENP	18.42	0.88	1.60	0.98	0.97	1.06	
	<i>Median</i>			<i>0.87</i>	<i>1.47</i>	<i>0.99</i>	<i>1.05</i>	<i>1.01</i>	

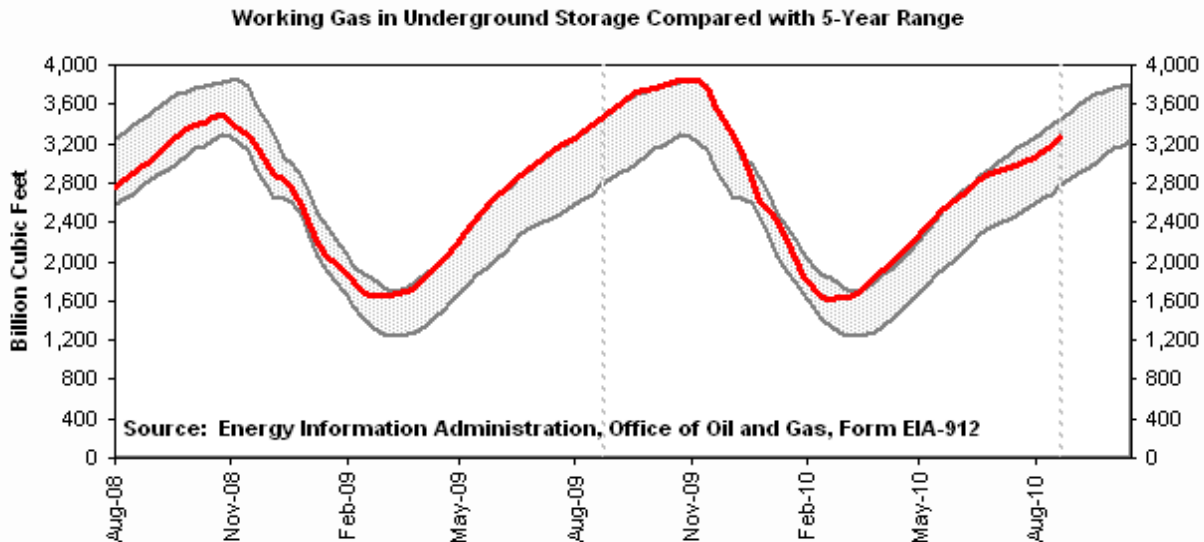
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