



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

September 28, 2012

Birchcliff Energy (BIREF) Strategic Montney Natural Gas

<i>Symbol</i>	BIREF	<i>Ebitda Next Twelve Months ending 9/30/13 (US\$m)</i>	160
<i>Rating</i>	Contrarian Buy	<i>North American Natural Gas/Ebitda (%)</i>	44
<i>Price (US\$/sh)</i>	6.67	<i>Natural Gas and Oil Production/Ebitda (%)</i>	100
<i>Pricing Date</i>	9/27/12	<i>Adjusted Reserves/Production NTM</i>	20.9
<i>Shares (mm)</i>	148	<i>EV/Ebitda</i>	9.4
<i>Market Capitalization (US\$m)</i>	990	<i>PV/Ebitda</i>	14.3
<i>Debt (US\$m)</i>	510	<i>Undeveloped Reserves (%)</i>	73
<i>Enterprise Value (EV) (US\$m)</i>	1,500	<i>Natural Gas and Oil Ebitda (\$/boe)</i>	21.80
<i>Present Value (PV) (US\$m)</i>	2,290	<i>Present Value Proven Reserves(\$/boe)</i>	18.30
<i>Net Present Value (US\$/share)</i>	12	<i>Oil and Gas Ebitda Margin (%)</i>	59
<i>Debt/Present Value</i>	0.22	<i>Earnings Next Twelve Months (US\$/sh)</i>	0.26
<i>McDep Ratio - EV/PV</i>	0.65	<i>Price/Earnings Next Twelve Months</i>	25
<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.			
Estimated present value presumes a long-term price for oil of US\$100 a barrel and natural gas, \$6 a million btu.			
For historical analysis of Birchcliff see www.mcdep.com/5bir.htm			

Summary and Recommendation

Five developing trends reinforce our Contrarian Buy recommendation of Canadian oil and gas producer **Birchcliff Energy (BIREF)** at current stock price of US\$6.70 compared to estimated Net Present Value (NPV) of US\$12 a share where the McDep Ratio would be 1.0. First, leading global players in liquefied natural gas (LNG), with the encouragement of Canadian government officials, are advancing projects that will require dedication of resources controlled by Birchcliff among others. Second, natural gas price is trending up from a decade low last spring. Third, Birchcliff's production is expected to leap to 26 thousand barrels equivalent daily (mbd) at year-end from about 21 mbd estimated for the third quarter. Fourth, Birchcliff's low cost operations are sustaining a high cash margin despite low price. Fifth, the company's financial position is sound. Planned spending next year would be covered by cash flow.

Boom in LNG Export Plans

Three large projects to export LNG from the West Coast of Canada have been announced in recent months to supplement two earlier projects and ahead of a prospective ExxonMobil venture. All the projects together, fully developed, would add up to more than current total natural gas production for all of Canada. The ultimate Asian market is many times the size of the Canadian natural gas industry. Moreover, being geographically closer, Canada would have a transportation advantage to Asia over competitive projects in the Middle East, Australia or the U.S. Gulf and Atlantic Coast. Canadian government officials have been on trade missions to Asia to promote the resource.



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

September 28, 2012

The connection to Birchcliff is that LNG projects need long-term supply to justify the high investment. Producers among the project partners have their own sources, but Asian partners need to line up their commitments. Malaysian Petronas acquired Birchcliff competitor Progress Energy at a 70% stock price premium announced on June 28. Look for a news milestone perhaps in early October that the Canadian government has approved the \$5.5 billion deal. Further confirmation that Canada welcomes Asian investment is the expected approval by mid-October of CNOOC's \$20 billion purchase of oil producer Nexen.

Birchcliff is one of a few pure-play small cap producers that might be acquired to secure supply to feed an export plant. We reprint slides from one of those companies, Advantage, which highlights Montney players and activity. The Montney Basin is the closest resource capable of supplying the projects to be located at Kitimat, Prince Rupert or elsewhere on the coast of British Columbia to liquefy natural gas and export it to Asia (see slide [Natural Gas Trunklines](#) on page 4). Birchcliff is in the heart of Montney active drilling contiguous with Advantage –Glacier, Arc and Encana (see slide [Recent M&A](#) on page 4).

Prospective acquirers already know Birchcliff after visiting the company's data room in a managed sales process late last year. The prospective buyer chosen for final negotiation failed to complete a deal when natural gas price collapsed in mid-January 2012. Now conditions are ripening for renewed action.

Natural Gas Price Uptrend Strengthens

Futures price for natural gas to be delivered over the next six years settling at \$4.34 a million btu are widening their margin above the 40-week average, thereby reinforcing the uptrend building over the past two months (see chart [Six-Year Commodity Price Meter](#) on page 5). The heating value gap with oil price, though narrowing, remains wide with oil at the equivalent of \$15 a million btu. Indeed, that is the approximate price for LNG in Asia. No wonder that Asian buyers would like to lock up some cheap North American natural gas. Whether the consumer or the LNG operator will profit from the spread is a matter of negotiation. Asian buyers have increasingly been participating in the transportation and liquefaction business to share those profits. The ultimate price protection is complete integration where the buyer owns the resource as well. Hence the strong incentive for Asian buyers to acquire Canadian natural gas at the resource level and the surest way to do that is to acquire whole companies.

McDep analysis presumes that investors and corporate buyers look at the same valuation. NPV is an estimate of what an acquirer might pay for a company to get its resources. From an acquisition point of view, Birchcliff has value not fully recognized in our estimated NPV because we limit present value to an arbitrary maximum multiple of cash flow (see table [Functional Cash Flow and Present Value](#) on page 5). Though the timing of an acquisition can't be assured, oil and gas companies tend to get acquired eventually. Nonetheless, putting the acquisition potential aside, an improving natural gas price trend is also a good sign for improving stock price for natural gas producers.



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

September 28, 2012

Birchcliff Production Undergoing a Step Advance Now

Successfully completing the expansion of its Pouce Coupee natural gas processing plant in recent weeks, Birchcliff is completing the wells to boost its production to 26 mbd at year-end, which we take to be the indicated rate for 2013 (see table Next Twelve Months Operating and Financial Estimates on page 6). Second quarter results reported in August set a new volume record. The company is meeting expectations, which lends credibility to its ongoing disclosures and projections.

Low Cost Producer

Despite lower natural gas price in the second quarter, cash flow (Ebitda) margin held at a profitable 58%, up slightly from the first quarter.

Financial Strength and Flexibility

Quick to recognize the implications of natural gas price weakness, Birchcliff strengthened its balance sheet with new equity and renewed its bank credit. As a result, the company was able to finance the completion of the plant expansion and the drilling of wells to produce more natural gas to use the new capacity. At the same time, management was prepared to scale back spending if natural gas price weakened further. Now at current futures prices, Birchcliff would generate enough cash flow to cover the drilling outlays necessary to maintain production at the year-end rate of 26 mbd. Furthermore, the plans will be ready to expand drilling if oil and gas prices rise to expand cash flow.

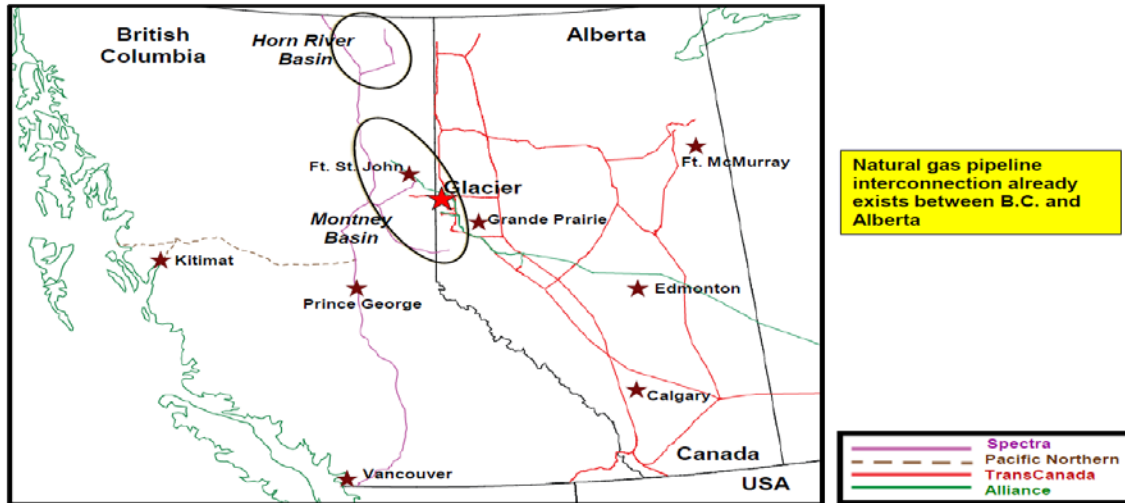
A recent preferred share offering further increases flexibility because it functions as permanent capital, which does not become due for repayment. Any further explanation becomes a bit technical. Meanwhile, with the marketability of the first offering now established, a follow on offering may be made on more favorable terms to Birchcliff. Such a deal could provide the capital to accelerate drilling if desirable.

A Tough Year for Some Small Cap and Income

Year to date 2012 has been a time for the customers of oil and gas producers (the rest of the stock market) to make some money and that is good for the future. The median of our large cap recommendations has appreciated, but three of our small cap buys including Birchcliff are down more than 20%. Overcoming our initial disappointment for those positions, we see “blood in the water” for future profit. The fundamental appeal is still there, we believe, and the selling forces appear mostly temporary. Values abound in our regular weekly tables (see Tables ISC-1 through ISC-4 on pages 7-10).

Kurt H. Wulff, CFA

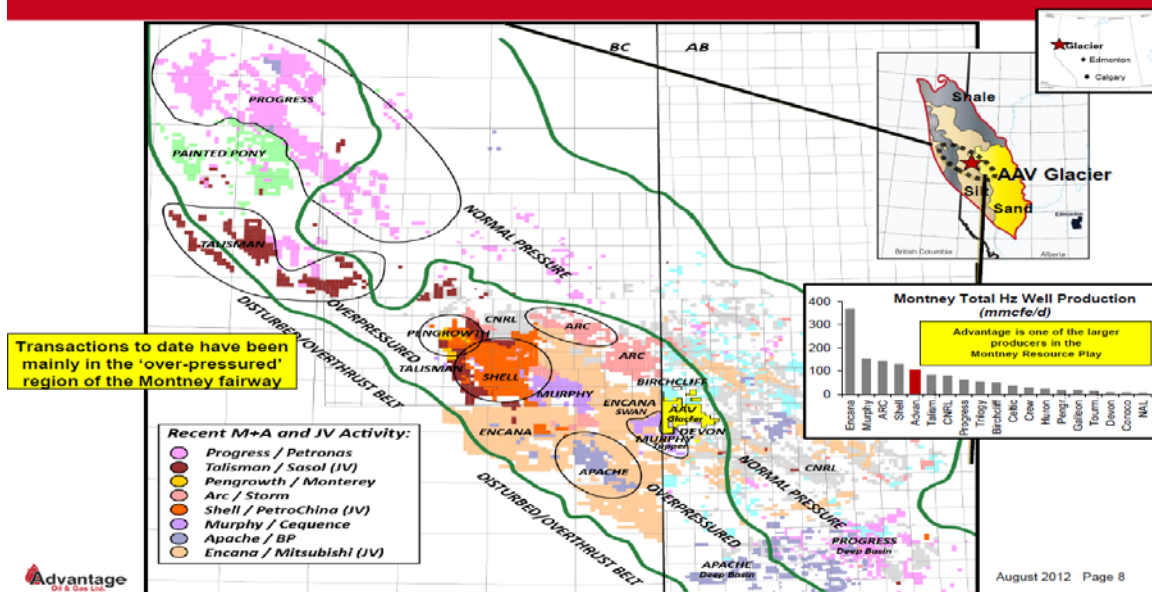
Western Canada Main Natural Gas Trunklines



Advantage Oil & Gas Ltd.

August 2012 Page 24

Recent M&A & JV Activity – Montney Fairway



Advantage Oil & Gas Ltd.

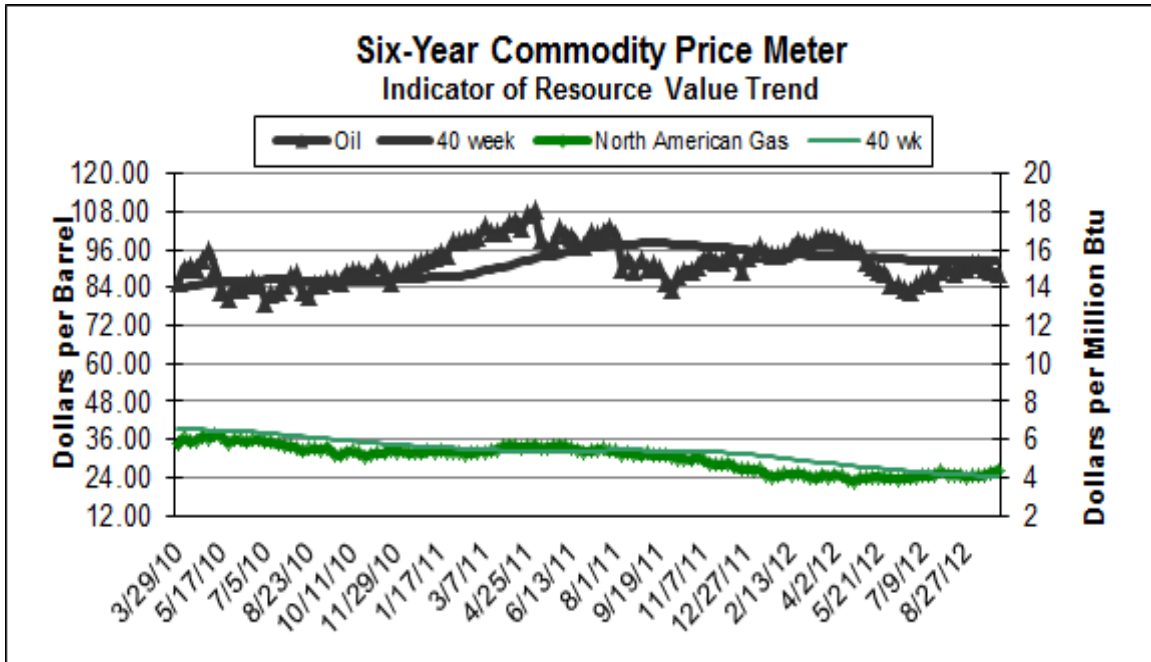
August 2012 Page 8



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

September 28, 2012



Birchcliff Energy Ltd.					
Functional Cash Flow and Present Value					
	<i>NTM</i>	<i>Adjusted</i>	<i>PV/</i>	<i>Present</i>	
	<i>Ebitda</i>	<i>R/P</i>	<i>Ebitda</i>	<i>Value</i>	
North American Natural Gas	70	11.6	20.6	1,440	63%
Oil	90	8.2	9.4	850	37%
	160	10.8	14.3	2,290	100%
Debt					510
Net Present Value (US\$mm)					1,780
Shares					148
Net Present Value - Standard Estimate (US\$/sh)					12
NPV Approximation by Cash Flow Multiple Depending on Reserve Life (US\$/sh)					8



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

September 28, 2012

Birchcliff Energy Ltd.										
Next Twelve Months Operating and Financial Estimates										
(Canadian Dollars)										
	Year	Q1	Q2	Q3E	Q4E	Year	Q1E	Q2E	Q3E	Next Twelve Months
	2011	3/31/12	6/30/12	9/30/12	12/31/12	2012E	3/31/13	6/30/13	9/30/13	9/30/13
Volume (before royalty)										
Natural Gas (mmcf)	82	95	101	95	105	99	120	120	120	116
Days	365	91	91	92	92	366	90	91	92	365
Oil (mmb)	1.62	0.47	0.48	0.47	0.49	1.91	0.54	0.55	0.55	2.13
Oil (mbd)	4.5	5.2	5.2	5.1	5.3	5.2	6.0	6.0	6.0	5.8
Total (mboed)	18.1	21.1	22.0	20.9	22.8	21.7	26.0	26.0	26.0	25.2
Price										
Henry Hub (US\$/mmbtu)	4.04	2.73	2.21	2.80	3.07	2.70	3.50	3.54	3.64	3.44
Currency (US\$/C\$)	1.01	1.00	0.99	1.02	1.02	1.01	1.02	1.02	1.02	1.02
Henry Hub (C\$/mmbtu)	3.99	2.73	2.24	2.74	3.00	2.68	3.42	3.46	3.56	3.36
Differential (C\$/mmbtu)	0.14	0.41	0.19	0.23	0.25	0.26	0.28	0.29	0.30	0.27
Company (C\$/mcf)	3.86	2.32	2.05	2.51	2.75	2.41	3.14	3.17	3.26	3.09
WTI Cushing (US\$/bbl)	95.12	102.93	93.32	92.24	92.04	95.13	92.98	93.55	93.20	92.94
WTI Cushing (C\$/bbl)	93.92	103.04	94.25	90.10	89.90	94.15	90.81	91.38	91.04	90.78
Differential (C\$/bbl)	2.25	12.59	12.49	11.94	11.91	12.09	12.04	12.11	12.06	12.01
Company (C\$/bbl)	91.67	90.45	81.76	78.16	77.98	82.06	78.78	79.27	78.97	78.77
Total (\$/bbl)	39.95	32.78	28.80	30.44	30.78	30.68	32.66	32.93	33.28	32.46
Revenue (\$mm)										
Natural Gas	116	20	19	22	27	87	34	35	36	131
Oil	149	43	39	37	38	156	43	43	44	167
Royalties	(29)	(7)	(6)	(6)	(7)	(26)	(8)	(8)	(9)	(32)
Total	235	56	52	52	58	217	68	69	71	266
Expense										
	87	24	22	22	24	91	28	29	29	110
Ebitda (\$mm)										
	148	31	30	31	34	126	40	41	42	157
Deprec., Deplet., & Amort.	72	22	23	23	23	91	23	19	19	84
Other non-cash	6	(3)	2			(1)	-			-
Interest	20	6	5	5	5	20	5	5	5	18
Ebt										
	50	6	1	3	6	16	12	17	18	54
Income tax	15	2	1	1	2	5	4	5	5	16
Net Income (\$mm)										
	35	4	-	2	4	11	9	12	13	38
Per share (\$)	0.27	0.03	-	0.02	0.03	0.08	0.06	0.08	0.08	0.26
Shares (millions)										
	131	131	139	139	139	136	139	154	154	148
Ebitda margin (after royalty)	63%	56%	58%	59%	59%	58%	59%	59%	59%	59%
Tax rate	30%	33%	100%	30%	30%	34%	30%	30%	30%	30%



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

September 28, 2012

Table ISC-1

McDep Income and Small Cap Energy Portfolio														
Debt, Segments, Cash Flow, Income and McDep Ratio														
	Symbol/Rating	Price (US\$/sh)	EV/ Market	Enterprise Value (\$mm)	PV(%)		EV/ Ebitda	Dist. NTM	Dist. Yield	McDep				
	B = Buy CB (see below)	27-Sep 2012	Cap		Nat Gas	Oil	NTM	(\$/un)	(%)	Ratio				
Small Cap Independent Producers														
PDC Energy	PDCE	31.57	1.72	1,690	54	46	10.2	-	-	1.03				
Peyto Exploration and Developmen	PEYUF	24.80	1.18	4,170	77	23	10.9	0.74	3.0	1.03				
Range Resources	RRC B	70.08	1.28	14,380	74	26	15.7	0.16	0.2	1.00				
Continental Resources (32%)	CLR	75.60	1.20	5,200	25	75	7.7	-	-	0.95				
Halcón Resources	HK	7.28	1.35	2,850	12	88	6.9	-	-	0.78				
Berry Petroleum Company	BRY	40.67	1.73	3,840	13	87	5.4	-	-	0.70				
Denbury Resources Inc.	DNR	16.54	1.48	9,610	6	94	5.9	-	-	0.68				
Birchcliff Energy Ltd.	BIREF CB	6.67	1.52	1,500	63	37	9.4	-	-	0.66				
Whiting Petroleum Corporation	WLL CB	47.08	1.34	7,520	8	92	4.8	-	-	0.61				
Cimarex Energy Company	XEC CB	58.83	1.24	6,320	45	55	5.2	0.48	0.8	0.59				
<i>Total or Median</i>											57,100	7.3	0.74	
Top Line Cash Payers														
Freehold Royalties Ltd.	FRHLF	20.20	1.04	1,360	16	84		1.72	8.5	0.96				
Dorchester Minerals, L.P.	DMLP CB	22.04	1.00	680	57	43		2.03	9.2	0.82				
Sabine Royalty Trust	SBR	51.69	1.00	750	55	45		3.80	7.4	0.80				
Permian Basin RT	PBT	15.19	1.00	710	37	63		1.06	7.0	0.76				
Cross Timbers Royalty Trust	CRT	31.61	1.00	190	70	30		2.55	8.1	0.72				
<i>Total or Median</i>											3,700		8.1	0.80
Bottom Line Cash Payers														
Linn Energy, LLC	LINE	41.19	1.74	14,190	40	60	13.6	2.90	7.0	1.19				
Vanguard Natural Resources, LLC	VNR	28.94	1.68	2,550	23	77	10.7	2.40	8.3	1.09				
Legacy Reserves L.P.	LGCY	29.01	1.31	1,810	24	76	9.1	2.24	7.7	0.97				
Enduro Royalty Trust (40%)	NDRO	18.10	1.00	240	39	61	8.0	1.76	9.7	0.86				
Enerplus Corporation	ERF CB	16.64	1.57	5,100	30	70	6.9	1.11	6.6	0.86				
San Juan Basin Royalty Trust	SJT CB	14.00	1.00	650	100	-	9.7	1.03	7.4	0.67				
Mesa RoyaltyTrust	MTR	24.87	1.00	46	75	25	8.6	2.10	8.5	0.62				
Hugoton RoyaltyTrust	HGT	6.70	1.00	270	88	13	6.3	0.34	5.1	0.48				
<i>Total or Median</i>											24,900	8.9	7.5	0.86
Composite														
<i>Enterprise Value Weighting</i>					85,600	38	62							0.84
<i>Equal Weighting</i>						45	55							0.82
<i>Equal Weighted Buys</i>						49	51							0.74

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 (PV) presumes long-term prices of \$100 a barrel for oil and \$6 a million btu for natural gas.

Dist. = Income distribution. NTM = Next Twelve Months Ended September 30, 2013. Enterprise Value = Market Cap and Debt.



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

September 28, 2012

Table ISC-3

McDep Income and Small Cap Energy Portfolio

Value Multiples - Rank by EV/Ebitda

			<i>Price</i>	<i>Revenue</i>	<i>Dist/</i>	<i>Adjstd</i>	<i>PV/</i>	<i>EV/</i>
	<i>Symbol/</i>		<i>(\$/sh)</i>	<i>Royalty</i>	<i>Equity</i>	<i>Resrvs/</i>	<i>Ebitda</i>	<i>Ebitda</i>
	<i>Rating</i>		<i>27-Sep</i>	<i>(%)</i>	<i>Ebitda</i>	<i>Prod</i>	<i>NTM</i>	<i>NTM</i>
			<i>2012</i>			<i>NTM</i>		
Small Cap Independent Producers								
Range Resources	RRC	B	70.08		-	14.7	15.7	15.7
Peyto Exploration and Development Corp	PEYUF		24.80		0.33	9.1	10.6	10.9
PDC Energy	PDCE		31.57		-	8.6	9.9	10.2
Birchcliff Energy Ltd.	BIREF	CB	6.67		-	20.9	14.3	9.4
Continental Resources (32%)	CLR		75.60		-	10.1	8.1	7.7
Halcón Resources	HK		7.28		-	5.6	8.8	6.9
Denbury Resources Inc.	DNR		16.54		-	13.0	8.6	5.9
Berry Petroleum Company	BRY		40.67		-	11.4	7.6	5.4
Cimarex Energy Company	XEC	CB	58.83		-	7.7	8.9	5.2
Whiting Petroleum Corporation	WLL	CB	47.08		-	9.3	8.0	4.8
	<i>Median</i>					<i>9.7</i>	<i>8.9</i>	<i>7.3</i>
Top Line Cash Payers								
Sabine Royalty Trust	SBR		51.69	100	1.00	7.9	17.1	13.6
Cross Timbers Royalty Trust	CRT		31.61	78	0.96	17.9	16.6	11.9
Freehold Royalties Ltd.	FRHLF		20.20	71	0.99	5.6	12.1	11.7
Dorchester Minerals, L.P.	DMLP	CB	22.04	77	1.00	6.4	13.3	10.9
Permian Basin RT	PBT		15.19	47	0.73	9.4	13.7	10.4
	<i>Median</i>					<i>7.9</i>	<i>13.7</i>	<i>11.7</i>
Bottom Line Cash Payers								
Linn Energy, LLC	LINE		41.19		1.11	15.1	11.5	13.6
Vanguard Natural Resources, LLC	VNR		28.94		0.94	14.0	9.8	10.7
San Juan Basin Royalty Trust	SJT	CB	14.00		0.72	8.6	14.6	9.7
Legacy Reserves L.P.	LGCY		29.01		0.70	11.4	9.4	9.1
Mesa RoyaltyTrust	MTR		24.87		0.74	7.7	14.0	8.6
Enduro Royalty Trust (40%)	NDRO		18.10		0.78	7.2	9.3	8.0
Enerplus Corporation	ERF	CB	16.64		0.42	6.3	8.1	6.9
Hugoton RoyaltyTrust	HGT		6.70		0.32	13.4	13.1	6.3
	<i>Median</i>					<i>10.0</i>	<i>10.7</i>	<i>8.9</i>
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, 2013; 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).								



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

September 28, 2012

Table ISC-4								
Oil and Gas Income and Small Cap Stocks								
Rank by Enterprise Value to 200 Day Average								
			Price (\$/sh)	Enterprise Value/				
	Symbol/ Rating	27-Sep 2012	52Wk High	52Wk Low	50 Day Avg.	200 Day Avg.	McDep Ratio	
Small Cap Independent Producers								
Peyto Exploration and Development C	PEYUF	24.80	0.97	1.54	1.13	1.23	1.03	
Range Resources	RRC B	70.08	0.95	1.25	1.05	1.10	1.00	
PDC Energy	PDCE	31.57	0.86	1.44	1.07	1.02	1.03	
Denbury Resources Inc.	DNR	16.54	0.84	1.35	1.03	0.99	0.68	
Continental Resources (32%)	CLR	75.60	0.81	1.58	1.02	0.99	0.95	
Whiting Petroleum Corporation	WLL CB	47.08	0.79	1.40	1.03	0.98	0.61	
Berry Petroleum Company	BRY	40.67	0.81	1.17	1.03	0.97	0.70	
Cimarex Energy Company	XEC CB	58.83	0.72	1.21	1.00	0.95	0.59	
Birchcliff Energy Ltd.	BIREF CB	6.67	0.53	1.21	0.99	0.84	0.66	
Halcón Resources	HK	7.28	0.62		0.97		0.78	
	<i>Median</i>		<i>0.81</i>	<i>1.35</i>	<i>1.03</i>	<i>0.99</i>	<i>0.74</i>	
Top Line Cash Payers								
Freehold Royalties Ltd.	FRHLF	20.20	0.95	1.45	1.03	1.05	0.96	
Dorchester Minerals, L.P.	DMLP CB	22.04	0.83	1.11	0.99	0.96	0.82	
Sabine Royalty Trust	SBR	51.69	0.77	1.13	0.97	0.91	0.80	
Permian Basin RT	PBT	15.19	0.65	1.05	0.89	0.78	0.76	
Cross Timbers Royalty Trust	CRT	31.61	0.62	1.05	0.87	0.78	0.72	
	<i>Median</i>		<i>0.77</i>	<i>1.11</i>	<i>0.97</i>	<i>0.91</i>	<i>0.80</i>	
Bottom Line Cash Payers								
Linn Energy, LLC	LINE	41.19	0.99	1.17	1.02	1.05	1.19	
Legacy Reserves L.P.	LGCY	29.01	0.95	1.18	1.04	1.04	0.97	
Vanguard Natural Resources, LLC	VNR	28.94	0.98	1.17	1.01	1.03	1.09	
Enerplus Corporation	ERF CB	16.64	0.68	1.25	1.05	0.93	0.86	
San Juan Basin Royalty Trust	SJT CB	14.00	0.56	1.16	0.95	0.81	0.67	
Mesa RoyaltyTrust	MTR	24.87	0.53	1.08	0.91	0.72	0.62	
Hugoton RoyaltyTrust	HGT	6.70	0.30	1.17	0.97	0.58	0.48	
	<i>Median</i>		<i>0.68</i>	<i>1.17</i>	<i>1.01</i>	<i>0.93</i>	<i>0.86</i>	

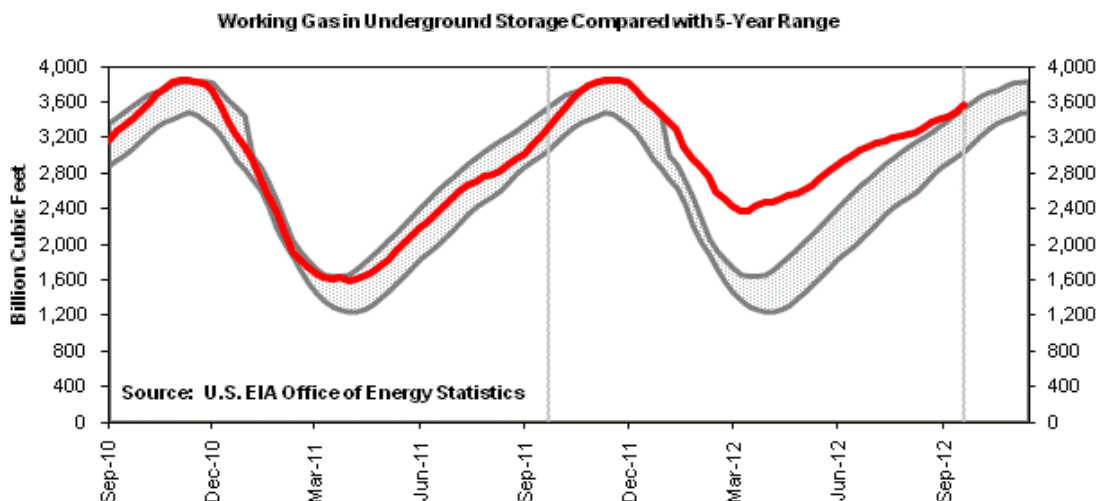
CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

September 28, 2012



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