

Real Value for Patient Investors

Summary and Recommendation

We think oil and gas income stocks have special appeal for investors looking for solid investment return with inflation protection and deflation resistance *and* are priced below their 52-week high. The prospect of solid return is enhanced by a median McDep Ratio of 0.84 for eleven U.S. royalty trusts and Canadian income trusts (see table [Rank by McDep Ratio](#)). Inflation protection stems from pure concentration on real assets of natural gas or oil whose prices are in rising trends ahead of inflation. While rising interest rates threaten deflation of value in financially weak entities, the U.S. royalty trusts have zero debt helping assure their continued income payments. Finally, the median of eleven income stocks is more than 20% below its 52-week high price while the median of 25 operating company stocks in our coverage is less than 5% below its high price for the past year. Investors seeking more oil exposure can readily add it with buy-recommended pure play **Canadian Oil Sands Trust (COSWF)** while investors seeking more natural gas exposure can add it with buy-recommended pure plays **San Juan Basin Royalty Trust (SJT)** and **Hugoton Royalty Trust (HGT)**. We have further comments on income stocks by Mr. Bob Simpson, not only chief executive of buy-recommended **XTO Energy (XTO)**, a top-performing natural gas producer, but also a contributing creator of four of the seven U.S. royalty trusts in our coverage. We end with the suggestion that keen interest by investors in new income stocks parallels 1979-1980 when oil and gas stocks and the stock market appreciated.

XTO Considers MLP

Properties in the Natural Buttes field in Utah, part of XTO's recently announced \$2.5 billion acquisition, may be placed in a new master limited partnership (MLP) according to XTO's Bob Simpson. Natural Buttes fits the chairman's fondness for the San Juan Basin as, "the type of asset you build a company on". Mr. Simpson's formative experience was working for Southland Royalty when it outbid Boone Pickens' company in about 1976 to acquire Aztec Oil and Gas whose sole asset was San Juan Basin natural gas production. Those properties then became the sole asset of SJT distributed to Southland stockholders in November 1980, a year after Mr. Pickens distributed **Mesa Royalty Trust (MTR)** in 1979. On the conference call on June 4 related to XTO's acquisition, Mr. Simpson recalls how SJT was created with "great assets" that have delivered an attractive return ever since. Natural Buttes has the same potential greatness in a less developed state than the San Juan Basin.

Mr. Simpson's experience leading up to the creation of HGT gives him confidence of the timing of the Natural Buttes acquisition. There is currently a steep transportation discount for Rocky Mountain natural gas that makes it less valuable for now. About ten years ago at another time when Rocky Mountain natural gas lacked adequate transportation capacity, XTO acquired the Rockies asset, Fontenelle. The transportation discount was temporary and Fontenelle now looks like "one of the best assets we ever bought". Within a few years after purchase, those properties became part of another new royalty trust, HGT.

Meanwhile the MLP has become more popular, in part because it can acquire additional properties while royalty trusts are limited to the assets placed in it at creation. Whether that is

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truly an advantage as often claimed, depends on implementation, we would add. MLP's can also pay management compensation, sometimes exorbitant and not fully accounted for, we might further warn.

Mr. Simpson sees tax considerations as a constraint on which properties XTO might place in an MLP. Those properties acquired recently at market prices are apparently more suitable for transfer to an MLP, considering taxes, in contrast to older properties at depleted historical cost.

In the end XTO's motivation for forming an MLP is financial. Mr. Simpson's justification for an MLP appears to be that value would be created when a long-life asset in a corporation trading at 5 times cash flow is placed into an income structure trading at 10 times cash flow.

The stocks in our coverage support that idea though perhaps to a lesser extent. The median current unlevered cash flow multiple, EV/Ebitda, is 5.7 for large cap exploration companies in our coverage, the group that includes XTO. Current unlevered cash flow multiple is 8.7 for our U.S. Royalty Trust group that also includes one MLP (see table [Rank by EV/Ebitda](#)).

Income Stock Interest an Omen for Industry Appreciation

We see a parallel in today's rekindling of interest in forming U.S. oil and gas income stocks with early 1979 when Boone Pickens of Mesa rediscovered the royalty trust concept and later that year formed the first in a renewed industry trend. Investors' enthusiastic response coincided with strong markets. From a lull in 1978, oil and gas stocks awakened to great gains in the next two years along with advances in the broader stock market as well. Those gains occurred despite rising interest rates and inflation. Ultimately there was a recession in about 1980-1982 brought about by drastic Federal Reserve action. Interest rates and inflation are at much lower levels in 2007 than in 1979 suggesting less likelihood of a severe move by the monetary authorities.

Kurt H. Wulff. CFA

Natural Gas and Oil Royalty Trusts
Rank by McDep Ratio: Market Cap and Debt to Present Value

	<i>Symbol/ Rating</i>	<i>Price (\$/sh) 7-Jun 2007</i>	<i>Shares (mm)</i>	<i>Market Cap (\$mm)</i>	<i>Net Present Value (\$/un)</i>	<i>Debt/ Present Value</i>	<i>McDep Ratio</i>	
U.S. Royalty Trusts								
Cross Timbers Royalty Trust	CRT	43.15	6.0	260	46.00	-	0.94	
Sabine Royalty Trust	SBR	41.73	14.6	610	45.00	-	0.93	
Dorchester Minerals, L.P.	DMLP	22.62	28.2	640	27.00	-	0.84	
Mesa RoyaltyTrust	MTR	57.00	1.9	110	70.00	-	0.81	
San Juan Basin Royalty Trust	SJT	B	32.21	46.6	1,500	40.00	-	0.81
Permian Basin RT	PBT		13.26	46.6	620	16.50	-	0.80
Hugoton RoyaltyTrust	HGT	B	26.61	40.0	1,060	34.00	-	0.78
	<i>Total or Median</i>			4,800			0.81	
Canadian Income Trusts (US\$)								
Pengrowth Energy Trust	PGH		18.68	244.0	4,560	17.00	0.29	1.07
Penn West Energy Trust	PWE	B	35.21	239.7	8,440	36.00	0.17	0.98
Enerplus Resources Fund	ERF		48.15	123.4	5,940	52.00	0.13	0.94
Canadian Oil Sands Trust	COSWF	B	29.23	479.0	14,000	39.00	0.08	0.77
	<i>Total or Median</i>			32,900		0.15	0.96	

B = Buy

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

Natural Gas and Oil Royalty Trusts
Rank by EV/Ebitda: Enterprise Value to Earnings Before Interest, Tax, Deprec.

	<i>Symbol/ Rating</i>	<i>Price (\$/sh) 7-Jun 2007</i>	<i>Adjstd Resrvs/ Prod NTM</i>	<i>PV/ Ebitda NTM</i>	<i>EV/ Ebitda NTM</i>	<i>P/E NTM</i>	<i>Divd or Distrib NTM (%)</i>	
U.S. Royalty Trusts								
Cross Timbers Royalty Trust	CRT	43.15	12.9	11.3	10.6	10.8	9.3	
Sabine Royalty Trust	SBR	41.73	10.2	11.2	10.4	10.4	9.6	
Dorchester Minerals, L.P.	DMLP	22.62	9.1	10.7	9.0	13.4	11.2	
Mesa RoyaltyTrust	MTR	57.00	23.7	10.6	8.6	9.9	10.1	
San Juan Basin Royalty Trust	SJT	B	32.21	10.2	10.5	8.4	10.3	9.7
Permian Basin RT	PBT		13.26	8.7	9.8	7.8	9.4	10.6
Hugoton RoyaltyTrust	HGT	B	26.61	14.0	9.3	7.3	10.2	9.8
	<i>Median</i>			10.2	10.6	8.6	10.3	9.8
Canadian Income Trusts (US\$)								
Canadian Oil Sands Trust	COSWF	B	29.23	21.1	11.8	9.0	12.1	6.8
Pengrowth Energy Trust	PGH		18.68	7.5	7.2	7.7	24.4	15.2
Penn West Energy Trust	PWE	B	35.21	7.6	7.3	7.1	14.6	10.9
Enerplus Resources Fund	ERF		48.15	9.0	7.5	7.0	12.9	9.9
	<i>Median</i>			8.3	7.4	7.4	13.7	10.4

EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended June 30, 2008; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses

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**Natural Gas and Oil Royalty Trusts
Rank by NTM Distribution Yield**

	<i>Symbol</i>	<i>Revenue Royalty (%)</i>	<i>Natural Gas/ Ebitda (%)</i>	<i>Dist/ Ebitda</i>	<i>Dist/ Equity Ebitda</i>	<i>NTM Distribution</i>		<i>Dist. Yield (%)</i>	
						<i>(\$mm)</i>	<i>(\$/un)</i>		
U.S. Royalty Trusts									
	Cross Timbers Royalty Trust	CRT	84	74	0.98	0.98	24	3.99	9.3
	Sabine Royalty Trust	SBR	100	59	1.00	1.00	59	4.03	9.6
	San Juan Basin Royalty Trust	SJT	-	98	0.82	0.82	145	3.12	9.7
	Hugoton Royalty Trust	HGT	-	92	0.71	0.71	105	2.61	9.8
	Mesa Royalty Trust	MTR	-	76	0.88	0.88	11	5.78	10.1
	Permian Basin RT	PBT	35	42	0.83	0.83	66	1.41	10.6
	Dorchester Minerals, L.P.	DMLP	64	77	1.00	1.00	71	2.52	11.2
	<i>Total or Median</i>			76	0.88	0.88	500		9.8
Canadian Income Trusts (US\$)									
	Canadian Oil Sands Trust	COSWF	-	(11)	0.55	0.60	950	1.98	6.8
	Enerplus Resources Fund	ERF	-	50	0.59	0.69	588	4.76	9.9
	Penn West Energy Trust	PWE	-	43	0.65	0.78	924	3.85	10.9
	Pengrowth Energy Trust	PGH	-	48	0.85	1.20	692	2.83	15.2
	<i>Total or Median</i>			45	0.62	0.73	3,200		10.4
	Kinder Morgan Energy Partners	KMP			0.80	1.75			6.2

NTM = Next Twelve Months Ended June 30, 2008

Ebitda = Earnings before interest, tax, depreciation and amortization

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