

Rating: Buy
S&P 500: 1117

ConocoPhillips Corporation Mega Cap Contender

<i>Symbol</i>	COP	<i>Ebitda Next Twelve Months ending 3/31/05 (US\$mm)</i>	17,600
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	13
<i>Price (US\$/sh)</i>	74.89	<i>Natural Gas and Oil Production/Ebitda (%)</i>	68
<i>Pricing Date</i>	6/3/04	<i>Adjusted Reserves/Production NTM</i>	11.1
<i>Shares (mm)</i>	691	<i>EV/Ebitda</i>	4.5
<i>Market Capitalization (US\$mm)</i>	51,800	<i>PV/Ebitda</i>	5.9
<i>Debt (US\$mm)</i>	28,000	<i>Undeveloped Reserves (%)</i>	33
<i>Enterprise Value (EV) (US\$mm)</i>	79,800	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	20.20
<i>Present Value (PV) (US\$mm)</i>	104,000	<i>Present Value Proven Reserves(US\$/boe)</i>	8.98
<i>Net Present Value (US\$/share)</i>	110	<i>Present Value Proven Reserves(US\$/mcf)</i>	1.50
<i>Debt/Present Value</i>	0.27	<i>Earnings Next Twelve Months (US\$/sh)</i>	11.89
<i>McDep Ratio - EV/PV</i>	0.77	<i>Price/Earnings Next Twelve Months</i>	6
<i>Dividend Yield (%/year)</i>	2.3	<i>Indicated Annual Dividend (US\$/sh)</i>	1.72

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

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

Summary and Recommendation

We continue to recommend current purchase of the common shares of **ConocoPhillips (COP)** for near mega cap size participation in the rising profit opportunities in oil and gas production and refined products. Relative to the median measures of the five mega cap energy stocks, COP has less than half of the market cap and about twice the ratio of debt. Leverage is still moderate and decreasing rapidly. COP has more appreciation potential, but two thirds the dividend yield. Reserve life is longer, but concentration on production is less while concentration on refined products is more. We see about 47% appreciation potential to net present value of US\$110 a share subject to the risk mainly of stock market volatility.

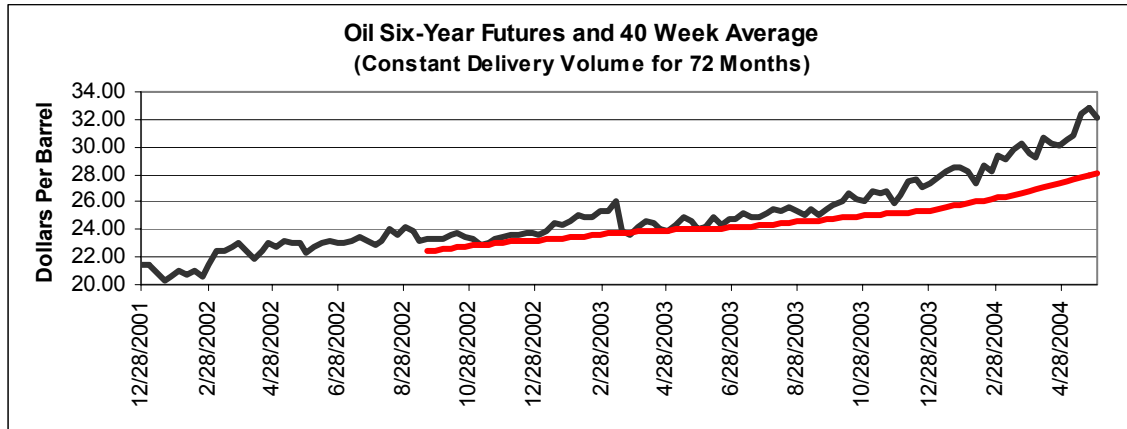
Oil Looks Up by the Charts, Fundamentals, Inflation and Security

Six-year futures describe the commodity price trends most relevant to estimating resource value. The longer time horizon better matches the period during which more of current resources will actually be produced. The longer term measure also smoothes the frantic near-month fluctuations and has the potential to keep climbing even if near-month quotes drop back temporarily.

The plots of weekly results since the beginning of 2002 trace a trend of six-year oil price rising 16% a year (see chart). We measure momentum with the 40-week moving average. The charts look good as long as the current six-year quote remains above the trailing average.

Fundamental factors support the price trends. Oil demand is strong with world economic growth paced by developing countries, especially China. Supply is tight as the Middle East is showing maturity with the workhorse giant fields on the verge of peaking.

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Monetary factors also favor oil investment as interest rates below inflation drive investors to real assets for protection against currency debasement. Compared to Treasury Inflation Protected Securities that we also favor, oil price is likely to rise more than the official government determined inflation measure.

There appears to be little of the cost of maintaining global security reflected in the price of oil. The U.S. military presence in the Middle East may be controversial today. Yet when the U.S. supported government in Iran fell at the end of the 1970s, the world experienced its highest energy prices ever.

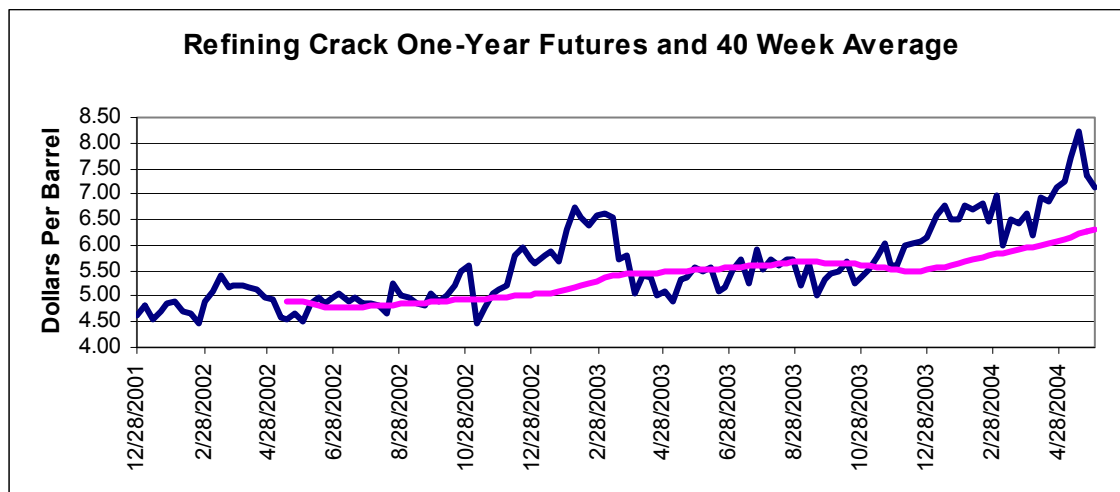
At some point oil price could be too strong and economic activity would be adversely affected. Six times in the past thirty years the annual gain in monthly price exceeded 70% briefly. July futures near \$40 a barrel for Light, Sweet Crude Oil would have to exceed \$52 a barrel to trigger a 70% warning.

Downstream Trends Also Strong

Industry people like to refer to the oil producing business as upstream and the oil refining/marketing business as downstream. Strong upstream business prospects captured in the rising trend of six-year futures are complemented by improving downstream prospects captured in the trend of one-year refining crack futures (see chart).

Compared to the two previous years, there has been no sign yet of a temporary peak in the trend. Perhaps there will be some falloff this year as in the past, but it would occur from a higher level.

The crack spread we measure is the price of two-thirds barrel of gasoline plus one-third barrel of heating oil minus a barrel of crude oil. While there are innumerable varieties of crude oil and products quoted around the world there is only one source of transparent, public quotes of futures prices for the next year, the New York Mercantile Exchange. As a result we use the Nymex quotes as an indicator of future downstream profitability globally, recognizing that markets are linked meaningfully, if not perfectly. Finally, the crack spread should be seasonally neutral because it always includes twelve months.



Volume, Price and Costs Translate to Attractive Cash Flow

Our process of estimating company-specific present value begins with an estimate of next twelve months cash flow. Current projections lead to a healthy level of unlevered cash flow, also known as Ebitda, short for earnings before interest, tax, depreciation and amortization (see table). We choose the next twelve months ending March 31, 2005 as the relevant time period.

For the next twelve months we project natural gas and oil volume near the first quarter 2004 level. That is sufficient for our valuation calculation. Management provides rich detail in conference calls, presentations and copious regulatory disclosures to put more color on a projection of growth for the rest of the decade.

We take the futures market at face value in projecting price for the next twelve months. Henry Hub quotes guide our projection of natural gas revenue. Light Sweet Crude quotes guide our projections of oil revenue. The refinery crack futures guide our projections of downstream cash flow. Because futures are constantly changing, our projection is adjusted accordingly. As a result, the specific amounts we project today may not be the amounts realized when the company next reports.

Assess Present Value Multiple Depending on Reserve Life

The important variables in the valuation of future production are captured in base year cash flow and a multiple of that cash flow that depends on reserve life. Indeed investors do differentiate on that basis as reflected in a high correlation of unlevered cash flow multiple with adjusted reserve life. We convert the market relationship to a formula that produces an anticipatory value with somewhat more sensitivity to reserve life.

The adjusted reserve life index is the sum of developed and half undeveloped reserves divided by next twelve months production. When we last did an industry-wide upward revaluation on March 23, we estimated cash flow multiple equal to 2.5 plus 0.5 times reserve life. That approximates present value assuming constant commodity price near the one-year quotes at that time, about \$35 a barrel for crude oil. Higher commodity prices since then imply higher cash flow and lower multiple.

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ConocoPhillips
Next Twelve Months Operating and Financial Estimates

	<i>Q1</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Next Twelve Months</i>
	<i>3/31/04</i>	<i>6/30/04</i>	<i>9/30/04</i>	<i>12/31/04</i>	<i>2004E</i>	<i>3/31/05</i>	<i>3/31/05</i>
Volume							
Natural Gas (mmcf)							
U.S. (or North America)	1,846	1,846	1,846	1,846	1,846	1,846	1,846
Overseas (or Int'l)	1,578	1,599	1,485	1,693	1,589	1,578	1,589
Total	3,424	3,445	3,331	3,539	3,435	3,424	3,435
Oil (mbd)	1,024	1,024	1,024	1,024	1,041	1,024	1,041
Total gas & oil (bcf)	878	884	877	896	3,535	878	3,535
Price							
Natural gas (\$/mcf)							
Henry Hub (\$/mmbtu)	5.64	6.22	6.78	6.93	6.39	7.11	6.76
U.S. (or North America)	4.79	5.28	5.75	5.89	5.43	6.04	5.74
Overseas (or Int'l)	4.12	4.62	4.82	4.61	4.54	4.40	4.61
Total	4.48	4.97	5.34	5.27	5.02	5.28	5.22
Oil (\$/bbl)							
WTI Cushing	35.23	39.51	41.20	39.42	38.84	37.67	39.45
Worldwide	30.50	34.21	35.67	34.13	33.63	32.62	33.76
Total gas & oil (\$/mcf)	4.87	5.44	5.73	5.54	5.40	5.38	5.52
NY Harbor 3-2-1 (\$/bbl)	6.98	12.29	9.34	5.82	8.61	5.82	8.32
Revenue (\$mm)							
Natural Gas							
U.S. (or North America)	796	887	977	1,000	3,659	1,003	3,867
Overseas (or Int'l)	585	672	658	718	2,632	625	2,673
Total	1,381	1,559	1,635	1,717	6,292	1,629	6,540
Oil	2,898	3,251	3,390	3,244	12,783	3,100	12,984
Other	25,938	25,938	25,938	25,938	103,752	25,938	103,752
Total	30,217	30,748	30,963	30,899	122,827	30,666	123,276
Expense							
Fixed	888	888	888	888	3,551	888	3,551
Variable	888	998	1,042	1,029	3,957	981	4,051
Other	24,738	24,007	24,379	24,848	97,972	24,848	98,082
Ebitda (\$mm)							
Exploration and Production	2,503	2,924	3,094	3,044	11,566	2,859	11,922
Other	1,200	1,931	1,559	1,090	5,780	1,090	5,670
Total Ebitda	3,703	4,855	4,654	4,134	17,346	3,949	17,592
Exploration	143	143	143	143	572	143	572
Deprec., Deplet., & Amort.	918	918	918	918	3,672	918	3,672
Other non cash	31	31	31	31	124	31	124
Ebit	2,611	3,763	3,562	3,042	12,978	2,857	13,224
Interest	145	145	145	145	580	145	580
Ebt	2,466	3,618	3,417	2,897	12,398	2,712	12,644
Income Tax	863	1,266	1,196	1,014	4,339	949	4,425
Net Income (\$mm)							
Exploration and Production	1,257						
Other	536						
Unallocated	(190)						
Total	1,603	2,352	2,221	1,883	8,059	1,763	8,219
Shares (millions)							
Per share (\$)	694	694	694	694	694	680	691
Ebitda Margin (E&P)	2.31	3.39	3.20	2.71	11.61	2.59	11.89
Tax Rate	59%	61%	62%	61%	61%	60%	61%
	35%	35%	35%	35%	35%	35%	35%

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Extra Oil Potential in Alaska and Venezuela

Looking into the makeup of the company's long adjusted reserve life we see oil in Alaska and oil in Venezuela accounting for higher multiples of next twelve months production. Overall Alaskan volume including the Prudhoe Bay and Kuparuk fields appears to be declining less rapidly than average.

In Venezuela, two new heavy oil projects are backed by reserves that last indefinitely. The amount currently booked is about thirty years at last year's rate of production. Expanding production at the Hamaca project would reduce reported life on currently booked reserves and it may justify booking of additional reserves.

Extra Natural Gas Potential in Australia and Indonesia

A firm contract to sell the gas from a Liquefied Natural Gas plant under construction justifies the recent booking of reserves from the Bayu Undan project offshore Australia. That confirms the near-term producing volume growth implied by long life.

Natural gas offshore and onshore Indonesia has been connected to markets and volumes are building there also. Further volumes in Indonesia have been discovered, but not yet booked awaiting project development.

ConocoPhillips the Largest U.S. Oil Refiner

Interacting with members of the Petroleum Analysts of Boston on June 3, Chief Financial Officer John Carrig said that the company's current mix of production and refining felt optimal. Enjoying the exceptional current profitability, Mr. Carrig has no delusions that it is still a cyclical business. The company's leading refining position in the U.S. translates to more sensitivity to global wholesale product margins than the median mega cap peer despite the company's lesser representation in Europe and Asia. Near term reported profits are likely to be quite strong.

As Debt Declines, Stock Repurchase and Higher Dividends More Likely

Since the company has a full suite of long-term projects, there are no plans to boost spending as a result of recent commodity price strength. Mr. Carrig argues that there is little ConocoPhillips can be do in a short time to increase oil and gas supply. Sound projects take years to bring to fruition.

The priority to reduce debt is nearing an end as the company may be down to its target in just a few more months. Then, or sooner, the money is available for stock repurchase and higher dividends.

Kurt H. Wulff, CFA

Research Methodology/Ratings Description: McDep Associates is an independent research originator focused on oil and gas stocks exclusively. The firm applies the thirty years of experience of its analyst to estimate a present value of the oil and gas resources and other businesses of covered companies. That value is compared with a company's stock market capitalization and debt. Stocks with low market cap and debt relative to present value tend to outperform stocks with high market cap and debt relative to present value. Buy recommendations are expected to deliver a total return better than 7% per year above inflation. Hold recommendations assume the attributes of the underlying business are more than fully reflected in the current price of the stock. Sell recommendations are expected to deliver a negative total return less than 7% per year including the effects of inflation.

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