Rating: Buy
S&P 500: 1099

ConocoPhillips
Lukoil Investor?

Symbol	COP	*Ebitda Next Twelve Months ending 6/30/05 (US$mm)*	16,300
Rating	Buy	*North American Natural Gas/Ebitda (%)*	13
Price (US$/sh)	73.18	*Natural Gas and Oil Production/Ebitda (%)*	72
Pricing Date	8/30/04	*Adjusted Reserves/Production NTM*	11.2
Shares (mm)	699	*EV/Ebitda*	4.7
Market Capitalization (US$mm)	51,200	*PV/Ebitda*	6.3
Debt (US$mm)	26,200	*Undeveloped Reserves (%)*	33
Enterprise Value (EV) (US$mm)	77,400	*Natural Gas and Oil Ebitda (US$/boe)*	20.20
Present Value (PV) (US$mm)	103,100	*Present Value Proven Reserves(US$/boe)*	9.50
Net Present Value (US$/share)	110	*Present Value Proven Reserves(US$/mcfe)*	1.58
Debt/Present Value	0.25	*Earnings Next Twelve Months (US$/sh)*	10.53
McDep Ratio - EV/PV	0.75	*Price/Earnings Next Twelve Months*	7
Dividend Yield (%/year)	2.4	*Indicated Annual Dividend (US$/sh)*	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

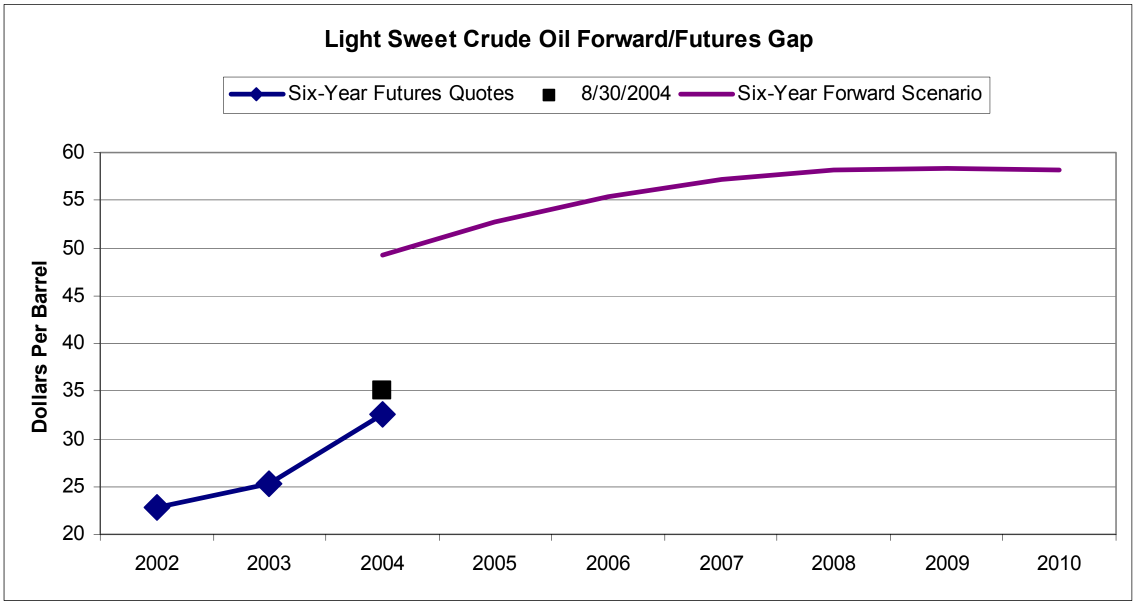
We continue to recommend the common shares of **ConocoPhillips (COP)** for near mega cap size participation in the rising profit opportunities in oil and gas production and refined products. Speculation that COP may invest several billion dollars in Russian oil giant, Lukoil, may cause some investors to fear dilution or political uncertainty. By our valuation such a transaction would be accretive and COP's size mitigates risk. We also illustrate a calculation that the company's current stock price corresponds to a 7% real return on a constant real oil price of just $25 a barrel. In contrast, our present value of equity assumes about $35 constant real and the current spot price for the commodity is about $42. We discuss recent stock price action since earnings were reported and reaffirm our conclusion that investment prospects justify our recommendation.

Moderate Oil Price Scenario

The value of the company depends in large part on the future price of crude oil. Publicly traded in the commodity markets, futures contracts for delivery over the next six years continue in a steep uptrend. Whether the trend will slow for awhile we cannot know. Our scenario is that a move that began in the low $20 and is now in the mid $30 could reach $50 (see chart <u>Light Sweet Crude Oil Forward/Futures Gap</u>).

To construct the scenario we assumed oil would peak in 2010 at $50 in 2003 dollars. That is more moderate than the peak in early 1981 at more than $80 in 2003 dollars. Then we applied 3% per year inflation and calculated six-year averages to build a forward curve.

Economics support the price trends. Oil demand is strong with world economic growth paced by developing countries, especially China. Supply growth is limited as spare capacity has virtually disappeared. The largest producing fields in the Middle East are now mature. It will take time, large amounts of capital and a secure political climate to boost producing rates.



Monetary factors favor oil investment as interest rates below inflation drive investors to real assets for protection against the dollar losing value. If similar past periods are any guide, the authorities may not raise interest rates above inflation for the rest of the decade.

Environmental factors favor higher oil and gas price. Coal is still a quarter of world primary energy supply. Cleaner oil and gas are undervalued as long as we tolerate environmentally disadvantageous coal.

Political factors favor higher oil price in consuming countries and producing countries. Consuming governments often resort to artificial forces to hold down oil price that can appear to work temporarily.

In producing countries we have seen time and again that oil production goes down when international oil companies are not welcome. After Iran, Iraq and Venezuela, now Saudi Arabia appears vulnerable to political change that may bring about production decline.

Too much of a gain in oil price might cause problems of economic adjustment though we think much of the concern expressed is exaggerated. Nonetheless we have a threshold of 60% gain in monthly price compared to a year earlier when we start to become concerned about weak demand for oil. October futures currently near $42 a barrel would have to remain above $52 for the 60% threshold to be breached.

One-Year Futures Point to Higher Cash Flow and Profits

As our next twelve months (NTM) cash flow model moves ahead to the period ending June 30, 2005 expectations also advance mainly because of advancing one-year futures. We relate natural gas and oil price to the quotes for commodities traded on the New York Mercantile Exchange (see table Next Twelve Months Operating and Financial Estimates).

ConocoPhillips
Next Twelve Months Operating and Financial Estimates

	Q1 *3/31/04*	*Q2* *6/30/04*	*Q3E* *9/30/04*	*Q4E* *12/31/04*	***Year*** ***2004E***	*Q1E* *3/31/05*	*Q2E* *6/30/05*	***Next Twelve Months*** ***6/30/05***
Volume								
Natural Gas (mmcfd)								
U.S. (or North America)	1,846	1,810	1,810	1,810	**1,819**	1,810	1,810	**1,810**
Overseas (or Int'l)	1,578	1,493	1,485	1,693	**1,562**	1,578	1,493	**1,562**
Total	3,424	3,303	3,295	3,503	**3,381**	3,388	3,303	**3,372**
Oil (mbd)	1,024	1,012	1,012	1,012	**1,041**	1,012	1,012	**1,041**
Total gas & oil (bcf)	878	871	873	892	**3,515**	875	871	**3,512**
Price								
Natural gas ($/mcf)								
Henry Hub ($/mmbtu)	5.64	6.10	5.52	5.83	**5.77**	6.74	6.01	**6.03**
U.S. (or North America)	4.79	5.22	4.73	4.99	**4.93**	5.77	5.14	**5.15**
Overseas (or Int'l)	4.12	3.47	3.89	3.81	**3.83**	3.72	3.61	**3.76**
Total	4.48	4.43	4.35	4.42	**4.42**	4.81	4.45	**4.51**
Oil ($/bbl)								
WTI Cushing	35.23	38.34	43.00	42.07	**39.66**	41.02	39.90	**41.50**
Worldwide	30.35	34.00	38.13	37.31	**34.95**	36.38	35.39	**37.05**
Total gas & oil ($/mcf)	4.86	5.24	5.66	5.57	**5.33**	5.63	5.40	**5.56**
NY Harbor 3-2-1 ($/bbl)	6.98	11.58	7.40	5.54	**7.87**	6.58	6.57	**6.52**
Revenue ($mm)								
Natural Gas								
U.S. (or North America)	796	860	787	831	**3,274**	940	847	**3,405**
Overseas (or Int'l)	585	472	532	593	**2,182**	528	491	**2,144**
Total	1,381	1,332	1,319	1,425	**5,456**	1,467	1,338	**5,549**
Oil	2,884	3,231	3,624	3,546	**13,285**	3,457	3,363	**13,990**
Other	25,952	27,323	27,323	27,323	**107,922**	27,323	27,323	**109,293**
Total	30,217	31,886	32,266	32,294	**126,663**	32,247	32,025	**128,832**
Expense								
Fixed	881	932	932	932	**3,678**	932	932	**3,730**
Variable	881	932	1,010	1,016	**3,839**	1,006	961	**3,993**
Other	24,752	25,573	26,079	26,328	**102,732**	26,180	26,180	**104,768**
Ebitda ($mm)								
Exploration and Production	2,503	2,698	3,000	3,022	**11,224**	2,986	2,808	**11,816**
Other	1,200	1,750	1,245	995	**5,189**	1,143	1,143	**4,525**
Total Ebitda	3,703	4,448	4,245	4,017	**16,413**	4,129	3,951	**16,342**
Exploration	143	163	163	163	**632**	163	163	**652**
Deprec., Deplet., & Amort.	918	912	912	912	**3,654**	912	912	**3,648**
Other non cash	31	20	20	20	**91**	20	20	**80**
Ebit	2,611	3,353	3,150	2,922	**12,036**	3,034	2,856	**11,962**
Interest	145	159	159	159	**622**	159	159	**636**
Ebt	2,466	3,194	2,991	2,763	**11,414**	2,875	2,697	**11,326**
Income Tax	863	1,118	1,047	967	**3,995**	1,006	944	**3,964**
Net Income ($mm)								
Exploration and Production	1,257	1,354						
Other	536	835						
Unallocated	(190)	(113)						
Total	1,603	2,076	1,944	1,796	**7,419**	1,869	1,753	**7,362**
Shares (millions)	694	699	699	699	**698**	699	699	**699**
Per share ($)	2.31	2.97	2.78	2.57	**10.63**	2.67	2.51	**10.53**
Ebitda Margin (E&P)	59%	59%	61%	61%	**60%**	61%	60%	**60%**
Tax Rate	35%	35%	35%	35%	**35%**	35%	35%	**35%**

Investors who want calendar year estimates can find 2004 in the table. For 2005 we suggest using the next twelve months as a rough estimate. Estimates can change frequently along with oil markets.

Present Value at Real Price and Real Return

NTM estimates determine to a large extent the first year of projected cash flow that we discount to present value (see table Present Value of Oil and Gas Reserves). The calculation is set up on the basis of a barrel of proven reserves, 0.67 developed and 0.33 undeveloped.

ConocoPhillips
Present Value of Oil and Gas Reserves

Volume Decline (%/yr):	10	Nymex Oil Price Post 2005 ($/bbl)	35
Volume Enhancement (%/yr):	8	Price/Nymex Post 2005 (%):	90
Variable Cost (%):	26	Real Discount Rate (%/yr):	7.0
Capex/Cash Flow (%):	20		

Year	Basic (bbl)	Volume Enhanced (bbl)	Total (bbl)	Price ($/bbl)	Revenue ($)	Fixed Cost ($)	Var. Cost ($)	Cash Flow ($)	Cap Ex ($)	Free CF ($)	Disc Factor	Present Value ($)
Total 2005 through 2024; years ending on 6/30												
	0.670	0.331	1.001	31.64	31.66	6.71	8.23	16.71	1.86	14.85	0.64	$\boxed{9.50}$
2005	0.074	0.000	0.074	33.38	2.48	0.34	0.65	1.50	0.30	1.20	0.97	1.16
2006	0.067	0.006	0.073	31.50	2.30	0.34	0.60	1.37	0.27	1.10	0.90	0.99
2007	0.061	0.011	0.072	31.50	2.27	0.34	0.59	1.34	0.27	1.07	0.84	0.91
2008	0.055	0.016	0.071	31.50	2.23	0.34	0.58	1.32	0.26	1.05	0.79	0.83
2009	0.050	0.020	0.070	31.50	2.20	0.34	0.57	1.29	0.26	1.03	0.74	0.76
2010	0.045	0.024	0.069	31.50	2.16	0.34	0.56	1.26	0.25	1.01	0.69	0.70
2011	0.040	0.027	0.067	31.50	2.13	0.34	0.55	1.24	0.25	0.99	0.64	0.64
2012	0.037	0.030	0.066	31.50	2.09	0.34	0.54	1.21	0.00	1.21	0.60	0.73
2013	0.033	0.027	0.060	31.50	1.89	0.34	0.49	1.06	0.00	1.06	0.56	0.60
2014	0.030	0.024	0.054	31.50	1.71	0.34	0.44	0.93	0.00	0.93	0.53	0.49
2015	0.027	0.022	0.049	31.50	1.54	0.34	0.40	0.81	0.00	0.81	0.49	0.40
2016	0.024	0.020	0.044	31.50	1.39	0.34	0.36	0.70	0.00	0.70	0.46	0.32
2017	0.022	0.018	0.040	31.50	1.26	0.34	0.33	0.60	0.00	0.60	0.43	0.26
2018	0.020	0.016	0.036	31.50	1.14	0.34	0.30	0.51	0.00	0.51	0.40	0.20
2019	0.018	0.015	0.033	31.50	1.03	0.34	0.27	0.43	0.00	0.43	0.37	0.16
2020	0.016	0.013	0.030	31.50	0.93	0.34	0.24	0.35	0.00	0.35	0.35	0.12
2021	0.015	0.012	0.027	31.50	0.84	0.34	0.22	0.29	0.00	0.29	0.33	0.09
2022	0.013	0.011	0.024	31.50	0.76	0.34	0.20	0.23	0.00	0.23	0.31	0.07
2023	0.012	0.010	0.022	31.50	0.69	0.34	0.18	0.17	0.00	0.17	0.29	0.05
2024	0.011	0.009	0.020	31.50	0.62	0.34	0.16	0.12	0.00	0.12	0.27	0.03

While there are many assumptions that could be discussed, discount rate and oil price are especially important. Price escalation and discount rate interact. In this case we make the simplification of dealing in constant dollars. That assumes price escalation, cost escalation and discount rate are all net of inflation.

For discount rate we use a 7% real return per year on an unlevered basis. That means a buyer who pays present value would earn 7% per year above inflation if all the projections were to materialize as stated.

First year oil price is from the futures market. We hold it constant at an arbitrary level thereafter. The assumed price listed in the upper right hand corner is the commonly quoted benchmark Light, Sweet Crude. A price of $35 a barrel leads to present value of future cash flow from a barrel of reserves equal to $9.50 (see box in right hand column).

Present Value per Barrel Leads to Present Value per Share

We illustrate the calculation of Net Present Value (NPV) in a sensitivity table where each column is headed by a different oil price (see table Net Present Value Calculation). Oil price corresponds to present value per barrel which then leads step by step to the final result. The price of $35 a barrel corresponds to our standardized present value of $110 a share. In reverse fashion, for a present value of $73, near the current stock price, the corresponding constant real oil price would be $25.

ConocoPhillips
Net Present Value Calculation

Constant Oil Price ($/bbl):	25	35	40	50
Present Value per Barrel ($):	6.20	9.50	11.10	14.40
Oil and Gas Reserves (million barrels equivalent):	7,848	7,848	7,848	7,848
Present Value of Oil and Gas Reserves ($mm):	48,700	74,600	87,100	113,000
Present Value of Other Businesses ($mm):	28,600	28,600	28,600	28,600
Total Present Value ($mm):	77,300	103,200	115,700	141,600
Debt ($mm):	26,200	26,200	26,200	26,200
Present Value of Equity ($mm):	51,100	77,000	89,500	115,400
Shares (mm):	699	699	699	699
Net Present Value ($/sh):	73	110	128	165

Buy Russian Oil in the Stock Market

ConocoPhillips and other international companies have been seeking for years the appropriate opportunity to invest in the future oil potential of Russia. Progress has been slow though important direct investments are being made. Meanwhile, Russian companies have partially matured to become actively traded in the world stock markets. **BP** has taken a 50% equity stake in a top Russian producer that accounts for more than 20% of BP's production.

Believing in the appeal of buying oil in the stock market separately we recommend that investors buy the shares of **Lukoil (LUKOY)** while limiting the size of holding to control political risk. ConocoPhillips might derive the same economic benefits from owning Lukoil stock and may be able to leverage the relationship further. At the same time, we would hope that a large international company like COP has sufficient standing that would better assure that it is treated fairly in future economic and political relationships.

As an indicator of the appeal of Russian oil we can compare the Enterprise Value (stock market cap and debt) of a barrel of reserves. In each case we exclude a portion of Enterprise Value that we attribute to downstream operations. On that basis, Lukoil is priced at less than $0.50 per barrel compared to COP at $2.70.

Two important events have given public identity to a possible future transaction. Mr. Jim Mulva, chairman of ConocoPhillips apparently has met with Mr. Putin, the Russian leader, to discuss relevant matters as reported in the press. Recently the Russian government has apparently set an auction date of September 29 to sell the remaining 7.6% of Lukoil stock owned by the government. The value of the stake is about $2 billion at current market. COP presumably has an appetite for an ultimate larger transaction that could involve joint investment or purchase of some of the third or so of stock held by management of Lukoil.

Stock Price Deviation an Opportunity

COP stock continues to trade near $74 the price to which it fell in three days from a temporary high of almost $80 on August 3. While oil price was volatile there was not a similar pattern in the commodity. We note that larger peers **ChevronTexaco (CVX)** and **ExxonMobil (XOM)** dropped at the same time.

Was it because of earnings? If so, the stock market reaction was delayed. The three companies reported the previous week beginning with COP on July 28. COP reported second quarter results of $2.97 compared to the estimate of $3.39 in our analysis published on June 4. Our estimates fluctuate continuously with commodity futures and there was some decline in the month of June that would account for some of the difference. Nonetheless we have allowed for somewhat higher expenses in our Next Twelve Months projection.

The decline in stock price was greater for COP than for CVX which was greater than for XOM. That volatility is partly explained by a ratio of debt for COP that is twice that for CVX that in turn is almost twice that for XOM.

While it may be uncomfortable for the investor who bought COP at $79 on August 3, we see no cause for undue concern over current operations though there are always ongoing positive surprises and disappointments. The potential Lukoil transaction could be an important different fundamental step. Meanwhile the transaction may or may not take place. In either event we like ConocoPhillips stock as a long-term commitment to what we believe will be a profitable environment for oil and gas companies.

Kurt H. Wulff, CFA

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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 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.