

Rating: Buy
S&P 500: 1190

ConocoPhillips Connecting with Lukoil

<i>Symbol</i>	COP	<i>Ebitda Next Twelve Months ending 12/31/05 (US\$mm)</i>	17,100
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	12
<i>Price (US\$/sh)</i>	85.95	<i>Natural Gas and Oil Production/Ebitda (%)</i>	62
<i>Pricing Date</i>	12/2/04	<i>Adjusted Reserves/Production NTM</i>	11.9
<i>Shares (mm)</i>	702	<i>EV/Ebitda</i>	5.0
<i>Market Capitalization (US\$mm)</i>	60,300	<i>PV/Ebitda</i>	6.0
<i>Debt (US\$mm)</i>	25,300	<i>Undeveloped Reserves (%)</i>	33
<i>Enterprise Value (EV) (US\$mm)</i>	85,600	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	19.20
<i>Present Value (PV) (US\$mm)</i>	102,500	<i>Present Value Proven Reserves(US\$/boe)</i>	8.08
<i>Net Present Value (US\$/share)</i>	110	<i>Present Value Proven Reserves(US\$/mcf)</i>	1.35
<i>Debt/Present Value</i>	0.25	<i>Earnings Next Twelve Months (US\$/sh)</i>	11.16
<i>McDep Ratio - EV/PV</i>	0.84	<i>Price/Earnings Next Twelve Months</i>	8
<i>Dividend Yield (%/year)</i>	2.0	<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 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 enhanced by an expected 10% stake in Russian producer Lukoil. On the basis of estimates for Lukoil we have carried since March 2004, COP enhances its net present value by more than \$2 a share. We have not made that adjustment yet nor does the amount reflect any benefits to be achieved from the two companies working together to pursue new opportunities. We see potential appreciation in COP stock to our pre-Lukoil estimate of present value of \$110 a share that relates to a constant real oil price of \$35 a barrel. The average futures price for continuous delivery over the next six years is about \$39 a barrel.

Lukoil Deal Adds Value

At the end of September, COP paid \$2 billion to the Russian government for a 7.6% stake in Lukoil. COP apparently is buying additional Lukoil stock in the open market as it targets 10% ownership by year end. It looks like the recent oil stock pullback enables COP to get Lukoil stock at a better price than might otherwise be the case. COP intends to buy another 10% over the next few years.

The possibility of the deal was widely discussed and we commented favorably on it. COP held a meeting for analysts at the time of the deal. COP had a special meeting for analysts last month to discuss the outlook for all of its operations.

We continue to recommend Lukoil stock for appreciation potential to net present value of \$208 a share (see table [Lukoil Statistical Summary](#)). COP paid \$123 for a stock that trades near that price and is worth more by our estimate.

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Lukoil Statistical Summary

<i>Symbol</i>	(LKOH) LUKOY	<i>Ebitda Next Twelve Months ending 12/31/05 (US\$m)</i>	7,200
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	0
<i>Price (US\$/sh)</i>	121.50	<i>Natural Gas and Oil Production/Ebitda (%)</i>	51
<i>Pricing Date</i>	12/2/04	<i>Adjusted Reserves/Production NTM</i>	12.2
<i>Shares (mm)</i>	209	<i>EV/Ebitda</i>	3.9
<i>Market Capitalization (US\$m)</i>	25,300	<i>PV/Ebitda</i>	6.5
<i>Debt (US\$m)</i>	2,900	<i>Undeveloped Reserves (%)</i>	40
<i>Enterprise Value (EV) (US\$m)</i>	28,300	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	5.81
<i>Present Value (PV) (US\$m)</i>	46,300	<i>Present Value Proven Reserves(US\$/boe)</i>	2.38
<i>Net Present Value (US\$/share)</i>	208	<i>Present Value Proven Reserves(US\$/mcf)</i>	0.40
<i>Debt/Present Value</i>	0.06	<i>Earnings Next Twelve Months (US\$/sh)</i>	17.42
<i>McDep Ratio - EV/PV</i>	0.61	<i>Price/Earnings Next Twelve Months</i>	7
<i>Dividend Yield (%/year)</i>	2.8	<i>Indicated Annual Dividend (US\$/sh)</i>	3.41

Note: Estimated cash flow and earnings tied to one-year futures prices for oil and refined products.

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Expect Volume Growth in Global Oil and LNG

While the Lukoil transaction enhances the attractiveness of COP on a statistical basis and perhaps more qualitatively, the main appeal in the stock rests on the prospects for the existing basic businesses. To no surprise for a near mega cap energy company, COP's oil resources account for the dominant portion of its value (see table Functional Cash Flow and Present Value). The company expects to maintain production in traditional areas and to add growing volumes from the Arctic region of North America and Russia as well as from oil sands in Canada and Venezuela.

Though overseas natural gas is the smallest of the four functional areas there is favorable growth potential in liquefied natural gas (LNG). A project in Australia is included in reserves and a project in the Middle East is likely.

COP has Arctic natural gas resources that probably exceed currently proven North American natural gas reserves. Political negotiations for the terms of a natural gas pipeline from Alaska to the lower 48 states continue and are always part of a complete discussion of national energy policy. Though it appears important, the pipeline is unlikely to be in service before 2014.

ConocoPhillips
Functional Cash Flow and Present Value

	<i>NTM Ebitda</i>	<i>Adjusted</i>	<i>PV/</i>	<i>Present</i>	
	<i>(US\$m)</i>	<i>R/P</i>	<i>Ebitda</i>	<i>Value</i>	
				<i>(US\$m)</i>	
North American Natural Gas	2,101	12.1	6.1	12,800	12%
Overseas Natural Gas	1,127	11.3	5.8	6,500	6%
Oil	7,329	12.0	6.0	44,100	43%
Downstream	6,513		6.0	39,100	38%
	17,070	11.9	6.0	102,500	100%
Debt (US\$m)				25,300	
Net Present Value (US\$m)				77,200	
Shares (mm)				702	
Net Present Value (US\$/sh)				110	

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Adjusted reserve life of 11.9 years for oil and natural gas is longer than for peer companies. Comparing present value against the latest NTM cash flow projection results in a multiple, PV/Ebitda, of 6.0 times. In the current correlation of present value with reserve life for 28 stocks, the company's multiple could be considered low by 0.9 times below the level implied by the correlation. Should that difference persist in our continuous analysis there could be a case for an upward revision for present value compared to peer companies

Largest U.S. Refiner Well-Placed for Oil Sands Growth

Predecessor Phillips' purchase of the refiner, TOSCO, a few years ago now looks timely as the refining margin has improved along with oil price. The merger of Conoco and Phillips added advanced, complex refineries in Europe and Asia to the company's position as the largest U.S. refiner. Occasionally during the past year refining margins reached that \$10 a barrel, or so, level where new investment can be justified. Those levels would have to be sustained for a few years before COP would consider a new grass roots facility. Meanwhile COP is gearing up its existing refineries to handle the heavier and more sulfurous oil that is likely to account for all of the world's incremental supply. The company sees benefits of integrating refining with oil sands output from Canada and Venezuela.

Cash Flow Continues at a High Level

Commodity price drives cash flow in our model (see table [Next Twelve Months Operating and Financial Estimates](#)). We hold volume constant in our projection expecting to be favorably surprised as the company attempts to achieve annual volume growth.

After a gain in the last quarter of 2004, cash flow would be sustained at a high level in 2005. Of course that could change depending on how well futures prices anticipate actual prices among other factors.

Investors' greatest concern may be the sustainability of the current level of oil price. Energy consumers and energy investors should, in our opinion, take recent oil price action as a sign of a long term change to higher price. Recent softening of oil price is welcome relief for the economy while we adjust to the price increases that have occurred and prepare for those that may occur in the future.

Oil Price Move Possibly Just Starting

To offset any inclination to underestimate further potential for oil and gas price, we compare the relatively stable price period from 1992 to 2001 to the period from 1964 to 1973. Each was a ten year period that immediately preceded a sharply lower stock market in 2002 and in 1974. After quiescence, oil price started moving up in each case. We may be in the early stages of a new historic move (see chart [Light, Sweet Crude Oil Price Cycle](#)).

Frankly, few investors would give much weight to the likelihood of continued oil price strength. Contrast that with the growing chorus for a weaker dollar. It may just be that oil price is not high, but the real value of the dollar is low. That, too, is a parallel to historical experience.

Let us imagine how the cycle might unfold. By the way we chose to draw the chart Year 13 corresponds to 1976 and 2004. Once the move got going in the previous cycle, the annual

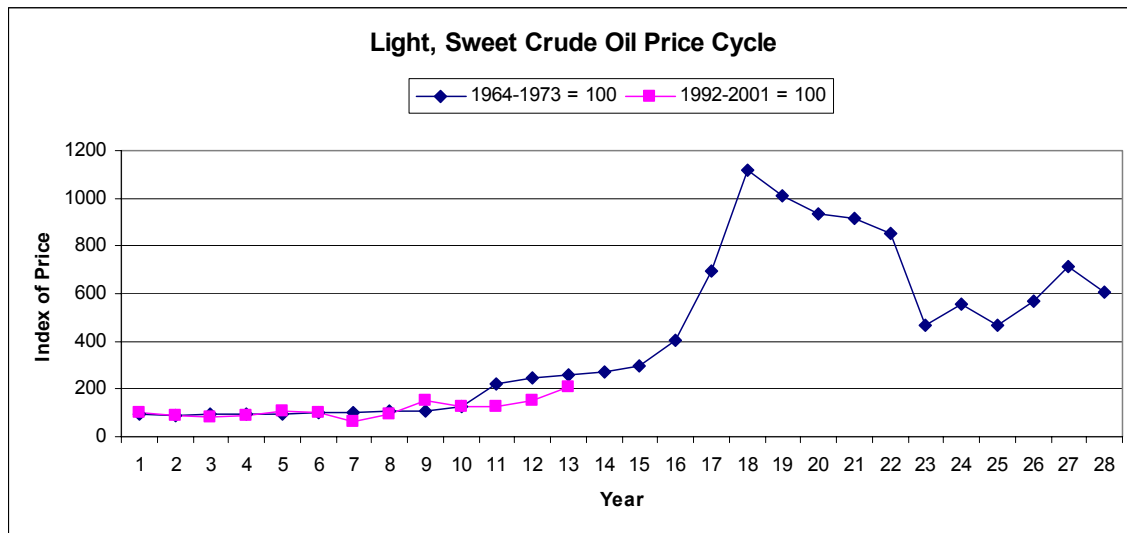
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average oil price did not decline until Year 19 (1982). The annual peak of 1100, or 11 times the first ten year average, was too high to be sustained. It might be less disruptive economically if the peak ahead of us were lower and the decline shallower. The end point in Year 28 at 600 implies a tripling over the next 15 years. If higher oil price unfolded gradually it would give everyone time to adjust.

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Next Twelve Months Operating and Financial Estimates

	<i>Q1</i>	<i>Q2</i>	<i>Q3</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</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>6/30/05</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>12/31/05</i>
Volume										
Natural Gas (mmcf)										
U.S. (or North America)	1,846	1,810	1,809	1,809	1,818	1,809	1,809	1,809	1,809	1,809
Overseas (or Int'l)	1,578	1,493	1,374	1,693	1,534	1,578	1,493	1,374	1,693	1,534
Total	3,424	3,303	3,183	3,502	3,353	3,387	3,302	3,183	3,502	3,343
Oil (mbd)	1,024	1,012	953	953	985	953	953	953	953	953
Total gas & oil (bcf)	871	853	819	848	3,391	819	821	819	848	3,307
Price										
Natural gas (\$/mcf)										
Henry Hub (\$/mmbtu)	5.64	6.10	5.75	7.15	6.16	6.83	6.30	6.37	6.65	6.54
U.S. (or North America)	4.79	5.22	5.06	6.29	5.34	6.01	5.54	5.61	5.85	5.75
Overseas (or Int'l)	4.12	3.47	3.72	4.21	3.90	3.68	3.66	3.59	3.61	3.64
Total	4.48	4.43	4.48	5.28	4.68	4.92	4.69	4.74	4.77	4.78
Oil (\$/bbl)										
WTI Cushing	35.23	38.34	43.89	49.69	41.79	43.43	43.23	42.42	42.69	42.94
Worldwide	30.35	34.00	38.93	44.06	36.70	38.52	38.34	37.62	37.86	38.13
Total gas & oil (\$/mcf)	4.85	5.23	5.77	6.56	5.60	5.86	5.77	5.72	5.72	5.77
NY Harbor 3-2-1 (\$/bbl)	6.98	12.78	7.83	5.06	8.16	6.46	7.99	7.96	5.35	6.94
Revenue (\$mm)										
Natural Gas										
U.S. (or North America)	805	860	842	1,047	3,554	978	913	933	973	3,797
Overseas (or Int'l)	591	472	470	655	2,188	522	497	454	563	2,036
Total	1,396	1,332	1,312	1,702	5,742	1,500	1,410	1,387	1,536	5,833
Oil	2,828	3,131	3,413	3,863	13,235	3,304	3,325	3,298	3,319	13,246
Other	25,993	27,423	30,016	30,016	113,449	30,016	30,016	30,016	30,016	120,065
Total	30,217	31,886	34,741	35,582	132,426	34,820	34,751	34,701	34,871	139,143
Expense (\$mm)										
Fixed	860	882	1,060	1,060	3,863	1,060	1,060	1,060	1,060	4,241
Variable	860	882	1,060	1,249	4,052	1,078	1,062	1,051	1,089	4,281
Other	24,793	25,673	28,266	28,762	107,494	28,485	28,194	28,198	28,675	113,552
Ebitda (\$mm)										
Exploration and Production	2,503	2,698	2,604	3,256	11,062	2,666	2,612	2,573	2,705	10,557
Other	1,200	1,750	1,750	1,255	5,955	1,532	1,822	1,818	1,341	6,513
Total Ebitda	3,703	4,448	4,354	4,511	17,017	4,197	4,434	4,392	4,046	17,070
Exploration	143	163	205	205	716	205	205	205	205	820
Deprec., Deplet., & Amort.	918	912	938	938	3,706	938	938	938	938	3,752
Other non cash	31	20	12	12	75	12	12	12	12	48
Ebit	2,611	3,353	3,199	3,356	12,520	3,042	3,279	3,237	2,891	12,450
Interest	145	159	101	101	506	101	101	101	101	404
Ebt	2,466	3,194	3,098	3,255	12,014	2,941	3,178	3,136	2,790	12,046
Income Tax	863	1,118	1,084	1,139	4,205	1,029	1,112	1,097	977	4,216
Net Income (\$mm)										
Exploration and Production	1,257	1,354	1,420							
Other	536	835	762							
Unallocated	(190)	(113)	(168)							
Total	1,603	2,076	2,014	2,116	7,809	1,912	2,066	2,038	1,814	7,830
Shares (millions)										
Per share (\$)	694	699	702	702	699	702	702	702	702	702
Ebitda Margin (E&P)	2.31	2.97	2.87	3.02	11.17	2.72	2.94	2.90	2.58	11.16
Ebitda Margin (E&P)	59%	60%	55%	59%	58%	55%	55%	55%	56%	55%
Tax Rate	35%	35%	35%	35%	35%	35%	35%	35%	35%	35%

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Kurt H. Wulff, CFA

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