Rating: Buy
S&P 500: 1096

Devon Energy Company
Restored Financial Quality

Symbol	DVN	*Ebitda Next Twelve Months ending 3/31/05 ($mm)*	6,700
Rating	Buy	*North American Natural Gas/Ebitda (%)*	61
Price ($/sh)	59.85	*Natural Gas and Oil Production/Ebitda (%)*	100
Pricing Date	5/13/04	*Adjusted Reserves/Production NTM*	6.4
Shares (mm)	247	*EV/Ebitda*	3.5
Market Capitalization ($mm)	14,800	*PV/Ebitda*	5.3
Debt ($mm)	8,500	*Undeveloped Reserves (%)*	25
Enterprise Value (EV) ($mm)	23,300	*Natural Gas and Oil Ebitda ($/boe)*	26.20
Present Value (PV) ($mm)	35,600	*Present Value Proven Reserves($/boe)*	18.90
Net Present Value ($/share)	110	*Present Value Proven Reserves($/mcfe)*	3.20
Debt/Present Value	0.24	*Price/Earnings Next Twelve Months*	5
McDep Ratio - EV/PV	0.65	*Dividend Yield (%)*	0.7

Summary and Recommendation

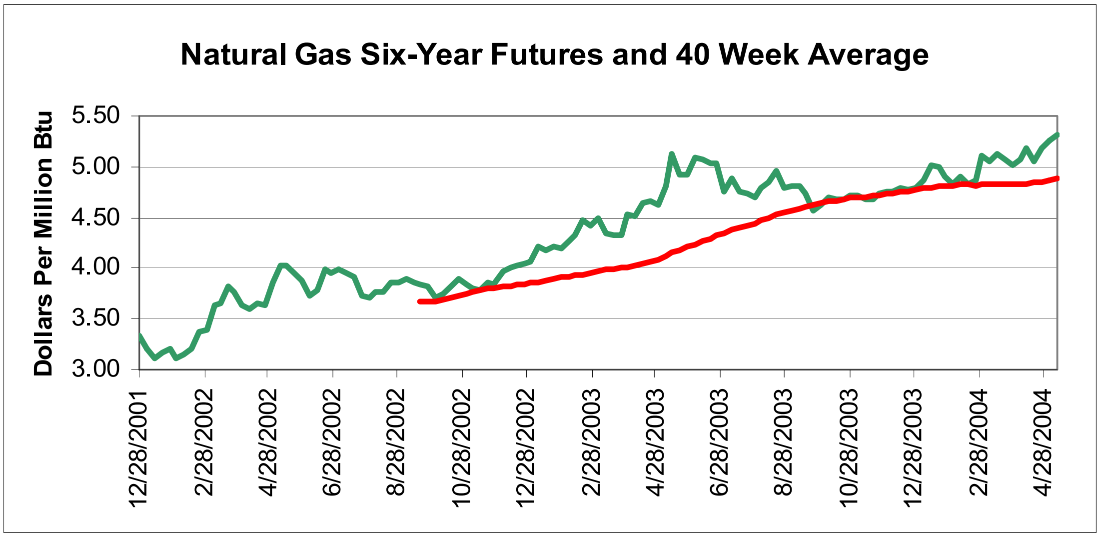
We initiate a "Buy" rating on the common shares of **Devon Energy Company (DVN)** for natural gas and oil value at newly acceptable financial risk. Devon's ratio of debt to present value has declined from 0.48 two years ago to 0.24 now. Mr. Larry Nichols, Devon's chairman, has a long record of repeated success in using debt to make well-timed acquisitions and then rapidly regenerating debt capacity. In addition to debt, a short reserve life limits the multiple investors can pay for cash flow. Taking that into account along with Devon's high profitability per unit we see possible appreciation in stock price of some 80% to reach our estimate of net present value. The main risk may be whether natural gas and oil price are at a multi-year peak now as most may believe or in the early years of a long term rise as we believe.

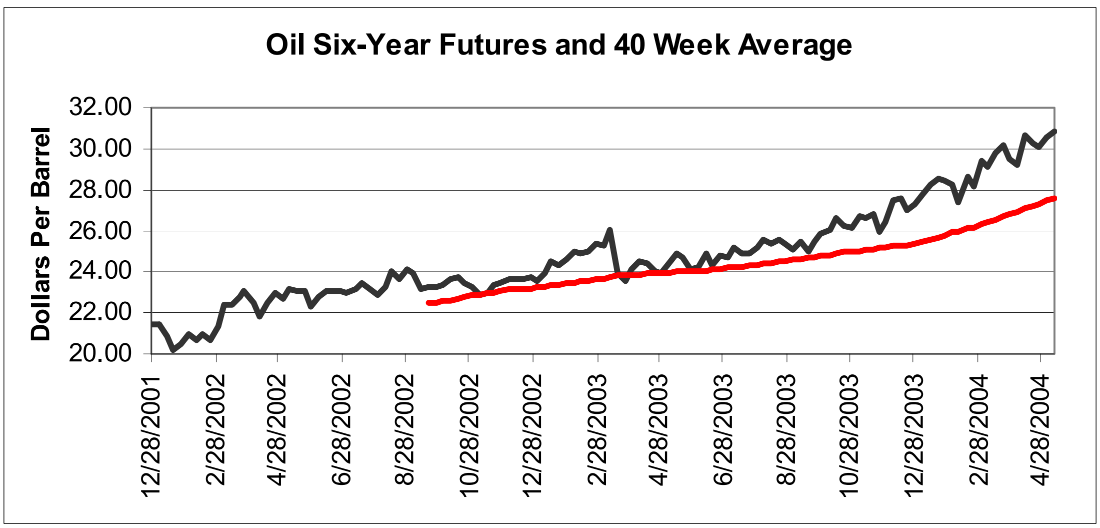
Six-Year Futures Point to Growing Oil and Gas Value

About 61% of the value in Devon is sensitive to North American natural gas price and the remainder to global crude oil price. Thirty years ago when we last had a decade long major move in oil there was no meaningful futures market. Today futures prices for natural gas are quoted every trading day for each of 72 months for the next six years. Similarly futures prices for oil are quoted for the same period, but not for every month in the out years because there is less seasonality in crude oil price. We average the quotes for 72 months, interpolating where necessary for oil.

The plots of weekly results since the beginning of 2002 trace a trend of six-year natural gas price rising 22% a year and six-year oil, 16% a year (see charts). We measure momentum with the 40-week moving average.

Fundamental factors support the price trends. As the cleanest fuel, natural gas should continue to advance in price relative to oil as the world increasingly desires a cleaner environment.
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.





Interest rates below inflation encourage investment in assets like natural gas and oil that can increase in price more than inflation. Larry Nichols is looking pretty smart or lucky to have borrowed aggressively at cheap rates to buy assets at cheap prices.

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. June futures near $40 a barrel for Light, Sweet Crude Oil would have to exceed $52 a barrel to trigger a 70% warning.

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 some $6.7 billion 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. The rationale is that if one is buying a stock today, previously reported cash flow is relevant only for the information it may give about future cash flow.

Devon Energy
Next Twelve Months Operating and Financial Results

	Q1 3/31/04	*Q2E 6/30/04*	*Q3E 9/30/04*	*Q4E 12/31/04*	***Year 2004E***	*Q1E 3/31/05*	***Next Twelve Months 3/31/05***
Volume							
Natural Gas (mmcfd)							
U.S.	1,669	1,669	1,669	1,669	**1,674**	1,669	**1,669**
Canada	739	739	739	739	**741**	739	**739**
Overseas	33	33	33	33		33	**33**
Total	2,441	2,441	2,441	2,441	**2,448**	2,441	**2,441**
Oil (mbd)	296	296	296	296	**296**	296	**296**
Total gas & oil (bcf)	384	384	388	388	**1,543**	379	**1,539**
Price							
Natural gas ($/mcf)							
Henry Hub ($/mmbtu)	5.64	6.02	6.29	6.46	**6.10**	6.64	**6.35**
U.S.	5.14	5.48	5.73	5.89	**5.56**	6.05	**5.79**
Canada	5.07	5.41	5.65	5.81	**5.48**	5.97	**5.71**
Overseas	3.14	3.43	3.40	3.26	**3.31**	3.13	**3.31**
Total	5.09	5.43	5.67	5.83	**5.51**	5.99	**5.73**
Oil ($/bbl)							
WTI Cushing	35.23	38.46	38.17	36.55	**37.10**	35.16	**37.08**
Worldwide	28.66	31.29	31.06	29.73	**30.19**	28.61	**30.18**
Total gas & oil ($/mcf)	4.96	5.34	5.46	5.46	5.31	5.47	**5.43**
Revenue ($mm)							
Natural Gas							
U.S.	781	833	879	904	**3,396**	909	**3,524**
Canada	341	364	384	395	**1,483**	397	**1,539**
Overseas	9	10	10	10	**40**	9	**40**
Total	1,131	1,207	1,274	1,308	**4,920**	1,315	**5,103**
Oil	772	842	845	809	**3,269**	762	**3,259**
Other	(82)	(20)	(20)	(20)	**(142)**	(20)	**(80)**
Total	1,821	2,029	2,099	2,098	**8,047**	2,057	**8,283**
Expense							
Fixed	186	186	186	186	**742**	186	**742**
Variable	186	200	207	206	**798**	202	**815**
Other							
Ebitda ($mm)	1,450	1,644	1,707	1,706	**6,507**	1,669	**6,725**
Deprec., Deplet., & Amort.	572	572	572	572	**2,288**	572	**2,288**
Other Non Cash		(60)	(60)	(60)	**(180)**	(60)	**(240)**
Ebit	878	1,132	1,195	1,194	**4,399**	1,157	**4,677**
Interest	118	118	118	118	**472**	118	**472**
Ebt	760	1,014	1,077	1,076	**3,927**	1,039	**4,205**
Income Tax	266	355	377	377	**1,374**	364	**1,472**
Net Income ($mm)	494	659	700	699	**2,552**	675	**2,734**
Shares (millions)	247	247	247	247	**988**	247	**247**
Per Share ($)	2.00	2.67	2.83	2.83	**10.33**	2.73	**11.07**
Ebitda Margin	80%	81%	81%	81%	**81%**	81%	**81%**
Tax Rate	35%	35%	35%	35%	35%	35%	**35%**

For the next twelve months we project constant natural gas and oil volume at 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. 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.

Like most producers, Devon is losing money this year on oil price hedges. We project cash flow before the deduction for hedging while our projected net income is after hedging. Devon could argue that when its debt was high, it needed the insurance of hedging. Since most hedges are for a year or less, there is little long term consequence.

There is also a separate line of business in natural gas processing that we do not break out. We have simply included the profit as part of the producing business and omitted the revenues. That simplification contributes to Devon's unusually high cash flow per unit of production and as a percent of revenue. A high concentration on natural gas also contributes to high margins as do highly productive oil wells in the Gulf of Mexico and offshore Africa.

Short 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.

Reported reserves at year end 2003 imply an adjusted life index of 6.4 years average with natural gas at 7.5 years and oil at only 4.9 years. The index is the sum of developed and half undeveloped reserves divided by next twelve months production. That could justify a multiple of 5.7 in the framework we applied on March 23 when we estimated present value assuming constant commodity price near the one-year quotes at that time, about $35 a barrel for crude oil. Our present value remains unchanged while higher commodity prices since then imply higher cash flow and a lower multiple of 5.3 times. We are saying that we think the multiple of cash flow should be 5.3 times while the actual multiple implied by current stock price is only 3.5 times.

Capable Management

The current chairman of Devon grew up in an entrepreneurial oil and gas tradition. Mr. Nichol's father, John Nichols, was a pioneer in applying drilling funds to develop natural gas in the San Juan Basin in the 1950s. When Devon went public in 1988 it's most important property was the coal seam natural gas rights under the Northeast Blanco unit in northwest New Mexico. Flush with natural gas and tax credits from that resource, Devon accelerated its growth with acquisitions.

Alta Energy was acquired when oil price and oil stocks took a temporary steep dip in 1994. Devon swooped in to acquire Pennzenergy in 1999 near $20 a share as we recall, shortly after the seller had mistakenly turned down an offer above $70. Only now is it obvious that acquiring Anderson Exploration and Mitchell Energy in rapid succession in 2001 and 2002 was also well-timed. Now the higher financial risk temporarily represented in Devon's stock is reduced by our measurement. The rich base of energy resources Mr. Nichols has acquired for the company appears to be worth more than the current price of the stock.

Kurt H. Wulff, CFA

Research Methodology: McDep Associates ("the firm") applies the thirty plus 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 becomes the denominator of the McDep Ratio while market capitalization and debt are the numerator. Stocks with low McDep Ratios tend to outperform stocks with high McDep Ratios on an unlevered basis. The firm emphasizes quantitative tools in deriving estimates while applying a final qualitative refinement.

Ratings Description: Stocks are rated by expected risk-adjusted return over one to three years compared to Treasury Inflation Protected Securities. Buy, Hold and Sell ratings imply expectations better than, equal to and inferior to those of TIPS. The McDep Ratio for a Buy may range up to 1.2; for a Hold**,** 1.0 to 1.4; and for a Sell, above 1.2.