Rating: Buy
S&P 500: 1076

Devon Energy Corporation
Capable Leader, Short Reserve Life

Symbol	DVN	*Ebitda Next Twelve Months ending 6/30/05 ($mm)*	6,800
Rating	Buy	*North American Natural Gas/Ebitda (%)*	59
Price ($/sh)	66.49	*Natural Gas and Oil Production/Ebitda (%)*	100
Pricing Date	8/11/04	*Adjusted Reserves/Production NTM*	6.6
Shares (mm)	249	*EV/Ebitda*	3.7
Market Capitalization ($mm)	16,600	*PV/Ebitda*	5.3
Debt ($mm)	8,700	*Undeveloped Reserves (%)*	25
Enterprise Value (EV) ($mm)	25,200	*Natural Gas and Oil Ebitda ($/boe)*	27.20
Present Value (PV) ($mm)	36,100	*Present Value Proven Reserves($/boe)*	19.20
Net Present Value ($/share)	110	*Present Value Proven Reserves($/mcfe)*	3.20
Debt/Present Value	0.24	*Earnings Next Twelve Months (US$/sh)*	9.56
McDep Ratio - EV/PV	0.70	*Price/Earnings Next Twelve Months*	7
Dividend Yield (%/year)	0.6	*Indicated Annual Dividend (US$/sh)*	0.40

Note: Estimated cash flow and earnings tied to one-year futures prices for natural gas and oil.
Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

Summary and Recommendation

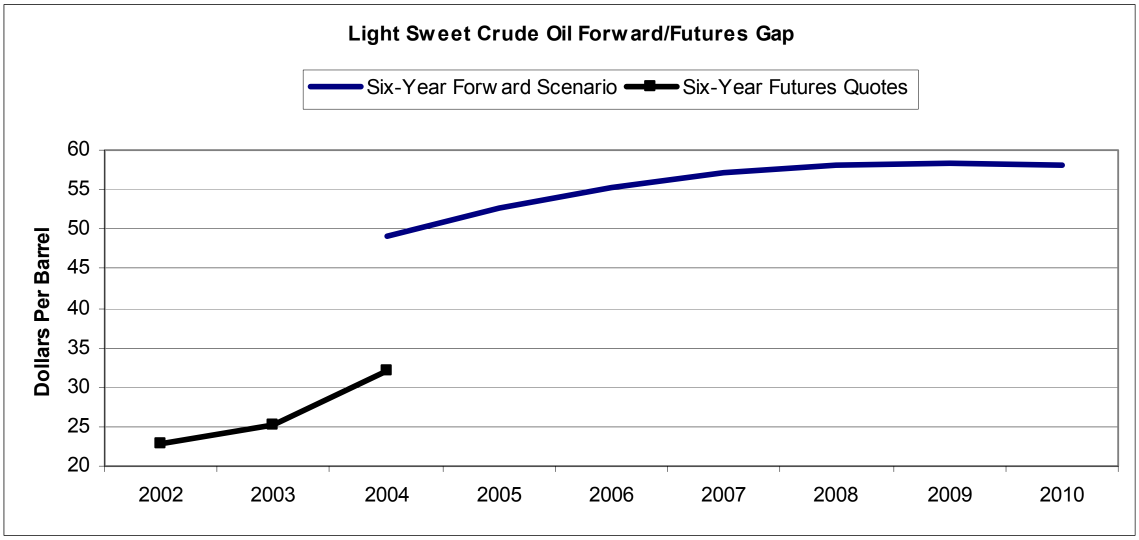
We continue a Buy rating on the common shares of **Devon Energy Corporation (DVN)** as a leading independent natural gas and oil producer under capable leadership subject to reserve life risk. At more than $16 billion in market cap, the company offers investors ready access to the greater relative appreciation potential of independent producers in a period of rising appreciation for oil and gas value. Devon contrasts with most of its peers in having the same person most responsible for the growth of the company in the past two decades, Mr. Larry Nichols, continuing as chairman and chief executive officer today. That source of reassurance helps offset the valuation risk of a shorter reserve life of 6.6 years on an adjusted basis.

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).

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 is tight as spare capacity has virtually disappeared and the largest producing area, the Middle East, is showing maturity with the workhorse giant fields on the verge of peaking.



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. Military force could fall into that category though we would like to believe the objectives for deployment would be more worthy. Thirty years ago some of the same political leaders now directing military force directed price controls in a failed attempt to hold oil price artificially low.

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.

Oil stock price can decline even if oil price remains firm. That happened in 1974 when economic activity and the stock market declined severely. It seemed to occur again in 2002 and we hope that is now behind us. Nonetheless the stock market may have begun a new moderate downward phase of its cycle. While oil stocks may not be entirely immune to surprise declines, we believe the fundamental outlook can carry the stocks higher over the next several years.

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).

Devon Energy
Next Twelve Months Operating and Financial Results

	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.	1,669	1,651	1,651	1,651	**1,660**	1,651	1,651	**1,651**
Canada	739	780	780	780	**772**	780	780	**780**
Overseas	33	24	24	24		24	24	**24**
Total	2,441	2,455	2,455	2,455	**2,458**	2,455	2,455	**2,455**
Oil (mbd)	296	275	275	275	**280**	275	275	**275**
Total gas & oil (bcf)	384	374	378	378	**1,513**	369	374	**1,498**
Price								
Natural gas ($/mcf)								
Henry Hub ($/mmbtu)	5.64	6.10	5.74	6.28	**5.94**	6.88	6.13	**6.26**
U.S.	5.14	5.41	5.09	5.57	**5.30**	6.10	5.44	**5.55**
Canada	5.07	5.31	5.00	5.47	**5.21**	5.99	5.34	**5.45**
Overseas	3.14	2.43	2.74	2.78	**2.80**	2.68	2.59	**2.70**
Total	5.09	5.35	5.04	5.51	**5.25**	6.03	5.38	**5.49**
Oil ($/bbl)								
WTI Cushing	35.23	38.34	43.19	43.93	**40.17**	42.25	40.88	**42.56**
Worldwide	28.66	30.90	34.80	35.40	**32.38**	34.05	32.95	**34.31**
Total gas & oil ($/mcf)	4.96	5.27	5.34	5.67	5.31	5.89	5.43	**5.58**
Revenue ($mm)								
Natural Gas								
U.S.	781	813	773	846	**3,213**	907	818	**3,344**
Canada	341	377	359	392	**1,469**	421	379	**1,551**
Overseas	9	5	6	6	**27**	6	6	**24**
Total	1,131	1,195	1,138	1,245	**4,708**	1,333	1,202	**4,918**
Oil	772	773	881	896	**3,321**	843	825	**3,443**
Other	(82)	(126)			**(208)**			**-**
Total	1,821	1,842	2,018	2,140	**7,822**	2,176	2,027	**8,361**
Expense								
Fixed	186	191	191	191	**759**	191	191	**764**
Variable	186	191	196	208	**780**	211	197	**812**
Other								
Ebitda ($mm)	1,450	1,460	1,631	1,741	**6,282**	1,774	1,639	$\boxed{\mathbf{6,785}}$
Deprec., Deplet., & Amort.	572	552	552	552	**2,228**	552	552	**2,208**
Other Non Cash			126	126	**252**	63	63	**378**
Ebit	878	908	953	1,063	**3,802**	1,159	1,024	**4,199**
Interest	118	134	134	134	**520**	134	134	**536**
Ebt	760	774	819	929	**3,282**	1,025	890	**3,663**
Income Tax	266	271	287	325	**1,149**	359	311	**1,282**
Net Income ($mm)	494	503	532	604	**2,134**	666	578	**2,381**
Shares (millions)	247	249	249	249	**994**	249	249	**249**
Per Share ($)	2.00	2.02	2.14	2.43	**8.58**	2.67	2.32	**9.56**
Ebitda Margin	80%	79%	81%	81%	**80%**	82%	81%	**81%**
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 one barrel equivalent of reported proven reserves, 0.75 barrel developed and 0.25 barrel undeveloped. As a result, total present value, the number in the box, is also present value per barrel of proven reserves.

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.

On discount rate we presume that earning a 5% real return per year on an unlevered basis is a decent achievement. That compares to the 2% real return per year offered by U.S. Treasury Inflation Protected Securities. For good measure we bump that up to 7%.

While 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.

Natural gas is particularly important at Devon accounting for 65% of reserves and 60% of NTM production. Because we combine oil and gas in the calculation we escalate the oil equivalent price as natural gas price advances relative to oil.

Present Value per Barrel Includes Uplift for Short Life

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). The price of $35 a barrel corresponds to our standardized present value of $110 a share.

Reported reserves that we use in the calculation understate likely future volumes. Contrary to our projection of volume decline in calculating the value of proven reserves, the company historically has added new reserves and slowed decline. Devon reports a moderate 25% of reserves as undeveloped. At least two areas, the Barnett Shale in North Texas and the deep water portion of the Gulf of Mexico offer extra future production probably not much reflected in proven reserves.

Present value per barrel multiplied by barrels of proven reserves tends to understate value more for companies with a shorter reserve life. We see that in a strong correlation of enterprise value with NTM cash flow and adjusted reserve life. We highlight the amount of the understatement as short life uplift that amounts to almost a quarter of reserve value in the standard case.

We know from experience that some well-run short-life companies have outperformed their longer-life peers even though the longer-life stocks were more asset rich. It is indisputable that short-life companies generate current cash flow at a higher rate relative to resource value. With more cash to reinvest, the short life company becomes more sensitive to return on that reinvestment. In Devon's case we know that Mr. Nichols has directed successful reinvestment in the past.

Devon Energy
Present Value of Oil and Gas Reserves

Volume Decline (%/yr):	17	Nymex Oil Price Post 2005 ($/bbl)	35
Volume Enhancement (%/yr):	5	Real Discount Rate (%/yr):	7.0
Capex/Cash Flow (%):	10	Variable Cost (%):	10

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												
	0.750	0.250	1.000	31.61	31.63	5.93	3.16	22.54	1.68	20.85	0.74	15.50
2005	0.133	0.000	0.133	33.48	4.46	0.40	0.45	3.62	0.36	3.26	0.97	3.15
2006	0.111	0.009	0.120	29.75	3.58	0.40	0.36	2.83	0.28	2.54	0.90	2.30
2007	0.093	0.016	0.109	30.11	3.27	0.40	0.33	2.55	0.25	2.29	0.84	1.94
2008	0.077	0.021	0.098	30.46	2.99	0.40	0.30	2.29	0.23	2.06	0.79	1.63
2009	0.064	0.024	0.088	30.82	2.73	0.40	0.27	2.06	0.21	1.85	0.74	1.37
2010	0.054	0.026	0.080	31.18	2.49	0.40	0.25	1.84	0.18	1.66	0.69	1.14
2011	0.045	0.027	0.072	31.54	2.27	0.40	0.23	1.65	0.16	1.48	0.64	0.96
2012	0.037	0.028	0.065	31.89	2.07	0.40	0.21	1.47	0.00	1.47	0.60	0.89
2013	0.031	0.023	0.054	32.25	1.75	0.40	0.17	1.18	0.00	1.18	0.56	0.66
2014	0.026	0.019	0.045	32.61	1.47	0.40	0.15	0.93	0.00	0.93	0.53	0.49
2015	0.022	0.016	0.038	32.96	1.24	0.40	0.12	0.72	0.00	0.72	0.49	0.36
2016	0.018	0.013	0.031	33.32	1.05	0.40	0.10	0.55	0.00	0.55	0.46	0.25
2017	0.015	0.011	0.026	33.68	0.88	0.40	0.09	0.40	0.00	0.40	0.43	0.17
2018	0.013	0.009	0.022	34.03	0.74	0.40	0.07	0.27	0.00	0.27	0.40	0.11
2019	0.010	0.008	0.018	34.39	0.63	0.40	0.06	0.17	0.00	0.17	0.37	0.06

Devon Energy
Net Present Value Calculation

Constant Oil Price ($/bbl):	30	35	40	50
Present Value per Barrel ($):	13.40	15.50	17.60	21.80
Oil and Gas reserves (million barrels equivalent):	1,880	1,880	1,880	1,880
Present Value of Oil and Gas Reserves ($mm):	25,200	29,100	33,100	41,000
Short Life Uplift ($mm)	7,000	7,000	7,000	7,000
Total	32,200	36,100	40,100	48,000
Debt ($mm):	8,700	8,700	8,700	8,700
Present Value of Equity ($mm):	23,500	27,400	31,400	39,300
Shares (mm):	249	249	249	249
Net Present Value ($/sh):	94	110	126	158

Midstream Business Included in Production

Management emphasizes to analysts that Devon has a somewhat more important “midstream” business of natural gas processing and related activities than is the case for peer companies. Such operations sometimes command premium valuations in the hands of master limited partnerships. We have left midstream in producing cash flow. It is reflected in a somewhat higher unlevered cash flow margin for production. Since our ultimate valuation corresponds to an unlevered cash flow multiple (PV/Ebitda) of 5.3 times, we could say that midstream is valued at a multiple of 5.3. If it were worth 8 times instead we could add perhaps $4 a share to present value. We feel that our overall estimates are already reasonable and imply a positive outlook for the stock.

Kurt H. Wulff, CFA