Rating: Buy
S&P 500: 1203

# Devon Energy
## Raise Net Present Value to $63 a Share

| | | | |
|---|---|---|---|
| *Symbol* | DVN | *Ebitda Next Twelve Months ending 3/31/06 (US$mm)* | 6,300 |
| *Rating* | Buy | *North American Natural Gas/Ebitda (%)* | 60 |
| *Price ($/sh)* | 40.72 | *Natural Gas and Oil Production/Ebitda (%)* | 100 |
| *Pricing Date* | 2/4/05 | *Adjusted Reserves/Production NTM* | 7.9 |
| *Shares (mm)* | 500 | *EV/Ebitda* | 4.1 |
| *Market Capitalization ($mm)* | 20,400 | *PV/Ebitda* | 5.9 |
| *Debt ($mm)* | 5,800 | *Undeveloped Reserves (%)* | 17 |
| *Enterprise Value (EV) ($mm)* | 26,200 | *Natural Gas and Oil Ebitda ($/boe)* | 29.00 |
| *Present Value (PV) ($mm)* | 37,300 | *Present Value Proven Reserves($/boe)* | 20.00 |
| *Net Present Value ($/share)* | 63 | *Present Value Proven Reserves($/mcfe)* | 3.30 |
| *Debt/Present Value* | 0.16 | *Earnings Next Twelve Months (US$/sh)* | 4.04 |
| *McDep Ratio - EV/PV* | 0.70 | *Price/Earnings Next Twelve Months* | 10 |
| *Dividend Yield (%/year)* | 1.0 | *Indicated Annual Dividend (US$/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)** for large cap North American natural gas representation and capable leadership. We raised our estimate of net present value for the independent producer to $63 a share from $55 on January 26, 2005 when we revised our estimate of long-term oil price to $40 a barrel constant real from $35. The new NPV matches the level previously calculated in a sensitivity illustration (see *Stock Idea*, Devon Energy, August 12, 2004). Compared to close peers, Devon is distinguished by having as its leader today the same person most responsible for the growth of the company in the past two decades, Mr. Larry Nichols. We see 55% stock price appreciation potential to net present value where the stock would then offer a continuing unlevered real return of some 7% per year at normal risk.

### Largest U.S. Independent Producer

Devon ranks fourth largest in North American Natural Gas by our estimate of present value (see table Present Value by Line of Business). The two largest producers, also buy-rated, are mega cap integrated oil companies concentrated more on international oil production and refining/marketing of oil products. The third largest producer, also buy-rated, is a Canadian company. That leaves Devon as the largest U.S. independent producer of the premium fuel. While size does not necessarily equate to performance it is important to institutional investors seeking performance for large sums under management.

**Present Value by Line of Business**
(US$millons)

| | *North American Natural Gas* | *Over-seas Natural Gas* | *Oil Production* | *Down-stream* | *Total* |
|---|---|---|---|---|---|
| Exxon Mobil Corporation | 38,000 | 54,000 | 172,000 | 110,000 | 374,000 |
| BP plc | 30,000 | 30,000 | 134,000 | 70,000 | 264,000 |
| Encana Corporation | 29,000 | - | 15,200 | - | 44,200 |
| Devon Energy Corporation | 23,500 | - | 13,800 | - | 37,300 |
| Burlington Resources | 20,000 | 1,300 | 8,300 | - | 29,600 |
| Anadarko Petroleum Corp. | 19,500 | - | 12,700 | - | 32,200 |
| ConocoPhillips | 16,000 | 8,000 | 49,700 | 42,000 | 115,700 |
| ChevronTexaco Corporation | 14,000 | 11,000 | 104,300 | 50,000 | 179,300 |
| XTO Energy Inc. | 12,000 | - | 2,900 | - | 14,900 |
| Royal Dutch Petroleum | 9,000 | 47,000 | 97,000 | 111,000 | 264,000 |
| Unocal Corporation | 6,000 | 6,000 | 10,300 | - | 22,300 |
| Occidental Petroleum Corp. | 5,700 | 600 | 30,400 | 4,800 | 41,500 |
| Petro-Canada | 5,000 | 1,000 | 12,500 | 3,900 | 22,400 |
| Marathon Oil Corporation | 3,700 | 1,500 | 8,300 | 7,400 | 20,900 |
| Imperial Oil Limited (30%) | 3,200 | - | 15,500 | 6,500 | 25,200 |
| Suncor Energy | 1,300 | - | 24,300 | 1,900 | 27,500 |
| Total S.A. | - | 43,000 | 84,800 | 48,000 | 175,800 |
| PetroChina Company Ltd (10%) | - | 13,000 | 139,800 | 21,000 | 173,800 |
| Lukoil Oil Company | - | - | 44,900 | - | 44,900 |
| Norsk Hydro ASA | - | 6,000 | 12,900 | 11,600 | 30,500 |
| CNOOC Limited (19%) | - | 3,300 | 24,300 | - | 27,600 |
| Canadian Oil Sands Trust (US$) | - | - | 10,100 | - | 10,100 |

North American Natural Gas is the larger of just two functional distinctions (see table Functional Cash Flow and Present Value). Projections assume completion of a sale of $1.5 billion of non-core properties within the next two months.

**Devon Energy**
**Functional Cash Flow and Present Value**

| | *NTM Ebitda (US$mm)* | *Adjusted R/P* | *PV/ Ebitda* | *Present Value (US$mm)* | |
|---|---|---|---|---|---|
| North American Natural Gas | 3,810 | 7.7 | 6.2 | 23,500 | 63% |
| Oil | 2,500 | 8.1 | 5.5 | 13,800 | 37% |
| | 6,310 | 7.9 | 5.9 | 37,300 | 100% |
| Debt (US$mm) | | | | | 5,800 |
| Net Present Value (US$mm) | | | | | 31,500 |
| Shares (mm) | | | | | 500 |
| Net Present Value (US$/sh) | | | | | 63 |

By virtue of its acquisition of Mitchell Energy, Devon is the dominant producer in the Barnett Shale, now possibly the largest gas field in Texas. The field accounts for about a quarter of Devon's natural gas reserves and production. Devon has converted most of the undeveloped reserves reported for the Mitchell acquisition into developed reserves. The company has further expanded reserves in the Mitchell area and is developing new reserves and production by the application of horizontal drilling outside the core area.

The Barnett Shale is proving to be an impressive legacy asset. Larry Nichols learned about the potential of great gas fields from his father, John Nichols, a pioneer in the development of the San Juan Basin in New Mexico. Other great fields for Devon in the U.S. are Carthage in East Texas and Washakie in Wyoming. In Canada, Devon has a large position in the Deep Basin that has similar characteristics as the San Juan Basin. The favorable timing of Mr. Nichol's deals that built the company to its current position is borne out by high cash flow generation at today's oil price.

Though the reserve life is short, Devon has visible replacement and possible growth prospects. In Canada, for example, the company has a project to recover oil from sands too deep to be mined, but susceptible to in-situ production by the SAGD, Steam-Assisted Gravity Drainage technique. Those prospects were dampened temporarily in the last quarter with an unusually steep price discount for the heavy oil product.

Devon has a 5.6% carried interest in the Azeri-Guneshli-Chiraq field in the Caspian Sea. As production builds up in the next few years Devon's share will approach 50,000 barrels daily with no further investment required.

**Expected Property Sales Influence Projections**

Production volumes are adjusted for expected property sales (see table Next Twelve Months Operating and Financial Estimates). Similarly we have adjusted reserves, debt and other financial measures.

Like most producers, Devon is losing money 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.

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.

**Buy Oil and Gas Producers at Mid Decade**

Measured by McDep Ratio, Devon stock appears undervalued along with peers (see table of stocks ranked by McDep Ratio). Three to five-fold gain potential for oil and gas price over the next 5 to 13 years justifies investment in recommended oil and gas producers, in our opinion. Supporting improving prospects, the average futures price of oil for continuous delivery over the next six years is in a multi-year uptrend as defined by the current quotes above the 40-week average. The current benchmark oil average futures price for the next six years is about $42 a barrel.

**Oil and Gas Producers**
**Rank by McDep Ratio: Market Cap and Debt to Present Value**

| | Symbol/ | Rating | Price ($/sh) 4-Feb 2005 | Shares (mm) | Market Cap ($mm) | Net Present Value ($/sh) | Debt/ Present Value | McDep Ratio |
|---|---|---|---|---|---|---|---|---|
| **Independent Natural Gas and Oil - Large Cap and Mid Cap** | | | | | | | | |
| XTO Energy Inc. | XTO | B1 | 36.84 | 279 | 10,270 | 45.00 | 0.16 | 0.85 |
| Encana Corporation | ECA | B1 | 60.75 | 472 | 28,700 | 77.00 | 0.18 | 0.83 |
| CNOOC Limited (19%) | CEO | B2 | 49.83 | 78 | 3,890 | 67.00 | - | 0.74 |
| Unocal Corporation | UCL | B3 | 49.64 | 271 | 13,500 | 65.00 | 0.21 | 0.82 |
| Occidental Petroleum Corp. | OXY | B3 | 59.94 | 406 | 24,400 | 87.00 | 0.15 | 0.74 |
| Devon Energy Corporation | DVN | B3 | 40.72 | 500 | 20,400 | 63.00 | 0.16 | 0.70 |
| Burlington Resources | BR | B1 | 44.35 | 391 | 17,300 | 67.00 | 0.12 | 0.70 |
| Anadarko Petroleum Corp. | APC | B1 | 66.20 | 246 | 16,300 | 113.00 | 0.14 | 0.64 |
| *Total or Median* | | | | | *135,000* | | *0.15* | *0.74* |

B1 = Buy full unlevered position, B2 = Buy half unlevered position, B3 = Alternative buy, H = Hold
S2 = Short half unlevered position, S3 = Short quarter unlevered position
McDep Ratio = **M**arket **c**ap and **De**bt to **p**resent value of oil and gas and other businesses

Kurt H. Wulff, CFA

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**Please see disclosures on the final page.**