Rating: Buy
S&P 500: 1122

Encore Acquisition Company
Proven Oil and Proven Management

Symbol	EAC	*Ebitda Next Twelve Months ending 3/31/05 ($mm)*	223
Rating	Buy	*North American Natural Gas/Ebitda (%)*	24
Price ($/sh)	27.70	*Natural Gas and Oil Production/Ebitda (%)*	100
Pricing Date	6/4/04	*Adjusted Reserves/Production NTM*	12.6
Shares (mm)	31	*EV/Ebitda*	5.2
Market Capitalization ($mm)	850	*PV/Ebitda*	7.9
Debt ($mm)	320	*Undeveloped Reserves (%)*	24
Enterprise Value (EV) ($mm)	1,160	*Natural Gas and Oil Ebitda ($/boe)*	25.20
Present Value (PV) ($mm)	1,750	*Present Value Proven Reserves($/boe)*	11.20
Net Present Value ($/share)	47	*Present Value Proven Reserves($/mcfe)*	1.90
Debt/Present Value	0.18	*Earnings Next Twelve Months (US$/sh)*	2.51
McDep Ratio - EV/PV	0.66	*Price/Earnings Next Twelve Months*	11
Dividend Yield (%/year)	0.0	*Indicated Annual Dividend (US$/sh)*	0.00

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

Summary and Recommendation

We continue to recommend current purchase of the common shares of **Encore Acquisition (EAC)** for small cap participation in the rising profit opportunities in oil and gas production. The company has a commanding position in a large, old oil field acquired from Shell. In addition to proven reserves that have a long life, enhanced recovery techniques promise to unlock important additional potential. For investors who like to be aligned with great managers, the chairman of the four-year old company has a winning record of being the driving force, or founder, of four all-time most successful small cap energy investments. We see about 70% appreciation potential to net present value of US$47 a share subject to the risk of moderate debt.

Oil Looks Up by the Charts, Fundamentals, Inflation and Security

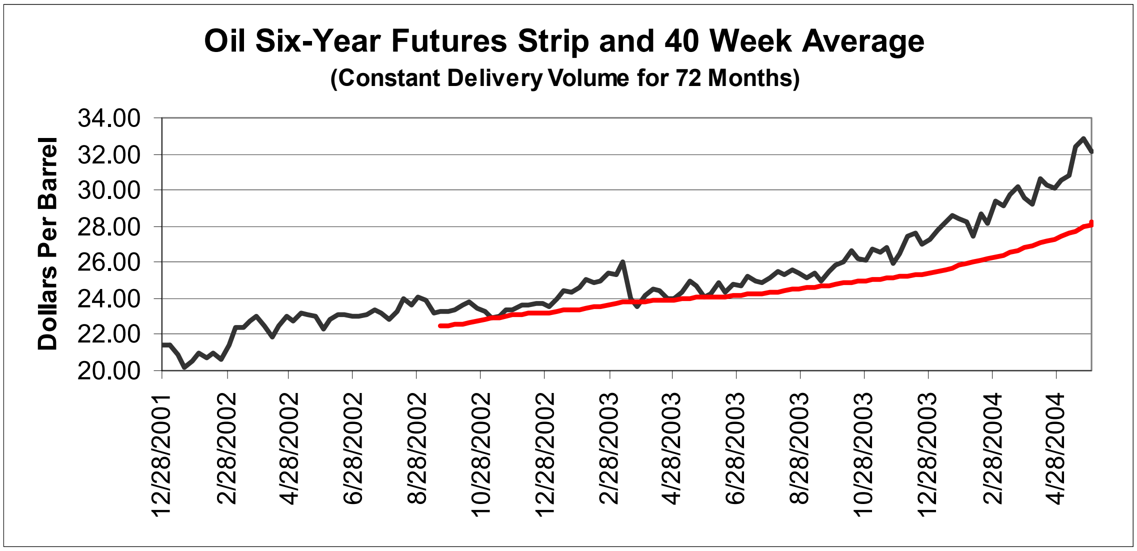
Six-year futures describe the commodity price trends most relevant to estimating resource value. The longer time horizon better matches the period during which more of current resources will actually be produced. The longer term measure also smoothes the frantic near-month fluctuations and has the potential to keep climbing even if near-month quotes drop back temporarily.

The plots of weekly results since the beginning of 2002 trace a trend of six-year oil price rising 16% a year (see chart). We measure momentum with the 40-week moving average.
The chart looks good as long as the current six-year quote remains above the trailing average.

Fundamental factors support the price trends. 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.

Monetary factors also favor oil investment as interest rates below inflation drive investors to real assets for protection against currency debasement. Compared to Treasury Inflation Protected

Securities that we also favor, oil price is likely to rise more than the official government determined inflation measure.



There appears to be little of the cost of maintaining global security reflected in the price of oil. Escalating violence in Saudi Arabia reminds us that the Iranian Revolution in 1979 was accompanied by a tripling in oil price after it had quadrupled earlier in the decade.

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. July 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 a healthy level 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.

For the next twelve months we project natural gas and oil volume near the first quarter 2004 level with an increment for the Cortez acquisition announced in April, but not for the Overton acquisition announced since then. 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.

Encore Acquisition Company
Quarterly 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)	27.7	34.0	34.0	34.0	**32.5**	34.0	**34.0**
Oil (mbd)	17.70	18.50	18.50	18.50	**18.30**	18.50	**18.50**
Total (mb)	2,009	2,199	2,223	2,223	**8,655**	2,175	**8,821**
Total (mbd)	22.3	24.2	24.2	24.2	**23.7**	24.2	**24.2**
Price							
Henry Hub ($/mmbtu)	5.64	6.13	6.30	6.54	**6.15**	6.78	**6.44**
Differential ($/mmbtu)	0.38	0.57	0.58	0.60	**0.54**	0.60	**0.60**
EAC ($/mcf)	5.12	5.57	5.72	5.94	**5.61**	6.16	**5.84**
WTI Cushing ($/bbl)	35.23	38.61	38.47	37.61	**37.48**	36.34	**37.76**
Differential	2.72	2.98	2.97	2.90	**2.86**	2.90	**2.91**
EAC ($/bbl)	32.51	35.64	35.50	34.71	**34.62**	33.53	**34.85**
Total ($/bbl)	32.14	35.11	35.22	34.92	**34.40**	34.33	**34.90**
Revenue ($mm)							
Natural Gas	13	17	18	19	**66**	19	**73**
Oil	52	60	60	59	**231**	56	**235**
Other	(5)				**(5)**		
Total	59	77	78	78	**292**	75	**308**
Expense							
Lease operating	10	11	12	12	**45**	11	**46**
Production taxes	6	8	8	8	**29**	7	**30**
General and administrative	4	2	2	2	**11**	2	**9**
Total	20	21	22	22	**84**	21	**85**
Ebitda	40	56	57	56	**208**	54	**223**
Deprec., Deplet., & Amort.	9	11	12	12	**44**	11	**46**
Other Non Cash	1	10	10	10	**31**	10	**40**
Ebit	30	34	35	35	**134**	32	**137**
Interest	4	4	5	5	**17**	5	**18**
Ebt	26	31	30	30	**117**	28	**118**
Income Tax	9	11	11	10	**41**	10	**41**
Net Income ($mm)	17	20	20	19	**76**	18	**77**
Per Share ($)	0.55	0.65	0.64	0.63	**2.48**	0.59	**2.51**
Shares (millions)	31	31	31	31	**31**	31	**31**
Lease operating ($/bbl)	5.10	5.20	5.20	5.20	**5.18**	5.20	**5.20**
Production taxes (%rev)	9.0	9.8	9.8	9.8	**9.6**	9.8	**9.8**
General and admin ($/bbl)	1.84	1.05	1.05	1.05	**1.23**	1.05	**1.05**
Deprec., D,& A ($/bbl)	4.61	5.20	5.20	5.20	**5.06**	5.20	**5.20**
Ebitda Margin	67%	72%	72%	72%	**71%**	72%	**72%**
Tax rate	35%	35%	35%	35%	**35%**	35%	**35%**

The company actively hedges oil and gas price at levels that justify its capital program. That takes some of the sizzle out of current prospects while it also limits the downside risk. The company still should derive most of the long-term benefit from the higher price we expect. We use unhedged prices for our cash flow projection that becomes a comparative benchmark for valuation. We make an allowance for hedging losses in estimating earnings.

Assess Present Value Multiple Depending on 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.

The adjusted reserve life index is the sum of developed and half undeveloped reserves divided by next twelve months production. When we last did an industry-wide upward revaluation on March 23, we estimated cash flow multiple equal to 2.5 plus 0.5 times reserve life. That approximates present value assuming constant commodity price near the one-year quotes at that time, about $35 a barrel for crude oil. Higher commodity prices since then imply higher cash flow and lower multiple.

Encore's most important real asset is the Cedar Creek Anticline (CCA) property in the Williston Basin of Montana and the Dakota's acquired from **Royal Dutch/Shell (RD)**. The property accounts for most of the long life in the company's portfolio. Encore's adjusted reserve life index of 12.6 years compares to a median 9.4 years for about 70 producers in our coverage.

The Cedar Creek properties are on the crest of a long geological feature that created the giant old oil field. Though the field had more than three billion barrels of original oil in place the amount recovered so far is a low 12% or so. The global giant, Shell, apparently was willing to part with its premier position at a time when it may not have been sufficiently confident about the economics of future recovery under its conservative oil price forecast. Nor did the CCA seem important enough to RD to get the creative attention a competent small cap producer could give it. In any event, Encore appears to have made an astute purchase. A low percentage of oil recovered implies more potential for future activity.

Hot Air Injection Might Double Recoverable Reserves

Also known as an air flood, the tertiary recovery procedure involves compressing air at the surface and injecting it in the producing formation where the temperature is high enough to cause oil in contact with the oxygen in the air to ignite spontaneously. The expanding gases provide the energy to drive more oil to the surface as we understand it. The technique has been known for more than a decade and its application has become promising in specific instances.

Capital costs for the air injection are not particularly high at $2 to $3 a barrel, but the economics are sensitive to operating costs and it takes time for the project to deliver the increased oil. Federal tax credits for enhanced oil recovery help.

Ironically, low cost electricity generated from coal increases the attractiveness of the technique. Electricity runs the motors that run the compressors that inject the air. Environmentally, one might look carefully at how much coal would be burned relative to the amount of oil produced. The long-term availability of cheap coal generated electricity may be questionable. Yet a small amount of electrical energy can have a magnified impact in a large amount of energy released underground that drives a valuable commodity to the surface.

Encore Founder a Money-Maker for Small Cap Oil and Gas Investors

Mr. Brumley has a long, distinguished career spanning practically a full 35-year cycle of the stock market. He was the driving force as president of Southland Royalty when its stock multiplied in the 1970s, the founder of **San Juan Basin Royalty Trust (SJT)** in 1980, **Cross Timbers Royalty Trust (CRT)** in 1992 and **XTO Energy (XTO)** which first went public in 1993.

Mr. Brumley has a sharp eye for quality oil and gas assets and the patience to wait for a payoff. Southland Royalty's major asset was the mineral rights under the Waddell Ranch in West Texas. Mr. Brumley wasn't there in 1925 when Gulf Oil signed a 50 year lease paying an eighth royalty to Southland. Mr. Brumley was there in 1975 when the lease expired in Southland's favor giving Southland the full volume of the field while Gulf Oil challenged unsuccessfully the expiration of lease terms.

Redeploying his company's new financial strength, Mr. Brumley acquired an undervalued asset, Aztec Oil & Gas, which owned gas properties in the San Juan Basin. We thought Mr. Brumley overpaid when Southland acquired Aztec for a price in 1976 that was 88% higher than less than a year earlier on May 16, 1975. As he would do repeatedly, Mr. Brumley paid a little more to make what he thought was an exceptional purchase.

In November 1980, Southland spun off the Aztec natural gas properties as the San Juan Basin Royalty Trust and the Waddell oil properties in the Permian Basin Royalty Trust. Southland stock was a ten-bagger as it appreciated from a split-adjusted $2.8 on May 16, 1975 to $38 in December 1980 counting the value of the royalty trusts. A few years later Burlington Resources acquired the remaining Southland Royalty.

After oil peaked in price, the royalty trusts went on to deliver a higher return than most independent producers. That was probably in part because the cash flow was returned to the owners rather than being reinvested by managers who did not always make wise decisions. SJT appears to have delivered a ten-fold return in the 23 years since it was formed.

Out of a job after Southland was acquired, Mr. Brumley founded a private company that sought to acquire long life oil and gas producing assets with more potential than other buyers were willing to recognize. That company's first public effort was Cross Timbers Royalty Trust. The new entity packaged overriding royalty interests in San Juan Basin natural gas with some long life oil assets in West Texas and Oklahoma.

The private company then went public as Cross Timbers Oil Company. Renamed XTO Energy that company continues to be managed by long-time former colleagues. Both Cross Timbers Royalty Trust and its sponsor, XTO Energy, have been ten-baggers, returning at least ten times in ten years.

Now Mr. Brumley is back again with the descriptively named Encore Acquisition Company. Whether Encore will pay off for investors like Southland Royalty, San Juan Basin Royalty Trust, Cross Timbers Royalty Trust and XTO Energy, we cannot say. It seems like we have seen it before and we are inclined to think it might happen again with a little bit of luck.

Kurt H. Wulff, CFA

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 more than fully 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.

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