Rating: Buy
S&P 500: 1170

Encore Acquisition Company
Opportunity in Hedging Impact

Symbol	EAC	*Ebitda Next Twelve Months ending 12/31/05 (US$mm)*	288
Rating	Buy	*North American Natural Gas/Ebitda (%)*	26
Price ($/sh)	32.72	*Natural Gas and Oil Production/Ebitda (%)*	100
Pricing Date	11/19/04	*Adjusted Reserves/Production NTM*	11.9
Shares (mm)	33	*EV/Ebitda*	5.2
Market Capitalization ($mm)	1,070	*PV/Ebitda*	6.8
Debt ($mm)	430	*Undeveloped Reserves (%)*	24
Enterprise Value (EV) ($mm)	1,500	*Natural Gas and Oil Ebitda ($/boe)*	30.60
Present Value (PV) ($mm)	1,970	*Present Value Proven Reserves($/boe)*	12.00
Net Present Value ($/share)	47	*Present Value Proven Reserves($/mcfe)*	2.00
Debt/Present Value	0.22	*Earnings Next Twelve Months (US$/sh)*	3.27
McDep Ratio - EV/PV	0.76	*Price/Earnings Next Twelve Months*	10
Dividend Yield (%/year)	0.0	*Indicated Annual Dividend (US$/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)** as a small cap oil producer with long life production and unusual potential to expand reserves. The performance of the stock in recent weeks seems to reflect the 30% impact of hedging on reported net income for the latest quarter. Cash flow before hedging met our expectations. We continue to estimate net present value of $47 a share presuming a constant real oil price of $35 a barrel. The current average futures price for the next six years is about $41 a barrel. The company stands out at the low end of McDep Ratios for recommended stocks.

Concentrated on Long-Life Oil

Oil is the larger of just two functional distinctions (see table Functional Cash Flow and Present Value). After allocating cash flow on the basis of wellhead revenue we apply a cash flow multiple that depends mostly on reserve life. Despite a longer reported reserve life for natural gas, we apply a higher multiple to oil partly to recognize additional reserves not yet reported as proven.

Cedar Creek Anticline Yielding More Volume

Randy Limbacher, Chief Operating Officer of **Burlington Resources (BR)**, had enthusiastic comments about BR's activities on the Cedar Creek Anticline (CCA) near the Montana-North Dakota border. Mr. Limbacher expects BR to add about 2500 barrels daily of new production each quarter from the field. That is quite an indirect testimony to the attractiveness of Encore as the approximate 60% owner of the CCA. Ironically, the lease that BR holds was originally acquired by Southland Royalty when it was run by Mr. Jon Brumley, the founder of Encore. BR acquired Southland in an unfriendly takeover about 20 years ago.

Encore Acquisition Company
Functional Cash Flow and Present Value

	NTM Ebitda (US$mm)	*Adjusted R/P*	*PV/ Ebitda*	*Present Value (US$mm)*	
North American Natural Gas	76	12.6	6.6	500	25%
Oil	212	11.7	6.9	1,470	75%
	288	11.9	6.8	1,970	100%
Debt (US$mm)					430
Net Present Value (US$mm)					1,540
Shares (mm)					33
Net Present Value (US$/sh)					47

Encore's 108 million barrels (mmb) of proven reserves in the CCA account for two-thirds of corporate reserves. The essence of the opportunity in the stock is the potential increase in the recovery factor for CCA reserves. The upside is appealing because the 108 mmb reflects a recovery factor of only 19% of original oil in place (ooip).

Conventional upside, as Encore calls it, would add 42 mmb while taking recovery factor to 21%. The techniques primarily involve more efficient horizontal wells that include some water injectors for secondary recovery. That is the potential that BR seems to be tapping on their portion of the CCA.

Next Encore is tapping the Red River U4 formation with High Pressure Air Injection as a means of tertiary recovery. The RRU4 HPAI prospects have been proven on the portion of the CCA operated by private company, Continental Resources. RRU4 HPAI would add 68 mmb proven reserves to take recovery factor to 24%. A $76 million capital program to be completed over the next three years would develop some 27 mmb in the Pennel and Coral Creek units. About half of a $63 million capital investment has been spent to develop some 22 mmb in the Little Beaver unit.

Finally because Encore's acreage is on the crest of the CCA rather than on the flanks, it may have additional HPAI potential in zones that are now producing on the crest, but not on the flanks. Another 144 mmb of potential reserves outside the RRU4 would take recovery factor to 31% that is still modest compared to most successful oil fields.

Cash Flow Gains Appear Ahead

Commodity price drives further gains in cash flow in our model (see table Next Twelve Months Operating and Financial Estimates). The high rate of cash flow implies a low multiple of Enterprise Value to Ebitda near five times. The low multiple does not seem to reflect fully a reserve life near twelve years on our adjusted basis.

Cash flow could be greater if we included volume gains in our projections. Such gains appear likely. In any event a long reserve life offers protection against unexpected sharp decline.

Encore Acquisition Company
Next Twelve Months Operating and Financial Estimates

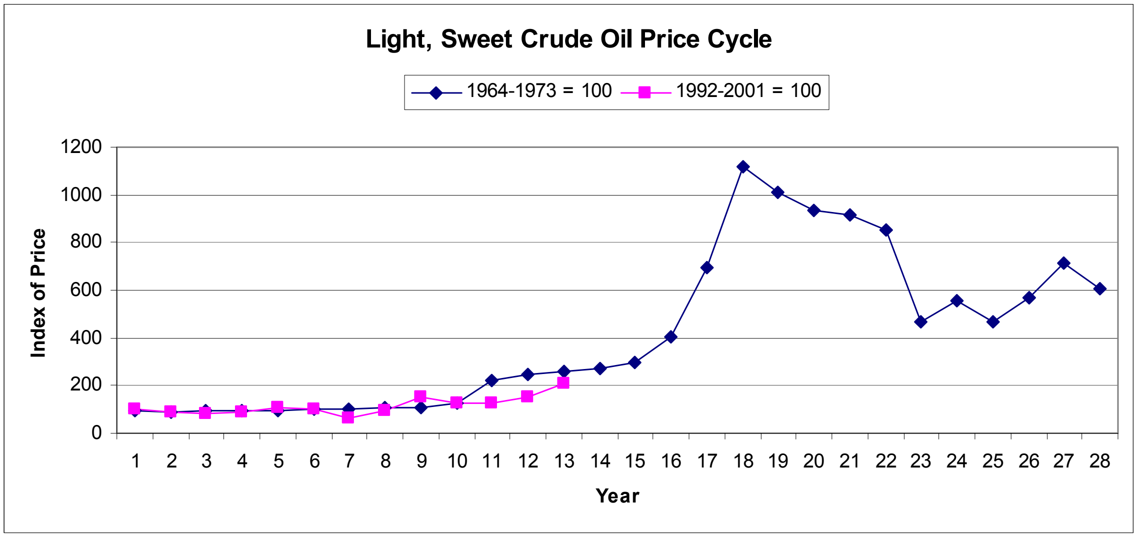
	Q1 3/31/04	*Q2 6/30/04*	*Q3 9/30/04*	*Q4E 12/31/04*	***Year 2004E***	*Q1E 3/31/05*	*Q2E 6/30/05*	*Q3E 9/30/05*	*Q4E 12/31/05*	***Next Twelve Months 12/31/05***
Volume										
Natural Gas (mmcfd)	27.7	35.3	44.2	44.2	**37.9**	44.2	44.2	44.2	44.2	**44.2**
Oil (mbd)	17.70	18.56	18.42	18.42	**18.28**	18.42	18.42	18.42	18.42	**18.42**
Total (mb)	2,009	2,223	2,372	2,372	**8,976**	2,320	2,346	2,372	2,372	**9,409**
Total (mbd)	22.3	24.4	25.8	25.8	**24.6**	25.8	25.8	25.8	25.8	**25.8**
Price										
Henry Hub ($/mmbtu)	5.64	6.10	5.75	6.82	**6.08**	7.77	6.69	6.70	7.00	**7.04**
Differential ($/mmbtu)	0.38	0.51	0.45	0.54	**0.45**	0.54	0.53	0.53	0.55	**0.56**
EAC ($/mcf)	5.12	5.59	5.30	6.29	**5.62**	7.16	6.16	6.17	6.45	**6.48**
WTI Cushing ($/bbl)	35.23	38.34	43.89	49.80	**41.81**	48.82	47.74	46.36	45.11	**47.01**
Differential	2.72	2.44	3.48	3.95	**3.05**	3.95	3.79	3.68	3.58	**3.74**
EAC ($/bbl)	32.51	35.90	40.41	45.84	**38.76**	44.95	43.95	42.68	41.53	**43.27**
Total ($/bbl)	32.14	35.33	37.95	43.52	**37.47**	44.37	41.96	41.07	40.72	**42.02**
Revenue ($mm)										
Natural Gas	13	18	22	26	**78**	28	25	25	26	**104**
Oil	52	61	68	78	**259**	75	74	72	70	**291**
Total	65	79	90	103	**336**	103	98	97	97	**395**
Expense										
Lease operating	10	11	13	13	**47**	13	13	13	13	**52**
Production taxes	6	7	8	10	**31**	10	10	10	9	**39**
General and administrative	4	4	4	4	**16**	4	4	4	4	**17**
Total	20	22	25	27	**94**	27	27	27	27	**107**
Ebitda	45	57	65	76	**243**	76	72	71	70	$\boxed{\textbf{288}}$
Exploration		2	0							
Deprec., Deplet., & Amort.	9	11	13	12	**46**	12	12	12	12	**49**
Hedging and other	6	10	13	18	**47**	15	12	11	11	**49**
Ebit	30	34	39	46	**148**	49	47	47	47	**190**
Interest	4	6	6	6	**23**	6	6	6	6	**26**
Ebt	26	28	32	39	**125**	43	41	41	40	**164**
Income Tax	9	10	11	14	**44**	15	14	14	14	**58**
Net Income ($mm)	17	18	21	26	**81**	28	26	27	26	**107**
Per Share ($)	0.55	0.58	0.64	0.78	**2.55**	0.85	0.80	0.82	0.80	**3.27**
Shares (millions)	31	31	33	33	**32**	33	33	33	33	**33**
Lease operating ($/bbl)	5.10	4.91	5.31	5.50	**5.21**	5.50	5.50	5.50	5.50	**5.50**
Production taxes (%rev)	9.0	9.1	9.0	9.8	**9.3**	9.8	9.8	9.8	9.8	**9.8**
General and admin ($/bbl)	1.84	1.63	1.78	1.78	**1.76**	1.82	1.80	1.78	1.78	**1.80**
Deprec., D,& A ($/bbl)	4.61	5.06	5.38	5.20	**5.08**	5.20	5.20	5.20	5.20	**5.20**
Ebitda Margin	69%	72%	72%	73%	**72%**	74%	73%	72%	72%	**73%**
Tax rate	35%	35%	35%	35%	**35%**	35%	35%	35%	35%	**35%**

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 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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