

Rating: Buy  
 S&P 500: 1154

## Encore Acquisition Company Momentum Test

<i>Symbol</i>	EAC	<i>Ebitda Next Twelve Months ending 3/31/06 (US\$m)</i>	298
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	27
<i>Price (\$/sh)</i>	34.47	<i>Natural Gas and Oil Production/Ebitda (%)</i>	100
<i>Pricing Date</i>	5/13/05	<i>Adjusted Reserves/Production NTM</i>	15.6
<i>Shares (mm)</i>	33	<i>EV/Ebitda</i>	5.2
<i>Market Capitalization (\$mm)</i>	1,120	<i>PV/Ebitda</i>	7.7
<i>Debt (\$mm)</i>	420	<i>Undeveloped Reserves (%)</i>	29
<i>Enterprise Value (EV) (\$mm)</i>	1,550	<i>Natural Gas and Oil Ebitda (\$/boe)</i>	31.40
<i>Present Value (PV) (\$mm)</i>	2,280	<i>Present Value Proven Reserves(\$/boe)</i>	13.20
<i>Net Present Value (\$/share)</i>	57	<i>Present Value Proven Reserves(\$/mcf)</i>	2.20
<i>Debt/Present Value</i>	0.19	<i>Earnings Next Twelve Months (US\$/sh)</i>	2.95
<i>McDep Ratio - EV/PV</i>	0.68	<i>Price/Earnings Next Twelve Months</i>	12
<i>Dividend Yield (%/year)</i>	0.0	<i>Indicated Annual Dividend (US\$/sh)</i>	0.00

Note: Estimated cash flow and earnings tied to one-year futures prices for oil and natural gas.

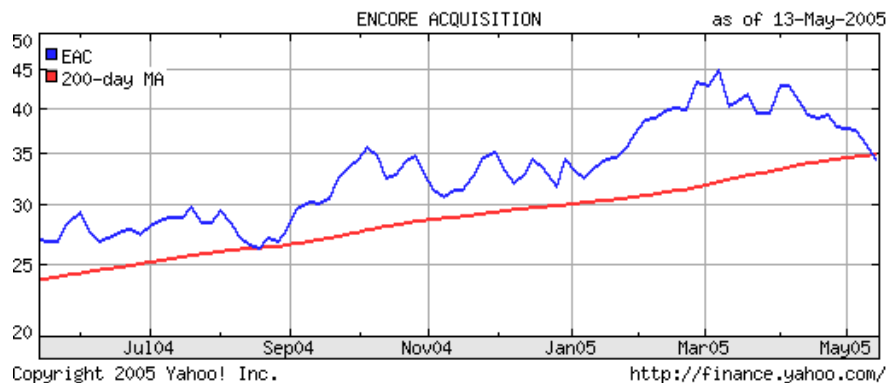
Reported results may vary widely from estimates. Estimated present value per share revised only infrequently.

### 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. After hitting a high above \$45 a share earlier this year, Encore has declined by about a quarter to its 200-day moving average. While that pattern is similar for peer companies, the average futures price for oil delivery over the next six years remains well above the 40-week average signaling a continuing uptrend for the industry. Though we pay attention to stock price momentum our buy recommendation is justified wholly on a fundamental basis. We see potential appreciation of 65% to our estimate of net present value.

### Stock Price Tests 200-Day Average

For most of the past three years Encore stock has been trading above its 200-day average, a favorable pattern that meets a popular definition of an upward trend. When the stock traded close to the 200-day average last fall it rebounded to a level comfortably above



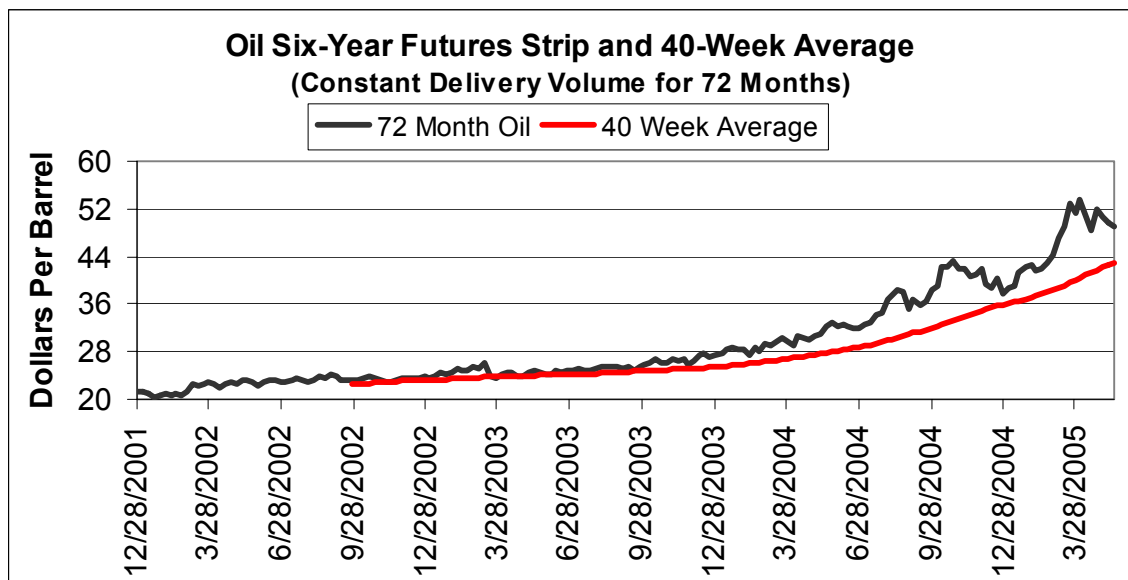
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the average. We are optimistic that will happen again now. Alternatively, the stock may trade around the 200-day average for awhile in a neutral pattern. The other possible outcome is that the stock trades below the moving average and stays there for awhile. In that case, momentum-conscious investors may direct their investment activity elsewhere temporarily.

### **Oil Price Points to Higher Stock Price**

Practically all of the resource value in Encore is sensitive to the international oil price. Estimated present value of \$57 a share presumes a long-term price of \$40 a barrel for light, sweet crude oil. Yet, Encore's enterprise value is only 0.68 times our standardized estimate as indicated by the McDep Ratio. Instead, Encore stock appears to be valued as though the long-term oil price would be just \$27 a barrel, one of the lowest indications among all our covered stocks.

Reading price from [www.nymex.com](http://www.nymex.com) on Friday, May 13, 2005, we calculate the current quote for oil to be delivered over the next 72 months at \$48.97 compared to the 40-week average of \$42.83 (see chart Oil Six-Year Futures Strip and 40-Week Average). The level is not only high compared to that embedded in Encore stock price, but also the trend is rising in a well-defined pattern. As a result the fundamental industry measure points to a higher price for Encore stock and a rising price trend.



### **High Pressure Air Injection Project Advancing**

Encore's current total proven reserves of 173 million barrels equivalent (mmbe) include 22 mmbe for three High Pressure Air Injection (HPAI) projects underway on the Cedar Creek Anticline (CCA) of Montana and North Dakota. The first project, a small pilot, Pennel and Coral Creek Phase I, has been successful in the middle of the long, narrow geologic structure. Injection started on the larger Little Beaver Phase I and Phase II project at the southern end of the anticline in early 2004. By late 2004 the oil production rate in the area started increasing in response to air injection. The third project, Pennel and Coral Creek Phase II is just beginning in the second quarter of 2005.

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The engineering work has been largely completed on 26 mmbe to be proven on three more projects to be started in 2006-2007, all in the central or southern part of the CCA. Engineering has begun on the seventh project, a small 1 mmbe pilot, North Pine Phase I at the northern end of the CCA.

When projects spread across the oil producing structure, with proven reserves of 49 mmbe, are all active, it becomes more certain that areas in-between are likely to be productive and could then be classified as proven reserves. Encore considers that up to an additional 174 mmbe could be proven.

### Value the Stock on Proven Reserves

While the visibility improves of a potential doubling of reserves with HPAI, our currently estimated present value corresponds only to proven reserves. The cash flow multiple implied by our estimate is in line with our correlation for some 30 producers, but gives only modest credit for a long life (see table Functional Cash Flow and Present Value). The company's natural gas properties may contribute more growth initially as it takes time for the high pressure air injection to contribute new oil production.

<b>Encore Acquisition Company</b>					
<b>Functional Cash Flow and Present Value</b>					
	<i>NTM Ebitda</i>	<i>Adjusted</i>	<i>PV/</i>	<i>Present</i>	
	<i>(US\$mm)</i>	<i>R/P</i>	<i>Ebitda</i>	<i>Value</i>	
				<i>(US\$mm)</i>	
North American Natural Gas	83	11.0	7.8	650	29%
Oil	220	17.3	7.4	1,630	71%
	303	15.4	7.5	2,280	100%
Debt (US\$mm)				420	
Net Present Value (US\$mm)				1,860	
Shares (mm)				33	
Net Present Value (US\$/sh)				57	

### Management Expects 10% Volume Growth in 2005

First quarter production in 2005 was on track to 10% growth for the year (see table Next Twelve Months Operating and Financial Estimates). Second quarter volumes may be reported at a lower level because of the complicated accounting rules for the net profits interest in the CCA held by MDU Resources. Apparently the SEC requires Encore to account for that interest on a cash basis as in royalty trust accounting. The distortions contribute distracting fluctuations in reported quarterly volume. We would recommend a different accounting technique, but management states that the Securities and Exchange Commission leaves no choice.

**Encore Acquisition Company**  
**Next Twelve Months Operating and Financial Estimates**

	<i>Q3</i>	<i>Q4</i>	<i>Year</i>	<i>Q1</i>	<i>Q2E</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Next Twelve Months</i>
	<i>9/30/04</i>	<i>12/31/04</i>	<i>2004</i>	<i>3/31/05</i>	<i>6/30/05</i>	<i>9/30/05</i>	<i>12/31/05</i>	<i>2005E</i>	<i>3/31/06</i>	<i>3/31/06</i>
<b>Volume</b>										
Natural Gas (mmcf)	44.2	46.7	<b>38.5</b>	49.5	47.0	48.0	49.0	<b>48.4</b>	50.0	<b>48.5</b>
Oil (mbd)	18.42	18.32	<b>18.25</b>	18.97	18.17	18.30	18.40	<b>18.46</b>	18.50	<b>18.34</b>
Total (mbd)	25.8	26.1	<b>24.7</b>	27.2	26.0	26.3	26.6	<b>26.5</b>	26.8	<b>26.4</b>
<b>Price</b>										
Henry Hub (\$/mmbtu)	5.75	7.10	<b>6.15</b>	6.27	6.89	6.68	7.24	<b>6.77</b>	7.92	<b>7.18</b>
Differential (\$/mmbtu)	0.45	0.41	<b>0.39</b>	0.41	0.55	0.53	0.57	<b>0.54</b>	0.57	<b>0.56</b>
EAC (\$/mcf)	5.30	6.69	<b>5.76</b>	5.77	6.34	6.15	6.67	<b>6.23</b>	7.29	<b>6.62</b>
WTI Cushing (\$/bbl)	43.89	48.31	<b>41.44</b>	49.65	50.46	50.95	51.88	<b>50.74</b>	51.81	<b>51.27</b>
Differential	3.48	4.46	<b>3.19</b>	4.46	4.72	4.76	4.85	<b>4.74</b>	4.85	<b>4.79</b>
EAC (\$/bbl)	40.41	43.85	<b>38.25</b>	45.01	45.75	46.19	47.03	<b>45.99</b>	46.97	<b>46.49</b>
Total (\$/bbl)	37.95	42.74	<b>37.29</b>	41.86	43.43	43.36	44.87	<b>43.38</b>	45.96	<b>44.41</b>
<b>Revenue (\$mm)</b>										
Natural Gas	22	29	<b>81</b>	26	27	27	30	<b>110</b>	33	<b>117</b>
Oil	68	74	<b>255</b>	77	76	78	80	<b>310</b>	78	<b>311</b>
Total	90	103	<b>336</b>	103	103	105	110	<b>420</b>	111	<b>428</b>
<b>Expense</b>										
Lease operating	13	13	<b>47</b>	15	15	16	16	<b>62</b>	16	<b>63</b>
Production taxes	8	9	<b>30</b>	9	9	9	10	<b>38</b>	10	<b>39</b>
General and administrative	4	5	<b>17</b>	6	6	6	6	<b>24</b>	6	<b>24</b>
Total	25	28	<b>94</b>	30	31	31	32	<b>124</b>	32	<b>125</b>
<b>Ebitda</b>	65	75	<b>242</b>	73	72	74	78	<b>296</b>	79	<b>303</b>
Exploration	0	2	<b>4</b>	3	3	3	3	<b>10</b>	3	<b>10</b>
Deprec., Deplet., & Amort.	13	15	<b>49</b>	17	17	17	17	<b>67</b>	17	<b>68</b>
Hedging and other	13	11	<b>39</b>	13	14	12	13	<b>52</b>	16	<b>56</b>
<b>Ebit</b>	39	47	<b>150</b>	40	42	45	47	<b>174</b>	46	<b>180</b>
Interest	6	7	<b>23</b>	7	8	8	8	<b>31</b>	8	<b>32</b>
<b>Ebt</b>	32	40	<b>126</b>	33	34	37	39	<b>143</b>	38	<b>148</b>
Income Tax	11	14	<b>44</b>	12	12	13	14	<b>50</b>	13	<b>52</b>
<b>Net Income (\$mm)</b>	21	26	<b>82</b>	22	22	24	26	<b>93</b>	25	<b>96</b>
Per Share (\$)	0.64	0.80	<b>2.57</b>	0.66	0.66	0.73	0.79	<b>2.84</b>	0.76	<b>2.94</b>
<b>Shares (millions)</b>	33	33	<b>32</b>	33	33	33	33	<b>33</b>	33	<b>33</b>
Lease operating (\$/bbl)	5.31	5.58	<b>5.24</b>	6.07	6.50	6.50	6.50	<b>6.39</b>	6.50	<b>6.50</b>
Production taxes (%rev)	9.0	9.0	<b>9.0</b>	8.9	9.0	9.0	9.0	<b>9.0</b>	9.0	<b>9.0</b>
General and admin (\$/bbl)	1.78	2.20	<b>1.87</b>	2.45	2.54	2.48	2.46	<b>2.48</b>	2.49	<b>2.49</b>
Deprec., D.& A (\$/bbl)	5.38	6.36	<b>5.39</b>	6.81	7.00	7.00	7.00	<b>6.95</b>	7.00	<b>7.00</b>
Ebitda Margin	72%	73%	<b>72%</b>	71%	70%	70%	71%	<b>71%</b>	71%	<b>71%</b>
Tax rate	35%	35%	<b>35%</b>	35%	35%	35%	35%	<b>35%</b>	35%	<b>35%</b>

**Ten-Bagger Brumley**

Mr. Jon Brumley, the founder of Encore, has a long, distinguished career guiding or creating five successful public oil and gas stocks before founding his latest venture. He was the driving force as president of Southland Royalty when its stock delivered a total return of 12.6 times, or 48% per year for five years from May 16, 1975 through December 1980. That exceeds a ten-bagger that multiplies ten times within ten years.

The man founded two royalty trusts that also qualified as ten baggers, **San Juan Basin Royalty Trust (SJT)** in 1980 and **Cross Timbers Royalty Trust (CRT)** in 1992. Moreover, royalty trust returns are lower risk because the trusts have no debt. Investors also did well in **Permian Basin Royalty Trust (PBT)** spun off to Southland Royalty shareholders in 1980 along with SJT. Finally, Mr. Brumley founded the predecessor company to **XTO Energy (XTO)** where former colleagues from Southland Royalty have achieved their own ten-bagger status.

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## Buy Oil and Gas Producers at Mid Decade

Stock prices for Encore and its peers have receded from recent highs to levels that correspond to low McDep Ratios (see table [Rank by McDep Ratio](#)). Meanwhile the multi-fold gain potential we have described for oil and gas price over the next 4 to 12 years is still there.

### Rank by McDep Ratio: Market Cap and Debt to Present Value

	<i>Symbol/ Rating</i>		<i>Price (\$/sh) 13-May 2005</i>	<i>Shares (mm)</i>	<i>Market Cap (\$mm)</i>	<i>Net Present Value (\$/sh)</i>	<i>Debt/ Present Value</i>	<i>McDep Ratio</i>
<b>Independent Natural Gas and Oil - Small Cap</b>								
Berry Petroleum Company	BRY	B	42.41	22	950	50.00	0.12	0.86
Energy Partners Ltd.	EPL	B	20.61	39	810	30.00	0.20	0.75
Cimarex Energy Company	XEC	B	34.58	81	2,790	50.00	0.15	0.74
Encore Acquisition Company	EAC	B	34.47	33	1,120	57.00	0.19	0.68
	<i>Total or Median</i>				5,700		0.17	0.74

Kurt H. Wulff, CFA

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