



# Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

May 14, 2010

## **Euroworries and the Appeal of Income and Small Cap**

### **Summary and Recommendation**

Five small cap natural gas buy recommendations **Hugoton Royalty Trust (HGT)**, **Dorchester Minerals (DMLP)**, **San Juan Basin Royalty Trust (SJT)**, **Birchcliff Energy (BIR.TO)** and **Cimarex Energy (XEC)** may appeal to investors seeking to protect against the declining value of the Euro in the face of government debt failures. Income and small cap oil and gas stock prices have advanced along with gold while the euro has declined. We believe in oil and gas as real assets whose nominal value should adjust upward as currencies inevitably lose purchasing power. Yet, our main investment case remains that energy is a growth investment because it is essential to the economic progress that nearly all strive to achieve.

Other background factors besides Euro debt problems include the economic recovery underway to which small cap stocks generally may be more sensitive. Also, higher spill risk in deep water oil, mainly under development by large cap companies, makes all other energy sources more valuable. Finally, there may be a turn in natural gas pricing ahead that reverses the long decline of the past few years. In the context of the trillions of dollars of government funds essentially wasted in order to avoid economic collapse, it would not take much in trading funds to have an impact on the clean fuel languishing at a third the price of oil.

Small cap and income stocks can more directly reflect resource value. The discipline of takeover potential works more readily than on the largest companies. Income distributions may give investors a quicker, tangible response to change in resource value.

Whatever the explanation, income and small cap stocks have opened a modest valuation premium to large cap. In an advancing market that premium could widen further just as it could shrink in a declining market. We resolve that uncertainty by recommending that investors have a sixth of oil and gas investment in the group, not counting the largest income stock. For weighting purposes, we count income stock **Canadian Oil Sands Trust (COSWF)** in the large cap Canadian group, covered separately in *Meter Reader*, where we would also have a sixth of oil and gas investment.

McDep Ratios near 1.0 suggest that valuation is in line with oil and gas values. Those resource values are likely to rise over time. Oil is already ahead of our long-term price assumption for estimating McDep Ratios. Natural gas is behind, but its appreciation potential may be stronger than that for oil.



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Our five natural gas buy recommendations, three income stocks and two growth stocks, trade at a median McDep Ratio of 0.95. The three income buys trade at a median distribution yield of 6.8% for the next twelve months (see Tables 1-3). Considering liquidity and trading limitations, investors may supplement recommended stocks by income or capital gain, top line or bottom line, oil or gas, debt or no, hedging or no, and value.

Meanwhile, like most of the stocks, average futures price for oil for the next six years at \$89 a barrel is above its 40-week average of \$86. Natural gas for the next six-years at \$6.26 a million Btu is below its 40-week average of \$6.47. We believe the prospects are favorable for the natural gas trend to turn up before next winter.

Kurt H. Wulff, CFA



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	Symbol/Rating	Price (US\$/sh)	EV/ Market	Enterprise Value (\$mm)	Present Value by Segment (%)		Dist. NTM (\$/un)	Dist. Yield (%)	McDep Ratio
					N.Amer. Natural Gas	Oil Prod'n			
	B = Buy CB (see below)	13-May 2010	Cap						
<b>Canadian Income Trusts (US\$)</b>									
Penn West Energy Trust	PWE	19.76	1.48	12,300	23	78	1.73	8.7	1.03
Pengrowth Energy Trust	PGH	10.31	1.48	4,400	38	62	0.81	7.8	0.96
Peyto Energy Trust	PEYUF	13.53	1.20	1,960	79	21	1.38	10.2	0.92
Enerplus Resources Fund	ERF	23.14	1.22	5,000	42	58	2.07	9.0	0.80
Canadian Oil Sands Trust	COSWF B	28.34	1.10	15,100		100	1.92	6.8	0.76
<i>Total or Median</i>				38,800					0.92
<b>Small Cap Independent Producers</b>									
Range Resources	RRC	48.79	1.26	8,850	71	29	0.12	0.3	1.19
Petro-Hawk	HK	20.31	1.53	9,390	97	3	-	-	1.16
Berry Petroleum Company	BRY	33.58	1.62	2,780	30	70	0.30	0.9	0.97
Cimarex Energy Company	XEC B	71.95	1.10	6,760	66	34	0.32	0.4	0.96
Ultra Petroleum	UPL	46.97	1.16	8,320	90	10	-	-	0.94
Whiting Petroleum Corporation	WLL	85.67	1.24	5,810	13	87	-	-	0.86
Birchcliff Energy Ltd. (US\$)	BIREF B	9.28	1.21	1,430	66	34	-	-	0.71
<i>Total or Median</i>				41,900					0.97
<b>Top Line Cash Payers</b>									
Sabine Royalty Trust	SBR	51.57	1.00	750	39	61	3.53	6.8	1.15
Cross Timbers Royalty Trust	CRT	38.85	1.00	230	78	22	2.67	6.9	1.14
Permian Basin RT	PBT	18.60	1.00	870	27	73	1.28	6.9	1.03
Dorchester Minerals, L.P.	DMLP B	26.68	1.02	810	67	33	1.80	6.8	0.99
Freehold Royalty Trust (US\$)	FRHLF	16.72	1.08	1,060	29	71	1.65	9.9	0.98
<i>Total or Median</i>				3,700					1.03
<b>Bottom Line Cash Payers</b>									
Linn Energy, LLC	LINE	25.38	1.47	5,360	45	55	2.52	9.9	1.13
Legacy Reserves L.P.	LGCY	23.00	1.38	1,250	16	84	2.08	9.0	1.10
Mesa Royalty Trust	MTR	52.00	1.00	97	75	25	3.36	6.5	1.08
San Juan Basin Royalty Trust	SJT B	23.83	1.00	1,110	100	-	1.48	6.2	1.04
Encore Energy Partners, L.P. (52%)	ENP	17.63	1.33	550	23	77	2.11	12.0	1.03
Hugoton Royalty Trust	HGT B	19.70	1.00	790	90	10	1.57	8.0	0.94
<i>Total or Median</i>				9,200					1.06
<b>Composite (excl COSWF)</b>									
<i>Enterprise Value Weighting</i>				79,900	55	45			1.00
<i>Equal Weighting</i>					55	45			1.01
<i>Equal Weighted Buys</i>					65	35			0.98

CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses.

Present Value presumes long-term prices of \$75 a barrel for oil and \$8 a million btu for natural gas.

Dist. = Income distribution. NTM = Next Twelve Months Ended March 31, 2011. Enterprise Value = Market Cap and Debt.



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<b>McDep Income and Small Cap Energy Portfolio</b>								
<b>Net Present Value and McDep Ratio</b>								
			<i>Price</i>			<i>Net</i>		
	<i>Symbol/</i>		<i>(\$/sh)</i>	<i>Shares</i>	<i>Market</i>	<i>Present</i>	<i>Debt/</i>	
	<i>Rating</i>	<i>13-May</i>	<i>2010</i>	<i>(mm)</i>	<i>Cap</i>	<i>Value</i>	<i>Present</i>	
					<i>(\$mm)</i>	<i>(\$/un)</i>	<i>Value</i>	
							<i>McDep</i>	
							<i>Ratio</i>	
<b>Canadian Income Trusts (US\$)</b>								
Penn West Energy Trust	PWE		19.76	420.7	8,310	19.00	0.33	1.03
Pengrowth Energy Trust	PGH		10.31	290.0	2,990	11.00	0.31	0.96
Peyto Energy Trust	PEYUF		13.53	120.5	1,630	15.00	0.15	0.92
Enerplus Resources Fund	ERF		23.14	177.0	4,100	30.00	0.14	0.80
Canadian Oil Sands Trust	COSWF	B	28.34	484.0	13,720	38.00	0.07	0.76
<i>Total or Median</i>					<i>30,800</i>		<i>0.15</i>	<i>0.92</i>
<b>Small Cap Independent Producers</b>								
Range Resources	RRC		48.79	160.0	7,020	35.00	0.25	1.19
Petro-Hawk	HK		20.31	303.0	6,140	16.00	0.40	1.16
Berry Petroleum Company	BRY		33.58	51.0	1,710	35.00	0.37	0.97
Cimarex Energy Company	XEC	B	71.95	85.4	6,140	75.00	0.09	0.96
Ultra Petroleum	UPL		46.97	154.0	7,160	50.00	0.13	0.94
Whiting Petroleum Corporation	WLL		85.67	59.2	4,680	95.00	0.17	0.86
Birchcliff Energy Ltd. (US\$)	BIREF	B	9.28	127.0	1,180	14.00	0.12	0.71
<i>Total or Median</i>					<i>34,030</i>		<i>0.17</i>	<i>0.96</i>
<b>Top Line Cash Payers</b>								
Sabine Royalty Trust	SBR		51.57	14.6	750	45.00	-	1.15
Cross Timbers Royalty Trust	CRT		38.85	6.0	230	34.00	-	1.14
Permian Basin RT	PBT		18.60	46.6	870	18.00	-	1.03
Dorchester Minerals, L.P.	DMLP	B	26.68	29.8	800	27.00	0.02	0.99
Freehold Royalty Trust (US\$)	FRHLF		16.72	58.4	980	17.00	0.08	0.98
<i>Total or Median</i>					<i>3,630</i>			<i>1.03</i>
<b>Bottom Line Cash Payers</b>								
Linn Energy, LLC	LINE		25.38	144.0	3,660	21.00	0.36	1.13
Legacy Reserves L.P.	LGCY		23.00	39.2	900	20.00	0.31	1.10
Mesa Royalty Trust	MTR		52.00	1.9	97	48.00	-	1.08
San Juan Basin Royalty Trust	SJT	B	23.83	46.6	1,110	23.00	-	1.04
Encore Energy Partners, L.P. (52%)	ENP		17.63	23.4	410	17.00	0.26	1.03
Hugoton Royalty Trust	HGT	B	19.70	40.0	790	21.00	-	0.94
<i>Total or Median</i>					<i>6,970</i>			<i>1.06</i>

B=Buy; CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

Present Value presumes long-term prices of \$75 a barrel for oil and \$8 a million btu for natural gas.



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**Table 3**

## McDep Income and Small Cap Energy Portfolio Value Multiples - Rank by EV/Ebitda

			<i>Price</i>		<i>Adjstd</i>			
			<i>(\$/sh)</i>	<i>Revenue</i>	<i>Dist/</i>	<i>Resrvs/</i>	<i>PV/</i>	
	<i>Symbol/</i>		<i>13-May</i>	<i>Royalty</i>	<i>Equity</i>	<i>Prod</i>	<i>Ebitda</i>	
	<i>Rating</i>		<i>2010</i>	<i>(%)</i>	<i>Ebitda</i>	<i>NTM</i>	<i>NTM</i>	
							<i>EV/</i>	
							<i>Ebitda</i>	
							<i>NTM</i>	
<b>Canadian Income Trusts (US\$)</b>								
Peyto Energy Trust	PEYUF		13.53		1.18	25.0	12.8	11.7
Canadian Oil Sands Trust	COSWF	B	28.34		0.58	31.4	11.6	8.8
Penn West Energy Trust	PWE		19.76		0.74	9.9	8.1	8.3
Pengrowth Energy Trust	PGH		10.31		0.61	9.7	8.4	8.0
Enerplus Resources Fund	ERF		23.14		0.60	9.7	8.6	7.0
	<i>Median</i>					9.9	8.6	8.3
<b>Small Cap Independent Producers</b>								
Range Resources	RRC		48.79		-	13.3	11.4	13.6
Petro-Hawk	HK		20.31		-	8.0	10.8	12.6
Ultra Petroleum	UPL		46.97		-	14.1	12.8	12.1
Birchcliff Energy Ltd. (US\$)	BIREF	B	9.28		-	23.6	16.0	11.3
Berry Petroleum Company	BRY		33.58		-	13.2	7.8	7.6
Whiting Petroleum Corporation	WLL		85.67		-	10.3	7.0	6.0
Cimarex Energy Company	XEC	B	71.95		-	6.4	6.0	5.8
	<i>Median</i>					13.2	10.8	11.3
<b>Top Line Cash Payers</b>								
Sabine Royalty Trust	SBR		51.57	100	1.00	9.2	12.8	14.6
Cross Timbers Royalty Trust	CRT		38.85	84	0.96	13.4	12.3	14.0
Dorchester Minerals, L.P.	DMLP	B	26.68	64	0.94	7.5	14.0	13.8
Permian Basin RT	PBT		18.60	32	0.90	13.1	12.7	13.1
Freehold Royalty Trust (US\$)	FRHLF		16.72	71	0.85	8.6	8.8	8.6
	<i>Median</i>					9.2	12.7	13.8
<b>Bottom Line Cash Payers</b>								
Linn Energy, LLC	LINE		25.38		1.56	20.3	13.0	14.7
Mesa RoyaltyTrust	MTR		52.00		0.91	9.1	13.0	14.1
San Juan Basin Royalty Trust	SJT	B	23.83		0.80	14.0	12.4	12.9
Hugoton RoyaltyTrust	HGT	B	19.70		0.90	12.3	12.1	11.3
Legacy Reserves L.P.	LGCY		23.00		0.87	12.0	8.4	9.2
Encore Energy Partners, L.P.	ENP		17.63		1.11	12.8	9.0	9.2
	<i>Median</i>					12.5	12.2	12.1

B=Buy; CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.  
 EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation  
 and amortization; NTM = Next Twelve Months Ended March 31, 2011; P/E = Stock Price to  
 Earnings; PV = Present Value of oil and gas and other businesses  
 Top Line Cash Payers defined as those having Revenue Royalty (see fifth column from right).



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