



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

May 1, 2009

The Natural Gas Contrarian

Summary and Recommendation

Only a diehard contrarian could be interested in natural gas with the near-month futures price down 74% from the 52-week high and a supply glut as far as the eye can see, some might say. Pure play, no-debt, no-hedge, buy-recommended **Hugoton Royalty Trust (HGT)** is down 71% from its high stock price and trades at 58% of its 200-day average in a sure indication of a downtrend, at least looking backwards. It is also trading up 52% from its low price and has 150% appreciation potential to a McDep Ratio of 1.0. With a little patience, investors can make money in the stock again, we believe.

Thumbnail of Natural Gas Industry Dynamics

On the upside we have to work through the current surplus either with reduced supply or increased demand. Investment in new supply is drying up and will eventually be zero if price stays low. Without new supply, old supply declines. If it doesn't decline enough this year, it will by next year or whatever it takes. On demand, we believe in economic growth. Economic growth requires energy. No new coal or nuclear plants are likely to be built in this country for a while. Even if you are more optimistic on coal and nuclear, it will be very expensive and take a long time. Conventional oil has essentially peaked. Alternative energy is vastly overrated and in the end won't be cheap or quick either. Looked at another way, alternative energy needs higher natural gas price more than natural gas does.

Much of the decline in industrial demand is inventory related. Once inventories are drawn down, chemical plants start running more again and use more natural gas.

LNG may be available cheap for the next few months, but the total amounts are small, like a few percent of world natural gas supply. Moreover, liquefaction plants are hugely expensive and no new ones will be built at today's LNG price.

Storage of natural gas is a seasonal issue. Once storage is full in November, it doesn't get fuller than full and the contribution storage can make to winter supply is finite. Then pricing depends on weather and domestic production as well as industrial activity. By next winter, domestic supply will likely be declining and can be increased again only after a time lag.

Meanwhile, new shale gas supply potential is indeed impressive. It is also given to exaggeration. To get the supply requires an equally massive drilling effort. Whenever we undertake large scale expansion of a new energy source as we did with nuclear power in the 1970s, oil sands in the 2000s, LNG in the 2000s, prices rise far above the early economics used to get the trend started. It is good to have a promising new supply source because that adds political justification for higher prices on existing supply.

Kurt H. Wulff, CFA



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Table 1										
McDep Income and Small Cap Energy Portfolio										
Debt, Business Segments and Income Yield										
						Present Value by Segment (%)				
	Symbol/Rating	Price (US\$/sh)	EV/ Market	Enterprise Value (\$mm)	NAmer. Natural Gas	Oil Prod'n	Dist. NTM (\$/un)	Dist. Yield (%)	McDep Ratio	
	B = Buy H = Hold	1-May 2009	Cap							
Canadian Income Trusts (US\$)										
Freehold Royalty Trust	FRHLF		10.05	1.27	630	29	71	1.01	10.1	0.62
Penn West Energy Trust	PWE	H	11.29	1.80	8,300	29	71	1.52	13.5	0.60
Pengrowth Energy Trust	PGH		6.78	1.98	3,400	40	60	1.01	14.9	0.59
Peyto Energy Trust	PEYUF		7.87	1.48	1,230	79	21	1.22	15.5	0.59
Canadian Oil Sands Trust	COSWF	B	22.00	1.11	11,800		100	0.50	2.3	0.55
Enerplus Resources Fund	ERF		19.99	1.25	4,100	46	54	1.82	9.1	0.51
<i>Total or Median</i>					29,500					
Small Cap Independent Producers										
Encore Acquisition Company	EAC	H	30.29	1.70	2,740	23	77	-	-	0.79
Berry Petroleum Company	BRY	H	16.58	2.30	1,710	38	62	0.30	1.8	0.62
Birchcliff Energy Ltd. (US\$)	BIREF		5.32	1.35	880	72	28	-	-	0.61
Cimarex Energy Company	XEC	B	28.26	1.37	3,210	66	34	0.24	0.8	0.59
<i>Total or Median</i>					8,540					
U.S. Royalty Trusts										
Cross Timbers Royalty Trust	CRT		21.84	1.00	130	69	31	1.41	6.4	0.68
Sabine Royalty Trust	SBR		37.33	1.00	540	43	57	2.29	6.1	0.62
San Juan Basin Royalty Trust	SJT	H	15.00	1.00	700	100	-	0.71	4.8	0.58
Permian Basin RT	PBT		9.20	1.00	430	33	67	0.69	7.6	0.48
Mesa RoyaltyTrust	MTR		27.30	1.00	50	75	25	2.79	10.2	0.41
Hugoton RoyaltyTrust	HGT	B	11.10	1.00	440	91	9	0.59	5.3	0.40
<i>Total or Median</i>					2,290					
U.S. Master Limited Partnerships (MLPs)										
Linn Energy, LLC	LINE		16.98	1.90	3,680	48	52	2.52	14.8	1.10
Encore Energy Partners, L.P. (3	ENP		17.00	1.27	230	24	76	2.00	11.8	1.00
Dorchester Minerals, L.P.	DMLP		17.70	1.00	500	51	49	1.38	7.8	0.55
<i>Total or Median</i>					4,410					
Composite (excl COSWF)										
<i>Enterprise Value Weighting</i>					36,000	45	55			0.65
<i>Equal Weighting</i>						53	47			0.66
<i>Equal Weighted Buys</i>						69	31			0.49
* Percentages in Symbol column refer to current market Enterprise Value weightings; Rating column, equal weightings.										
* Percentages in Price column refer to equal weighted buys.										



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Table 2								
Oil and Gas Income and Small Cap Stocks								
Net Present Value and McDep Ratio								
			Price (\$/sh)		Market Cap (\$mm)	Net Present Value (\$/un)	Debt/ Present Value	McDep Ratio
	Symbol/ Rating		1-May 2009	Shares (mm)				
Canadian Income Trusts (US\$)								
Freehold Royalty Trust	FRHLF		10.05	49.5	500	18.00	0.13	0.62
Penn West Energy Trust	PWE	H	11.29	410.0	4,630	25.00	0.26	0.60
Pengrowth Energy Trust	PGH		6.78	255.5	1,730	16.00	0.29	0.59
Peyto Energy Trust	PEYUF		7.87	105.9	830	16.00	0.19	0.59
Canadian Oil Sands Trust	COSWF	B	22.00	482.2	10,610	42.00	0.05	0.55
Enerplus Resources Fund	ERF		19.99	165.3	3,300	44.00	0.10	0.51
<i>Total or Median</i>					21,600		0.16	0.59
Small Cap Independent Producers								
Encore Acquisition Company	EAC	H	30.29	53.3	1,610	44.00	0.33	0.79
Berry Petroleum Company	BRY	H	16.58	44.6	740	40.00	0.35	0.62
Birchcliff Energy Ltd. (US\$)	BIREF		5.32	122.0	650	10.00	0.16	0.61
Cimarex Energy Company	XEC	B	28.26	83.2	2,350	55.00	0.16	0.59
<i>Total or Median</i>					5,350		0.24	0.61
U.S. Royalty Trusts								
Cross Timbers Royalty Trust	CRT		21.84	6.0	130	32.00	-	0.68
Sabine Royalty Trust	SBR		37.33	14.6	540	60.00	-	0.62
San Juan Basin Royalty Trust	SJT	H	15.00	46.6	700	26.00	-	0.58
Permian Basin RT	PBT		9.20	46.6	430	19.00	-	0.48
Mesa Royalty Trust	MTR		27.30	1.9	50	67.00	-	0.41
Hugoton Royalty Trust	HGT	B	11.10	40.0	440	28.00	-	0.40
<i>Total or Median</i>					2,290			0.53
U.S. Master Limited Partnerships (MLPs)								
Linn Energy, LLC	LINE		16.98	114.0	1,940	14.00	0.52	1.10
Encore Energy Partners, L.P. (32%)	ENP		17.00	10.6	180	17.00	0.21	1.00
Dorchester Minerals, L.P.	DMLP		17.70	28.2	500	32.00	-	0.55
<i>Total or Median</i>					2,620		0.21	1.00
B = Buy, H = Hold								
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 \$10 a million btu for natural gas.								



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Table 3								
Oil and Gas Income and Small Cap Stocks								
Value Multiples - Rank by EV/Ebitda								
			Price (\$/sh)	Revenue	Dist/ Equity	Adjstd Resrvs/ Prod	PV/ Ebitda	EV/ Ebitda
	Symbol/ Rating		1-May 2009	Royalty (%)	Ebitda	NTM	NTM	NTM
Canadian Income Trusts (US\$)								
	COSWF	B	22.00		0.27	23.2	23.1	12.7
	PEYUF		7.87		1.37	16.7	18.1	10.6
	PGH		6.78		0.99	7.8	15.6	9.2
	FRHLF		10.05	71	0.72	6.1	12.7	7.8
	PWE	H	11.29		0.77	8.2	12.7	7.6
	ERF		19.99		0.57	8.9	13.8	7.0
	<i>Median</i>					8.5	14.7	8.5
Small Cap Independent Producers								
	BIREF		5.32		-	9.5	22.1	13.4
	EAC	H	30.29		-	11.5	12.6	9.9
	BRY	H	16.58		-	11.3	14.7	9.1
	XEC	B	28.26		-	7.3	10.4	6.2
	<i>Median</i>					10.4	13.6	9.5
U.S. Royalty Trusts								
	SBR		37.33	100	1.00	9.8	26.2	16.3
	CRT		21.84	84	0.92	12.5	20.8	14.2
	SJT	H	15.00		0.67	9.1	24.2	14.0
	PBT		9.20	32	0.83	10.4	22.7	11.0
	HGT	B	11.10		0.53	12.7	25.0	9.9
	MTR		27.30		0.87	13.5	20.9	8.5
	<i>Median</i>					11.5	23.4	12.5
U.S. Master Limited Partnerships (MLPs)								
	LINE		16.98		5.37	17.7	29.8	32.9
	ENP		17.00		1.86	11.4	15.8	15.8
	DMLP		17.70	64	0.94	7.9	21.8	12.1
	<i>Median</i>					11.4	21.8	15.8
EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended March 31, 2010; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses								



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