

Rating: Buy
S&P 500: 1192

Unocal Corporation

Raise Net Present Value to \$65 a Share

<i>Symbol</i>	UCL	<i>Ebitda Next Twelve Months ending 3/31/06 (US\$mm)</i>	3,900
<i>Rating</i>	Buy	<i>North American Natural Gas/Ebitda (%)</i>	22
<i>Price (US\$/sh)</i>	49.41	<i>Natural Gas and Oil Production/Ebitda (%)</i>	100
<i>Pricing Date</i>	2/9/05	<i>Adjusted Reserves/Production NTM</i>	8.5
<i>Shares (mm)</i>	271	<i>EV/Ebitda</i>	4.6
<i>Market Capitalization (US\$mm)</i>	13,400	<i>PV/Ebitda</i>	5.7
<i>Debt (US\$mm)</i>	4,700	<i>Undeveloped Reserves (%)</i>	50
<i>Enterprise Value (EV) (US\$mm)</i>	18,100	<i>Natural Gas and Oil Ebitda (US\$/boe)</i>	25.00
<i>Present Value (PV) (US\$mm)</i>	22,400	<i>Present Value Proven Reserves(US\$/boe)</i>	12.70
<i>Net Present Value (US\$/share)</i>	65	<i>Present Value Proven Reserves(US\$/mcf)</i>	2.12
<i>Debt/Present Value</i>	0.21	<i>Earnings Next Twelve Months (US\$/sh)</i>	4.74
<i>McDep Ratio - EV/PV</i>	0.81	<i>Price/Earnings Next Twelve Months</i>	10
<i>Dividend Yield (%/year)</i>	1.6	<i>Indicated Annual Dividend (US\$/sh)</i>	0.80

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 a Buy rating on the common shares of **Unocal Corporation (UCL)** for global natural gas and oil prospects. We raised our estimate of net present value for the independent producer to \$65 a share from \$54 on January 26, 2005 when we revised our estimate of long-term oil price to \$40 a barrel constant real from \$35. The new NPV matches the level previously calculated in a sensitivity illustration (see *Stock Idea, Unocal Corporation*, August 23, 2004). Compared to close peers, Unocal is distinguished by high concentration on the long-term growth opportunity of overseas natural gas. We see 32% stock price appreciation potential to net present value where the stock would then offer a continuing unlevered real return of some 7% per year at normal risk.

Global Natural Gas Producer

Unocal has a high concentration on overseas natural gas as we categorize clean fuel production outside North America (see table Functional Cash Flow and Present Value). Natural gas is in great demand in rapidly growing, highly polluted countries that Unocal serves including Thailand, China, and Bangladesh. Unocal's proven reserves have a long life especially considering that we weight undeveloped reserves at half developed reserves in our adjusted reserve life.

No other company in our coverage has as much relative emphasis in overseas natural gas (see table Present Value by Line of Business). Only **Total (TOT)** comes close, Unocal's fellow supplier to the natural gas liquefaction plant in East Kalimantan, Indonesia.

Profitability of overseas natural gas is slow to respond to oil price increases. We take account of that in our present value estimate.

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Unocal
Functional Cash Flow and Present Value

	<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	852	8.0	7.0	6,000	27%
Overseas Natural Gas	1,052	9.4	5.7	6,000	27%
Oil	2,003	7.9	5.1	10,300	46%
	3,907	8.5	5.7	22,300	100%
Debt (US\$mm)					4,700
Net Present Value (US\$mm)					17,600
Shares (mm)					271
Net Present Value (US\$/sh)					65

Present Value by Line of Business
(US\$millions)

	<i>North</i>	<i>Over-</i>			
	<i>American</i>	<i>seas</i>			
	<i>Natural</i>	<i>Natural</i>	<i>Oil</i>	<i>Down-</i>	<i>Total</i>
	<i>Gas</i>	<i>Gas</i>	<i>Production</i>	<i>stream</i>	
Exxon Mobil Corporation	38,000	54,000	172,000	110,000	374,000
Royal Dutch/Shell	9,000	47,000	97,000	111,000	264,000
Total S.A.	-	43,000	84,100	48,000	175,100
BP plc	30,000	30,000	133,000	70,000	263,000
PetroChina Company Ltd	-	13,000	139,800	21,000	173,800
ChevronTexaco Corporation	14,000	11,000	104,300	50,000	179,300
ConocoPhillips	16,000	8,000	49,700	42,000	115,700
Unocal Corporation	6,000	6,000	10,300	-	22,300
Norsk Hydro ASA	-	6,000	12,700	11,600	30,300
CNOOC Limited	-	3,300	24,300	-	27,600
Marathon Oil Corporation	3,700	1,500	8,300	7,400	20,900
Burlington Resources	20,000	1,300	8,300	-	29,600
Petro-Canada	5,000	1,000	12,400	3,900	22,300
Occidental Petroleum Corp.	5,700	600	30,400	4,800	41,500

Cash Flow Continues at High Quarterly Rate

A strong fourth quarter in 2004 sets the stage for our projection of cash flow in 2005 (see table [Next Twelve Months Operating and Financial Estimates](#)). Projected Ebitda compared to Enterprise Value indicates an unlevered cash flow multiple of less than five times. That is a distinct indicator of an undervalued stock considering the quality of assets.

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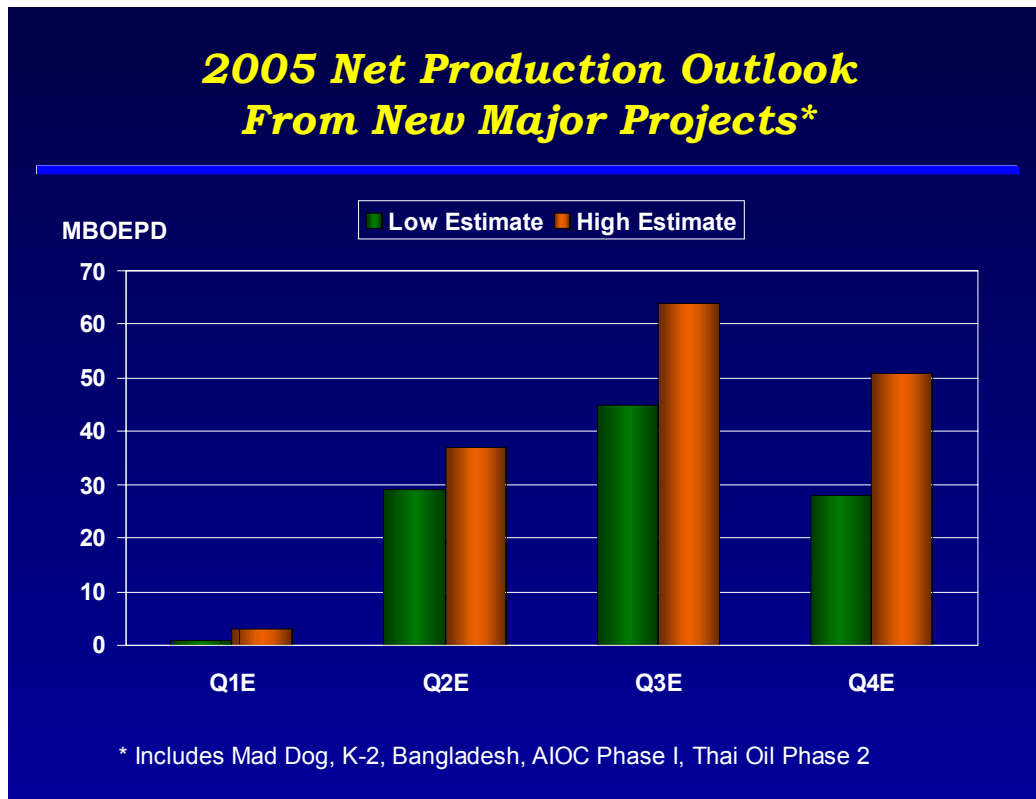
Unocal
Next Twelve Months Operating and Financial Estimates

	<i>Q3</i>	<i>Q4</i>	<i>Year</i>	<i>Q1E</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>
Volume										
Natural Gas (mmcf)										
North America	569	551	578	551	551	551	551	551	551	551
Overseas	942	993	941	993	993	993	993	993	993	993
Total	1,511	1,544	1,520	1,544	1,544	1,544	1,544	1,544	1,544	1,544
Oil (mbd)	155	171	159	171	171	171	171	171	171	171
Total gas & oil (mmb)	37	39	151	39	39	39	39	156	39	156
Total gas & oil (mbd)	407	428	412	428	428	428	428	428	428	428
Price										
Natural gas (\$/mcf)										
Henry Hub (\$/mmbtu)	5.75	7.10	6.15	6.16	6.08	6.24	6.61	6.27	7.09	6.50
North America	5.14	6.02	5.27	5.22	5.16	5.29	5.60	5.32	6.01	5.52
Overseas	3.20	3.42	3.17	3.52	3.62	3.72	3.82	3.67	3.92	3.77
Total	3.93	4.35	3.97	4.13	4.17	4.28	4.46	4.26	4.67	4.39
Oil (\$/bbl)										
WTI Cushing	43.89	48.30	41.44	45.83	46.24	45.94	45.22	45.81	44.42	45.46
Worldwide	40.36	44.41	37.92	42.14	42.52	42.24	41.58	42.12	40.84	41.80
Total gas & oil (\$/bbl)	29.97	33.40	29.25	31.70	32.00	32.29	32.66	32.17	33.13	32.52
Revenue (\$mm)										
Natural Gas										
North America	269	305	1,115	259	259	268	284	1,070	298	1,109
Overseas	277	313	1,093	315	327	340	349	1,332	351	1,367
Total	546	618	2,208	574	586	608	633	2,402	649	2,477
Oil	574	697	2,201	647	660	663	652	2,621	627	2,601
Other	872	1,032	3,802	1,032	1,032	1,032	1,032	4,126	1,032	4,126
Total	1,993	2,346	8,211	2,252	2,277	2,303	2,317	9,149	2,307	9,204
Expense										
Natural Gas and Oil	256	297	1,012	286	289	292	295	1,163	294	1,171
Other	872	1,032	3,802	1,032	1,032	1,032	1,032	4,126	1,032	4,126
Total	1,128	1,328	4,814	1,318	1,321	1,324	1,327	5,289	1,326	5,297
Ebitda (\$mm)	865	1,018	3,397	934	957	979	990	3,860	981	3,907
Exploration	91	167	435	167	167	167	217	718	217	768
Deprec., Deplet., & Amort.	248	277	997	277	277	277	277	1,108	277	1,108
Hedging	26	53	111	(32)	0	1	23	(8)	(12)	12
Interest	40	33	160	33	33	33	33	132	33	132
Ebt	460	488	1,693	457	480	502	440	1,879	454	1,876
Income tax	161	171	593	160	168	176	154	658	159	657
Net Income (\$mm)	299	317	1,101	297	312	326	286	1,221	295	1,219
Per share (\$)	1.09	1.17	4.01	1.10	1.15	1.20	1.06	4.51	1.09	4.50
Shares (millions)	274	271	275	271	271	271	271	271	271	271
Ebitda margin (E&P)	77%	77%	77%	77%	77%	77%	77%	77%	77%	77%
Tax rate - current	35%	35%	35%	35%	35%	35%	35%	35%	35%	35%

Incremental Volume in 2005 from Four Areas

Downloading from Unocal's website we see how new projects may contribute incremental volume this year (see chart [New Major Projects](#)). Footnoted, Mad Dog and K-2 are in the Gulf of Mexico and the remaining three projects are in Asia. The peak incremental volume projected for the third quarter is about 12% of current total company volume. Some of the increment will offset normal decline from base volume.

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Azerbaijan Prize Approaching Realization

AIOC on the chart above refers to Azerbaijan International Operating Company, the organization responsible for the six billion barrel Azeri-Chirag-Guneshli oil field in the Caspian Sea. Unocal's 10.3% share is the second largest after BP's 34.1%. An historic 1100 mile pipeline has just been completed from the Caspian to the Mediterranean through Turkey. The route is also described as Baku to Tbilisi to Ceyhan (a.k.a. BTC). Volumes will be ready to load into tankers at Ceyhan later this year. By 2009 AIOC expects to be producing a million barrels a day. Unocal's share would be \$800 million a year in after tax cash flow at \$40 oil according to management. Investors are probably not giving Unocal much credit for the potentially exceedingly valuable asset because development has been long delayed and political risks remain. Ceyhan, for example, is the same port in Turkey through which oil from northern Iraq is exported when it flows.

The China Connection

Recent speculation held that **CNOOC Limited (CEO)**, the Chinese independent, was eyeing the acquisition of Unocal. Though we have a buy recommendation on CNOOC we have no knowledge of any pending transaction. It would be a rather large deal for the acquirer as it is about the same size as the target. Strategically, of course, we believe that investing in new clean energy supply makes eminent sense. Chinese demand is creating some of the future value of oil and natural gas. It is only logical that Chinese companies should be interested in expanding internationally.

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Buy Oil and Gas Producers at Mid Decade

Measured by McDep Ratio, Unocal stock appears undervalued along with peers (see table [Rank by McDep Ratio](#)). Three to five-fold gain potential for oil and gas price over the next 5 to 13 years justifies investment in recommended oil and gas producers, in our opinion. Supporting improving prospects, the average futures price of oil for continuous delivery over the next six years is in a multi-year uptrend as defined by the current quotes above the 40-week average. The current benchmark oil average futures price for the next six years is about \$42 a barrel.

Oil and Gas Producers
Rank by McDep Ratio: Market Cap and Debt to Present Value

	<i>Symbol/</i>	<i>Rating</i>	<i>Price</i> <i>(\$/sh)</i> <i>9-Feb</i> <i>2005</i>	<i>Shares</i> <i>(mm)</i>	<i>Market</i> <i>Cap</i> <i>(\$mm)</i>	<i>Net</i> <i>Present</i> <i>Value</i> <i>(\$/sh)</i>	<i>Debt/</i> <i>Present</i> <i>Value</i>	<i>McDep</i> <i>Ratio</i>
Independent Natural Gas and Oil - Large Cap and Mid Cap								
XTO Energy Inc.	XTO	B1	38.00	279	10,600	45.00	0.16	0.87
Unocal Corporation	UCL	B3	49.41	271	13,400	65.00	0.21	0.81
Encana Corporation	ECA	B1	59.25	472	27,900	77.00	0.18	0.81
CNOOC Limited (19%)	CEO	B2	51.27	78	4,010	67.00	-	0.77
Occidental Petroleum Corp.	OXY	B3	61.29	406	24,900	87.00	0.15	0.75
Devon Energy Corporation	DVN	B3	40.45	500	20,200	63.00	0.16	0.70
Burlington Resources	BR	B1	43.89	391	17,200	67.00	0.12	0.70
Anadarko Petroleum Corp.	APC	B1	65.96	246	16,200	113.00	0.14	0.64
<i>Total or Median</i>					<i>134,000</i>		<i>0.15</i>	<i>0.76</i>

B1 = Buy full unlevered position, B2 = Buy half unlevered position, B3 = Alternative buy, H = Hold
 S2 = Short half unlevered position, S3 = Short quarter unlevered position
 McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses

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