

## **Cimarex Energy Company**

### **New Buy - Disciplined Natural Gas Reinvestment**

<i>Symbol</i>	<i>Price</i>	<i>Shares</i>	<i>Market Cap</i>	<i>Net</i>		<i>McDep Ratio</i>	<i>EV/</i>	<i>EV/</i>	<i>P/E</i>	<i>Div'd</i>	<i>PV/</i>
	<i>(US\$/sh)</i>			<i>Value</i>	<i>Debt/</i>		<i>Sales</i>	<i>Ebitda</i>		<i>NTM</i>	<i>NTM</i>
	<i>10-Oct</i>		<i>Cap</i>	<i>Present</i>	<i>Present</i>		<i>NTM</i>	<i>NTM</i>		<i>(%)</i>	<i>NTM</i>
	<i>2003</i>	<i>(mm)</i>	<i>(\$mm)</i>	<i>(\$/sh)</i>	<i>Value</i>		<i>NTM</i>	<i>NTM</i>			<i>NTM</i>
XEC	22.35	42.0	940	27.00	0.00	0.83	3.4	4.6	12.6	-	5.5

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

EV = Enterprise Value = Market Cap and Debt: US\$mm 940

Ebitda = Earnings before interest, tax, depreciation and amortization: US\$mm 206

NTM = Next Twelve Months Ended September 30, 2004; P/E = Stock Price to Earnings

PV = Present Value of energy businesses: US\$mm 1,130

### **Summary and Recommendation**

We recommend current purchase of the shares of small cap natural gas producer Cimarex Energy Company for compounding value of reserves through efficient reinvestment without debt and commodity price hedging. The company generates its own drilling prospects diversified across the U.S. without relying on acquisitions of properties from others. The risk of drilling is supported by a debt-free balance sheet, a rarity among public corporations. At the same time a strong financial position allows Cimarex to avoid costly commodity price insurance that most producers employ. The company's slow, but steady approach has worked in the past for Chairman Mick Merelli and his public stockholders. Moreover, by not paying current dividend income, Cimarex gives investors the option to defer tax on any return until the stock is sold. There are no assurances of immediate gain, or any gain, but we expect gradual progress over the years that we hope will add to a surprisingly favorable final result.

### **Reserves Also Reported Conservatively**

Besides no debt and no hedging, the company understates natural gas reserves compared to peers by not including undeveloped quantities in its totals. Yet Cimarex is drilling a couple hundred wells in 2003 that include many on locations that might have been classified as proven undeveloped last year.

On the basis of reported quantities, Cimarex has an adjusted reserve life of just 6.4 years (see Table). That is equal to the median for short-life peers and half the median for long-

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life peers. Our adjustment is to count undeveloped reserves at half the value of developed reserves to take account of the fact that additional investment is required to bring undeveloped reserves to production.

**Natural Gas and Oil Reserves**

	<i>Natural Gas</i>	<i>Oil</i>	<i>Total</i>	
	<i>(bcf)</i>	<i>(mmb)</i>	<i>(bcf)</i>	<i>(mmb)</i>
<i>Reserves (bcf or mmb)</i>				
Proven (P)	319	15	409	68
Proven Developed (PD)	318	15	407	68
Proven Undeveloped (PUD)	1	0	2	0
<i>Production, Next Twelve Months</i>				
	50	2.4	64	10.6
<i>Reserve Life Index (years)</i>				
R/P P	6.4	6.3	6.4	6.4
R/P PD	6.4	6.2	6.4	6.4
R/P PUD	0.0	0.1	0.0	0.0
R/P PD+.5PUD	6.4	6.3	6.4	6.4

Reserve life by itself is neither good nor bad. We have always had a bias for long life, but a well-managed company can also do well with short life. We also have a tendency to value resources more than management. We think we can identify quality resources, but have a harder time anticipating future management performance. Long life companies can coast on the asset base and do particularly well at times of advancing commodity price. Short life companies have to prove themselves almost every year. Yet as we have learned, long life can also be overstated and/or an ineffective management can waste a lot of the advantage of long life. Thus, Cimarex may be a short life company, but we shall try to show that the quality of its management leader is high.

**Cimarex Formed by Key Production and Helmerich and Payne**

The company's unusual characteristics become less surprising when we consider how Cimarex was formed only a year ago. About 60% of reserves were contributed by the producing operations from Helmerich & Payne. The rest of Cimarex was once Key Production.

Helmerich & Payne was in our first ranking of energy stocks in November 1982 by what was to become the McDep Ratio. It was most undervalued in the "Exploration – Large" category with "Market Cap & Debt" at 0.42 times "Property Value". Nine years later, in our Action Recommendation analysis in mid 1991, Helmerich & Payne's McDep Ratio was 0.68, the lowest in the "Diversified Companies – Small" group. We called attention to a high quality position in natural gas with a low percentage of reserves classified as

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undeveloped. We further emphasized that zero debt meant almost no financial risk, but suggested investors could add their own leverage if they wished. Though we diplomatically avoided mentioning the idea in our 16 page analysis 12 years ago, we think that moving the Hugoton natural gas reserves from a diversified company to a new independent producer is an intelligent move.

Key Production has been a stellar performer since it was formed in 1988. In April 1989 we wrote, "When Apache Corporation folded Apache Petroleum, its limited partnership, holders who did not want Apache Corporation stock were allowed to keep units that were transformed to stock in a new corporation, Key Production Company. Starting initial trading on October 17 at \$1-5/8, Key stock rose to \$2.50 recently. That's a 54% gain for almost a twobagger that annualizes to 199%, according to Compuserve. Apache Corporation which created Key Production has been accumulating the stock in the open market. That's sensible because the McDep Ratio for Key is still among the lowest for small production companies."

Key Production became independent of Apache in 1992 and was staffed with its own management headed by Mr. Merelli, a former Apache exec, as we recall. The strategy shifted to growth from a successful run of paying down debt and distributing a high dividend. We remarked in October 1992, "A low McDep Ratio ranks Key Production among the most undervalued of U.S. Production Companies – Small."

Along the way, we remember discussing disappointing performance in one of our recommendations and the client remarked, "You know the stock that really worked out well for me was Key Production!" For that we have to give credit to management headed by Mr. Merelli, the leader of Cimarex today.

The owner of a share of Key in 1987 would have received double digit percentage dividends for about four years and would now own a share of Cimarex. That's ten bagger performance, if not quite in ten years, then close to it.

### **Reinvestment Success Important to Value Creation**

Our investment bias is that high quality oil and gas resources are attractive to own, but creating new high quality properties is a tough business. Perhaps the former is true in part because of the latter. Cimarex has high margin properties, but they are being produced at a rapid rate and all the proceeds are being reinvested to find new resources. As a result reinvestment success may be an even more critical indicator of value creation than commodity price. We are willing to bet on the company's future success because we have seen how management has had historical success.

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Indeed it has taken awhile for Cimarex to bring new prospects to production at a stepped up pace for the new company. Volume expectations had to be scaled back slightly earlier this year. Recent progress apparently justifies improvement in expectations.

Favorable investment and operating characteristics help control reinvestment risk. The lack of selling production forward means that Cimarex will get more of the benefit of the higher commodity price we think is coming. In many cases it is almost shameful how much value some of Cimarex's competitors have given to commodity traders. There can be conflicts of interest where some producers may do commodity trading with a lender or an investment banker that might not otherwise be justified except in payment for unrelated services.

No debt allows Cimarex to take higher exploration risk while still being disciplined and prudent. No debt positions Cimarex to withstand any unforeseen financial accident in the economy that may be more likely in a high-debt world. Opportunistically, Cimarex could be a buyer should the energy resource market be temporarily stressed.

With no reported undeveloped reserves and with developed reserves estimated by the conservative firm of Ryder, Scott, Cimarex manages investor expectations conservatively. The risk of disappointment from management overpromising is low.

What if something happens to Mr. Merelli? There is no strong controlling interest in the heavily institutionally owned stock and Mr. Merelli is in his late 60s. The head of exploration, Mr. Tom Jordan, ex Key Production, is under 50. The head of production, Mr. Steve Shaw, ex Helmerich & Payne, is in his early 50s.

**Raise Present Value to \$27 a Share**

Volume has declined slightly this year, but the trend may have reversed. We project flat volume after a slight recovery. Our price projections are from the futures market. Then after assuming no major changes in cost structure we have a base level of cash flow to capitalize to a value for the company (see Table).

The most readily available quantitative indicator of cash flow multiple is adjusted reserve life. Considering that there probably are some undeveloped reserves that a peer company would report, a higher multiple than 5.5 times for peer companies might be justified.

Other qualitative factors relate to expected return on reinvested cash flow. For valuation purposes we assume that Cimarex will be equally successful as peers despite a better than average historical record for Key Production.

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As a result we assess a multiple of cash flow (PV/Ebitda) of 5.5 times that results in a Present Value of \$27 a share, up from \$24 previously. The McDep Ratio for Cimarex ranks it among the lowest in the short-life peer group.

**Cimarex Energy Company**  
**Next Twelve Months Operating and Financial Performance**

	<i>Q1</i>	<i>Q2</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Next</i>
	<i>3/31/03</i>	<i>6/30/03</i>	<i>9/30/03</i>	<i>12/31/03</i>	<i>2003E</i>	<i>Twelve</i>
						<i>Months</i>
						<i>9/30/04</i>
<b>Volume</b>						
Natural Gas (mmcf)	136	132	136	136	<b>135</b>	<b>136</b>
Oil (mbd)	7.2	6.7	6.5	6.5	<b>6.7</b>	<b>6.5</b>
Total (bcfe)	16.1	15.7	16.1	16.1	<b>64</b>	<b>64</b>
Total (mmcf)	179	172	175	175	<b>175</b>	<b>175</b>
<b>Price</b>						
Henry Hub (\$/mmbtu)	6.38	5.63	4.87	5.08	<b>5.49</b>	<b>5.06</b>
Differential (\$/mmbtu)	0.61	0.88	0.76	0.79	<b>0.77</b>	<b>0.79</b>
Company (\$/mcf)	5.76	4.75	4.11	4.29	<b>4.72</b>	<b>4.27</b>
WTI Cushing (\$/bbl)	34.03	29.07	30.22	30.00	<b>30.83</b>	<b>28.58</b>
Differential	3.89	1.16	1.21	1.20	<b>1.84</b>	<b>1.14</b>
Company (\$/bbl)	30.13	27.91	29.01	28.80	<b>28.99</b>	<b>27.44</b>
<b>Revenue (\$mm)</b>						
Natural Gas	70	57	51	54	<b>233</b>	<b>212</b>
Oil	20	17	17	17	<b>71</b>	<b>65</b>
Total	90	74	69	71	<b>304</b>	<b>277</b>
<b>Expense</b>						
Operating	7	8	8	8	<b>31</b>	<b>32</b>
Production taxes	7	6	6	6	<b>18</b>	<b>22</b>
General and administrative	4	4	4	4	<b>16</b>	<b>16</b>
Total	18	18	18	18	<b>71</b>	<b>70</b>
<b>Ebitda</b>	<b>72</b>	<b>56</b>	<b>51</b>	<b>53</b>	<b>232</b>	<b>206</b>
Deprec., Deplet., & Amort.	21	21	21	21	<b>84</b>	<b>84</b>
Other Non Cash	1	3	2	2	<b>7</b>	<b>8</b>
<b>Ebit</b>	<b>50</b>	<b>32</b>	<b>28</b>	<b>30</b>	<b>141</b>	<b>114</b>
Interest	-	-	-	-	-	-
<b>Ebt</b>	<b>50</b>	<b>32</b>	<b>28</b>	<b>30</b>	<b>141</b>	<b>114</b>
Income Tax	18	11	10	11	<b>49</b>	<b>40</b>
<b>Net Income (\$mm)</b>	<b>33</b>	<b>21</b>	<b>18</b>	<b>20</b>	<b>92</b>	<b>74</b>
Per Share (\$)	0.78	0.50	0.43	0.46	<b>2.18</b>	<b>1.77</b>
<b>Shares (millions)</b>	<b>42</b>	<b>42</b>	<b>42</b>	<b>42</b>	<b>42</b>	<b>42</b>

Kurt H. Wulff, CFA

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