McDep Associates
Independent Stock Idea
February 17, 2004

Rating: Buy
S&P 500: 1146

XTO Energy Inc
Breakout Valuation Potential

Symbol	*Price ($/sh) 13-Feb 2004*	*Shares (mm)*	*Market Cap ($mm)*	*Net Present Value ($/sh)*	*Debt/ Present Value*	*McDep Ratio*	*EV/ Sales 2001E*	*EV/ Ebitda NTM*	*P/E NTM*	*Div'd NTM (%)*	*PV/ Ebitda NTM*
XTO	28.30	188	5,320	33.00	0.19	0.89	4.7	6.6	13	0.1	7.5

McDep Ratio = **M**arket **c**ap and **De**bt to **p**resent value of oil and gas and other businesses		
EV = Enterprise Value = Market Cap and Debt:	$mm	6,800
Ebitda = Earnings before interest, tax, depreciation and amortization:	$mm	1,027
NTM = Next Twelve Months Ended December 31, 2004; P/E = Stock Price to Earnings		
PV = Present Value of energy businesses:	$mm	7,700
Present Value of Equity:	$mm	6,200

Summary and Recommendation

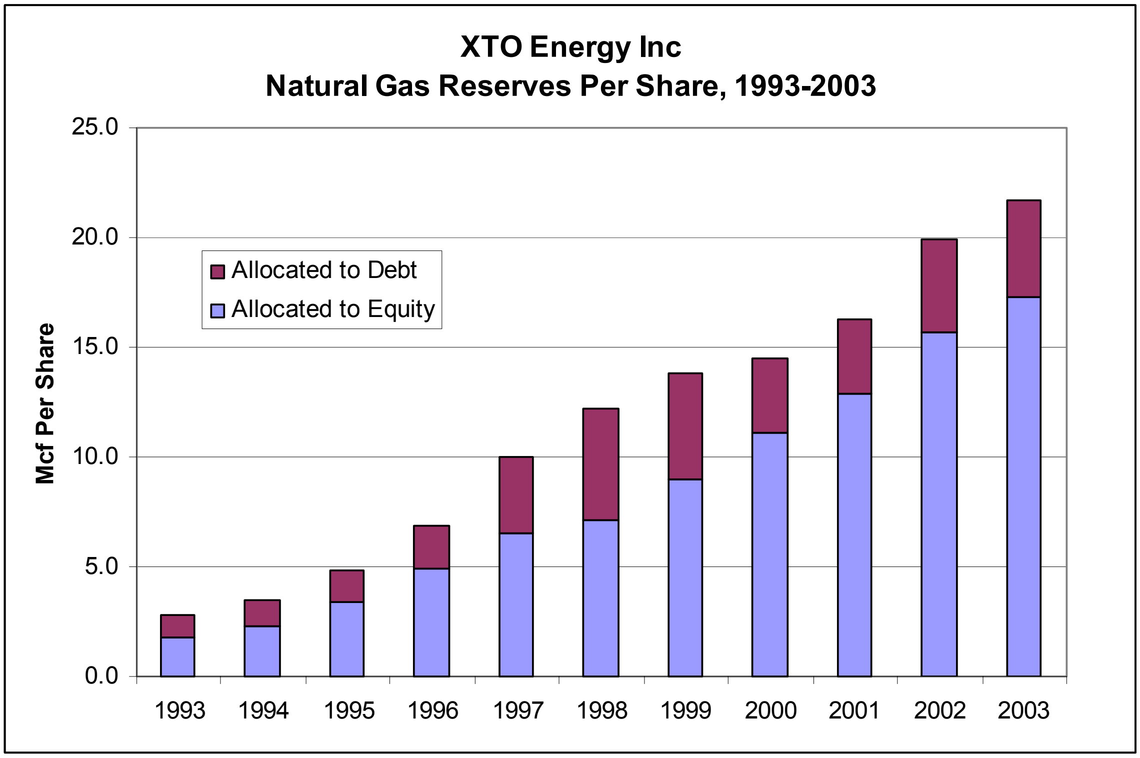
XTO Energy common stock has breakout valuation potential to more than twice current stock price when viewed in a growth framework as might be the case if energy attracts the wider investor interest we expect. The stock of the North American natural gas producer has already been a ten bagger, up more than ten times in price in the past ten years. Newly-public at the beginning of that period, the company achieved real growth of 25% per year since then in net natural gas reserves per share. Because XTO achieved most of its real growth in tough times when peers fell by the wayside, it may be more likely to do well in good times of rising commodity price. Management is looking at 15% real growth in 2004. If valued at 14 times cash flow on an unlevered basis, not hard to justify for the growth record and the prospects, the stock would be priced at $70 a share. The higher the valuation, the greater the risk, but we are not there yet.

Historical Real Growth at a High Rate

Independent producer XTO has a better ten-year record of total return to shareholders than any stock in our coverage that traded in the U.S. for that whole period. That superlative applies whether we compare XTO to mega caps, producer/refiners, large cap and mid cap independent natural gas and oil producers or oil service stocks in our groups.

XTO reports impressive ten-year growth in reserves and production. Yet, any company that makes acquisitions as XTO does can overstate growth. Growth in reserves can be overstated if it is achieved by increasing financial leverage. Growth in production can be overstated if it exceeds growth in reserves. When XTO states its ten year record of gains in reserves per share, the performance is hard to refute and matched by few if any peers.

The ten-year compound growth rates are 23% per year unlevered, debt plus equity, and 25% per year levered, equity only (see Chart). The data are extracted from company disclosures of reserves per share and debt per thousand cubic feet equivalent (mcfe).



We convert dollars of debt to mcfe by using a value that increases smoothly from $1.08 per mcf in 1993 to $1.63 per mcf in 2003. That understates the relative importance of debt in 1998 and 1999 when natural gas values declined below the smooth trend temporarily.

The 4% per year increase in conversion factor is a measure of price increase. Take account of price and the total of stock price and debt per share compounds at 28% per year. As a result, the impact of price inflation is minor compared to the impact of real growth in reserves.

Stock price compounded 14½ times, or 31% per year, if we got the historical prices right. Counting dividends the gain apparently was greater.

Acquire and Exploit Strategy Launched in 1976 by Predecessor

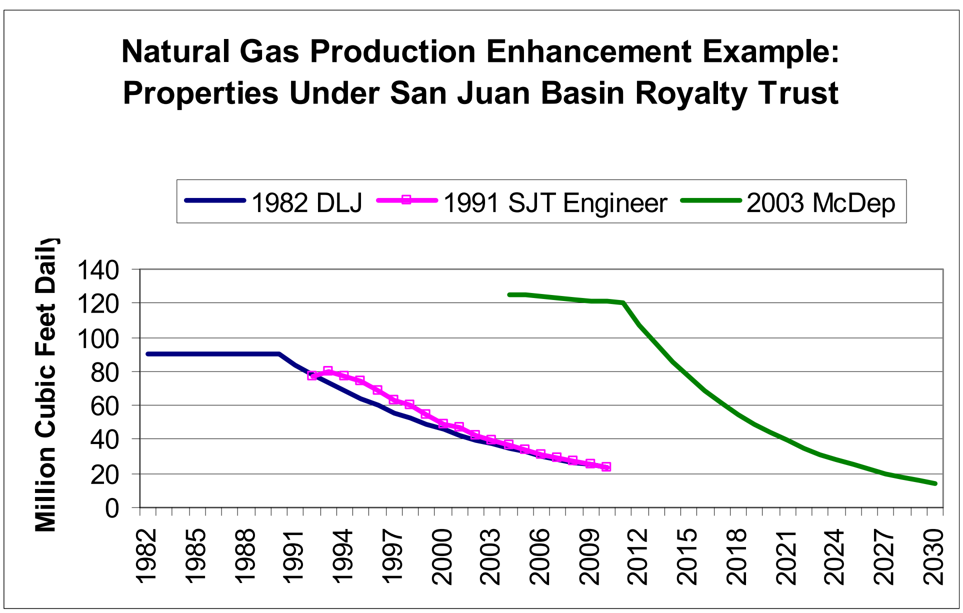
XTO's favorable performance has been achieved by acquiring long-life natural gas properties and investing in additional development to enhance reserves and production. In our characterization, XTO's strategy has its roots in the 1970s in the San Juan Basin of New Mexico and the Permian Basin of West Texas. Senior management of XTO cut their teeth at Southland Royalty the company that acquired Aztec Oil & Gas in 1976.

Soon after the deal we wrote in 1976, "Now Southland is aggressively developing the Aztec properties through the renegotiation of price terms and the initiation of a 250 well development program that will add significantly to volume in the San Juan Basin." In 1980 Southland transferred its properties to shareholders in the form of **San Juan Basin Royalty Trust (SJT)** and **Permian Basin Royalty Trust (PBT)**, but not before Southland Royalty stock was a ten bagger.

After **Burlington Resources (BR)** acquired Southland in the 1980s, the managers from Southland eventually formed Cross Timbers Oil Company. The latter went public in the early 1990s and later changed its name to XTO.

San Juan Basin Royalty Trust Analogy Illustrates Strategy

As we see it, the XTO managers went looking for more properties like those in SJT. To illustrate the promise we recap some of our historical work on SJT (see Chart). In 1982 we projected flat volume from the properties and then a decline that began in 1991.



Indeed, it looked like a decline started as anticipated. When we took the opportunity to look at the detailed reserve analysis of SJT's independent engineer in 1991, we saw little change from our projections of a decade earlier. By then we knew those expectations were too low because of new drilling activity in the area.

Since 1991, incidentally the period of XTO's success, new drilling shifted the curve of future production higher and to the right on the plot of volume and time. Recoverable reserves defined as future production have visibly increased. The total of currently projected recoverable reserves and the actual production from 1982 to 2003 appear to be more than twice projected recoverable reserves in 1982.

Graphically speaking, we have seen SJT production expectations start in the southwest quadrant and move toward the Northeast. That seems to be an apt metaphor for XTO's operating strategy.

Not surprisingly, XTO has San Juan Basin and Permian Basin properties with long-life and exploitation potential. Similar properties in East Texas now make up the largest concentration of XTO assets. There the company made, in our mind, an advantageous purchase of properties sold by a successor to Enserch, the Dallas gas utility no longer independent.

Future Real Growth Accentuated by Price Potential

At $5 billion in market cap, XTO has come a long ways, but is still small enough that likely acquisitions can have a measurable impact. The company has already made a quarter billion dollar acquisition in 2004 and sold a half billion dollars of ten-year notes at a low 5% interest cost.

Not only does XTO seem to have further opportunities to develop real growth, but the commodity price cycle may now be like a wind at XTO's back. Mr. Bob Simpson, the chairman of XTO, observed in the recent conference call that oil price seems to be in the early years of an extended run as it was when "we were just kids" thirty years ago.

Of course if oil is headed up, cleaner natural gas, XTO's primary emphasis, is likely to advance more than oil. Aztec's natural gas price was $0.30 a thousand cubic feet (mcf) in 1974. The same properties in SJT received a natural gas price of $2.33 an mcf in 1981. The price languished to just $1.75 in 1999, eighteen years later. In the new cycle the price averaged $3.58 last year.

Management's answer to the question about the prospects for future growth is to suggest a target of 25 mcfe per share by year end 2004. That would be real growth of about 15%.

Financial Leverage Reduced

A liquidity scare in 1998-1999 gave management a keen sense of downside risk that it doesn't want to be exposed to again. Debt has been paid down since then to the point where XTO's ratio of debt to present value, 0.19, is below that of its peers.

The company is an active user of commodity hedges against price declines. The hedging is further justified in management's mind by efficiencies in maintaining a steady drilling and development effort insulated from short-term commodity price fluctuations.

With the downside covered, management can be aggressive in pursuing a strategy to acquire and exploit natural gas properties. There may be some new emphasis on oil as well.

Seven Percent of Value Creation Allocated to Incentive Compensation

As the company has been successful, management has been compensated more. Last year top and middle management apparently were awarded about $70 million of bonus and performance stock for creating a billion dollars of incremental value for shareholders.

Responsible investors are justified in asking if such generous compensation is reasonable. By the standards of our low cost of capital, entrepreneurial economy, with its skewing of rewards, the XTO compensation program seems less unusual. Financial managers of the largest university endowment earn 10% of a relatively narrowly defined increment of performance. Twenty percent essentially has been blessed by no less than the most respected public pension and endowment funds that invest contributors' money in leveraged buyouts, private equity and hedge funds. High compensation private deals have become a reward at the end of public service for some of our most exalted political leaders. Finally, XTO's seven percent pales compared to fifty percent, clearly excessive in our opinion, for the popular energy limited partnership model.

Growth investors might even find the XTO compensation an attraction for investing in the stock. Seven percent is not so high that it would greatly impair favorable future results. Nor does it seem management has taken on unacceptable risk or falsified its accounting in order to earn its incentive compensation.

McDep Valuation Attractive

As we look back, the McDep framework was much too conservative in judging the value of XTO. On the positive side, we can say that XTO always exceeded our estimated net present value.

There probably were times, now is not one, when XTO may have looked less undervalued on the McDep Ratio than peers. On the recent conference call one questioner noted the "premium valuation" of XTO stock.

We can see in our work that XTO's cash flow multiple, EV/EBITDA, is higher than average. Yet a higher than average reserve life justifies most of that difference. As a result, XTO is an attractive stock to buy on the basis of McDep analysis without giving credit for growth potential.

XTO More Attractive than Some Pipeline Partnerships

The most immediate examples of higher energy valuation are the pipeline income partnerships. Investors are encouraged to believe that a 6% dividend can grow at 5-10% per year for a total return of 11-16%. Since the dividend may be all of the cash flow, the cash flow multiple that investors apply is in the high teens.

There are no pipeline partnerships that have a superior ten-year historical record to XTO that we know. Thus on history XTO ought to have as high a multiple.

On future prospects, we believe it is more likely that XTO can deliver a total return of 11-16% than is the case for the more popular partnerships. Management's suggestion of 15% real implies an equity total return approaching 20%. On a long-term sustained basis we would be more conservative in both cases.

Of course, pipelines are pipelines and XTO is production. In our mind the distinctions of one being more stable than the other are somewhat artificial and often exaggerated. Nonetheless some pipelines have had a good run in a period of stable to declining commodity price. That is changing. Times are likely to be better for producers in a new cycle. Even where pipeline cash flow may appear more stable it is often more highly leveraged such that net cash flow is less stable.

Growth May Be Worth 15 Times Cash Flow

EV/Ebitda multiples in the mid teens seem common enough for leading companies in non-energy fields. The common justification is that other industries have better prospects. Yet XTO was able to deliver ten-bagger performance during moderate energy industry growth.

History suggests to us that energy investment may attract more stock market attention in a stronger commodity price environment. By definition energy would also be attracting different investors. A new investor to energy may look at XTO and prefer the high real growth record the company has demonstrated and be more comfortable paying for it.

For a round number we suggest that XTO stock ought to be valued on a cash flow multiple of 15 or more. Fifteen per cent real return equals fifteen percent real growth, why not a 15 multiple? Then to allow for management compensation, we'll reduce that multiple to 14. XTO stock would be about $70 a share to be consistent with EV/Ebitda of about 14.

We don't expect $70 overnight. More likely XTO stock may keep climbing and draw increasing comments about its "premium multiple". Meanwhile buyers with a different frame of reference may be able to conclude that the cash flow multiple is low for the growth rate and in comparison to growth alternatives. Among our stocks, XTO is a top candidate for a breakout to growth valuation.

Kurt H. Wulff, CFA

XTO Energy Inc.
Next Twelve Months Operating and Financial Estimates

	Q1 3/31/03	*Q2 6/30/03*	*Q3 9/30/03*	*Q4 12/31/03*	***Year 2003***	*Q1E 3/31/04*	*Q2E 6/30/04*	*Q3E 9/30/04*	*Q4E 12/31/04*	***Next Twelve** Months 12/31/04*
Volume										
Natural Gas (mmcfd)	591	631	711	738	**668**	738	738	738	738	**738**
Oil (mbd)	19	19	20	19	**19**	19	19	19	19	**19**
Total gas & oil (bcf)	63	68	77	79	**286**	78	78	79	78	**312**
Price										
Natural gas ($/mcf)										
Henry Hub ($/mmbtu)	6.38	5.63	4.87	5.08	**5.49**	5.68	5.27	5.27	5.43	**5.41**
U.S. (or North America)	5.82	4.89	4.45	4.16	**4.77**	4.65	4.31	4.31	5.08	**4.59**
Oil ($/bbl)										
WTI Cushing	34.03	29.07	30.22	31.19	**31.13**	33.27	31.53	30.16	29.28	**31.06**
Worldwide	29.94	24.46	24.65	26.22	**26.25**	27.97	26.50	25.35	24.37	**26.05**
Total gas & oil ($/mcf)	5.69	4.76	4.40	4.19	**4.15**	4.66	4.33	4.30	4.94	**4.59**
Revenue ($mm)										
Natural Gas	310	281	291	282	**1,164**	313	290	293	345	**1,240**
Oil	50	43	46	47	**186**	49	47	45	43	**184**
Other	(107)	(42)	(15)	3	**(161)**	3	3	3	3	**11**
Total	253	282	322	332	**1,189**	365	339	341	390	**1,435**
Expense										
Production	62	66	74	76	**278**	80	77	77	83	**317**
Overhead	15	28	14	59	**116**	20	20	20	20	**80**
Other	(3)	19	1	(42)	**(25)**	3	3	3	3	**11**
Ebitda ($mm)	179	169	233	239	**820**	262	239	241	285	**1,027**
Exploration	1	0	0	1	**2**	1	1	1	1	**4**
Deprec., Deplet., & Amort.	61	67	76	80	**284**	80	80	80	80	**319**
Ebit	118	102	156	158	**534**	181	159	160	204	**704**
Interest	15	16	16	17	**64**	17	17	17	17	**66**
Ebt	103	86	140	142	**471**	165	142	144	188	**638**
Income Tax	36	30	49	50	**165**	58	50	50	66	**223**
Net Income ($mm)	67	56	91	92	**306**	107	92	93	122	**415**
Shares (millions)	172	180	186	188	**182**	188	188	188	188	**188**
Per share ($)	0.39	0.31	0.49	0.49	**1.68**	0.57	0.49	0.50	0.65	**2.21**
Ebitda Margin - O&G	79%	71%	74%	59%	**71%**	72%	71%	71%	73%	**72%**
Tax Rate	35%	35%	35%	35%	**35%**	35%	35%	35%	35%	**35%**

