Rating: Buy
S&P 500: 1136

# XTO Energy Inc.
## Breakthrough Acquisitions

| | | | |
|---|---|---|---|
| *Symbol* | XTO | *Ebitda Next Twelve Months ending 3/31/05 (US$mm)* | 1,800 |
| *Rating* | Buy | *North American Natural Gas/Ebitda (%)* | 82 |
| *Price (US$/sh)* | 26.37 | *Natural Gas and Oil Production/Ebitda (%)* | 100 |
| *Pricing Date* | 6/10/04 | *Adjusted Reserves/Production NTM* | 12.6 |
| *Shares (mm)* | 256 | *EV/Ebitda* | 5.2 |
| *Market Capitalization (US$mm)* | 6,700 | *PV/Ebitda* | 6.8 |
| *Debt (US$mm)* | 2,800 | *Undeveloped Reserves (%)* | 22 |
| *Enterprise Value (EV) (US$mm)* | 9,500 | *Natural Gas and Oil Ebitda (US$/boe)* | 28.13 |
| *Present Value (PV) (US$mm)* | 12,500 | *Present Value Proven Reserves(US$/boe)* | 13.50 |
| *Net Present Value (US$/share)* | 38 | *Present Value Proven Reserves(US$/mcfe)* | 2.25 |
| *Debt/Present Value* | 0.22 | *Earnings Next Twelve Months (US$/sh)* | 2.68 |
| *McDep Ratio - EV/PV* | 0.76 | *Price/Earnings Next Twelve Months* | 10 |
| *Dividend Yield (%/year)* | 0.2 | *Indicated Annual Dividend (US$/sh)* | 0.04 |

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**

**XTO Energy (XTO)** common stock has breakout valuation potential to more than twice current stock price when viewed in a growth framework. Though our present value is just $38 a share the company, always highly concentrated on U.S. natural gas, has rapidly surpassed all but the most recent present value estimates we made on it since 1993 when it first became publicly traded. On May 17 management scored a breakthrough billion dollar deal with **ChevronTexaco (CVX)** days after a smaller deal no less advantageous with **ExxonMobil (XOM)**. The ability to extract choice properties from reluctant sellers opens more opportunities to extend the company's growth record for years. Nor does there seem to be much valuation risk at the current low cash flow multiple and long reserve life. Financial risk is also just moderate.

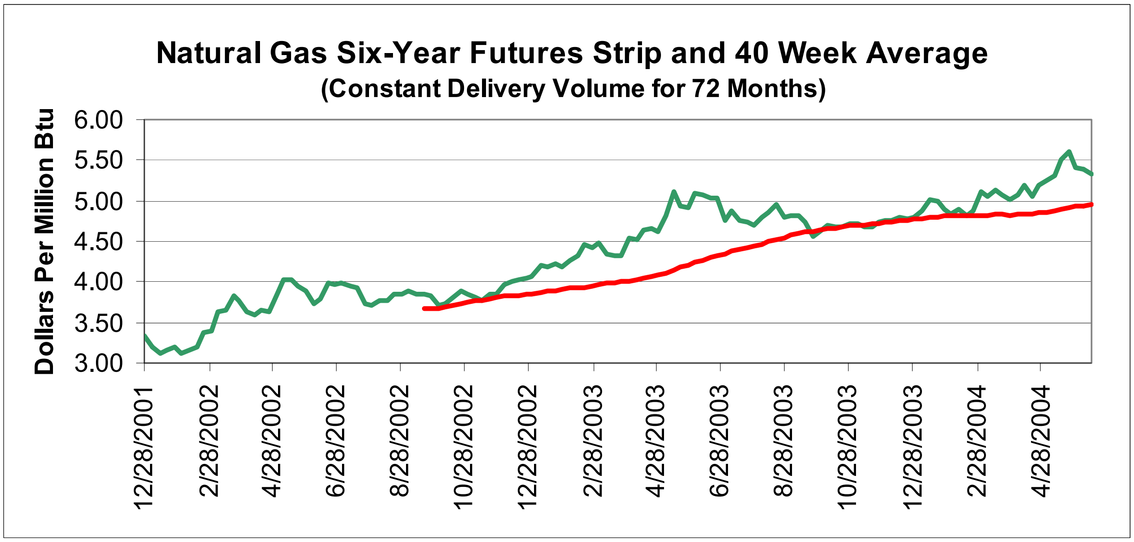
**Natural Gas Outlook Stronger than Oil**

Natural gas prices are advancing faster than oil. The ratio of natural gas to oil on a heating content basis advanced from 0.2 times oil in 1970 to 1.0 times oil today. That trend points to a ratio of perhaps 1.3 in 2010. We find that easy to believe in part because the ratio exceeded that for one-year futures for most of the spring of 2003. As the cleanest fuel, natural gas should continue to advance in price relative to oil as the world increasingly desires a cleaner environment.

Higher electricity quotes compared to a year ago point to possibly surprising strength in natural gas price in the hotter months ahead. A strong economy and air conditioning can stimulate a voracious appetite for electricity generated by natural gas.

Six-year futures describe the commodity price trends most relevant to estimating resource value. The longer time horizon better matches the period during which more of current resources will actually be produced. The longer term measure also smoothes the frantic near-month fluctuations and has the potential to keep climbing even if near-month quotes drop back temporarily.

The plots of weekly results since the beginning of 2002 trace a trend of six-year natural gas price rising 21% a year (see chart). Momentum is positive as long as the current six-year quote remains above the trailing 40-week average.




**Volume, Price and Costs Translate to Attractive Cash Flow**

Our process of estimating company-specific present value begins with an estimate of next twelve months cash flow. Current projections lead to a healthy level of unlevered cash flow, also known as Ebitda, short for earnings before interest, tax, depreciation and amortization (see table). We choose the next twelve months ending March 31, 2005 as the relevant time period. For the next twelve months we project natural gas and oil volume that includes the additions from acquisitions.

We take the futures market at face value in projecting price for the next twelve months. Henry Hub quotes guide our projection of natural gas revenue. Light Sweet Crude quotes guide our projections of oil revenue. Because futures are constantly changing, our projection is adjusted accordingly. As a result, the specific amounts we project today may not be the amounts realized when the company next reports.

**Assess Present Value Multiple Depending on Reserve Life**

The important variables in the valuation of future production are captured in base year cash flow and a multiple of that cash flow that depends on reserve life. Indeed investors do differentiate on that basis as reflected in a high correlation of unlevered cash flow multiple with adjusted reserve life. We convert the market relationship to a formula that produces an anticipatory value with somewhat more sensitivity to reserve life.

**XTO Energy Inc.**
**Next Twelve Months Operating and Financial Estimates**

| | *Q1 3/31/04* | *Q2E 6/30/04* | *Q3E 9/30/04* | *Q4E 12/31/04* | ***Year 2004E*** | *Q1E 3/31/05* | ***Next Twelve Months 3/31/05*** |
|---|---|---|---|---|---|---|---|
| **Volume** | | | | | | | |
| Natural Gas (mmcfd) | 771 | 771 | 870 | 920 | **833** | 920 | **870** |
| Oil (mbd) | 19 | 19 | 34 | 39 | **28** | 39 | **33** |
| Total gas & oil (bcf) | 81 | 81 | 99 | 106 | **366** | 105 | **391** |
| **Price** | | | | | | | |
| Natural gas ($/mcf) | | | | | | | |
| Henry Hub ($/mmbtu) | 5.64 | 6.22 | 6.78 | 6.93 | **6.39** | 7.11 | **6.76** |
| U.S. (or North America) | 4.79 | 5.60 | 6.10 | 6.24 | **5.72** | 6.40 | **6.10** |
| Oil ($/bbl) | | | | | | | |
| WTI Cushing | 35.23 | 39.51 | 41.20 | 39.42 | **38.84** | 37.67 | **39.45** |
| Worldwide | 29.61 | 34.77 | 36.26 | 34.69 | **34.31** | 33.15 | **34.66** |
| Total gas & oil ($/mcf) | 4.81 | 5.62 | 6.09 | 6.15 | **5.74** | 6.22 | **6.04** |
| **Revenue** ($mm) | | | | | | | |
| Natural Gas | 336 | 393 | 488 | 528 | **1,745** | 536 | **1,945** |
| Oil | 52 | 61 | 113 | 124 | **351** | 118 | **417** |
| Other | 7 | | - | - | **7** | - | **-** |
| Total | 395 | 454 | 601 | 652 | **2,103** | 653 | **2,361** |
| **Expense** | | | | | | | |
| Production | 86 | 93 | 108 | 113 | **401** | 113 | **428** |
| Overhead | 14 | 14 | 20 | 20 | **68** | 20 | **74** |
| Other | 14 | 7 | 7 | 7 | **35** | 7 | **28** |
| **Ebitda** ($mm) | 281 | 340 | 466 | 512 | **1,599** | 513 | **1,832** |
| Exploration | 1 | 1 | 1 | 1 | **4** | 1 | **4** |
| Deprec., Deplet., & Amort. | 82 | 89 | 109 | 117 | **396** | 117 | **431** |
| Other non cash | | 52 | 72 | 78 | **202** | 17 | **219** |
| **Ebit** | 198 | 198 | 284 | 317 | **997** | 378 | **1,177** |
| Interest | 20 | 20 | 35 | 35 | **110** | 35 | **125** |
| **Ebt** | 178 | 178 | 249 | 282 | **887** | 343 | **1,052** |
| Income Tax | 62 | 62 | 87 | 99 | **310** | 120 | **368** |
| **Net Income ($mm)** | 116 | 116 | 162 | 183 | **576** | 223 | **684** |
| **Shares** (millions) | 236 | 236 | 260 | 260 | **250** | 260 | **256** |
| Per share ($) | 0.49 | 0.49 | 0.62 | 0.70 | **2.31** | 0.86 | **2.68** |
| Ebitda Margin - O&G | 74% | 76% | 79% | 80% | **78%** | 80% | **79%** |
| Tax Rate | 35% | 35% | 35% | 35% | **35%** | 35% | **35%** |

The adjusted reserve life index is the sum of developed and half undeveloped reserves divided by next twelve months production. When we last did an industry-wide upward revaluation on March 23, we estimated cash flow multiple equal to 2.5 plus 0.5 times reserve life. That approximates present value assuming constant commodity price near the one-year quotes at that time, about $35 a barrel for crude oil. Higher commodity prices since then imply higher cash flow and lower multiple.

**Deal Includes 25% of Yates Oil Field**

Yates is our all-time favorite West Texas oil field. It was the jewel of **Marathon Oil (MRO)** especially during the mid 1970s when the producing rate doubled to 100,000 barrels daily from the 50,000 bd limit imposed for decades by the Texas regulators. It is still hard for us to accept that Marathon sold its 50% interest, mostly last year. Now XTO is fortunate in being able to acquire ChevronTexaco's share of about 25%. Of course volume has declined to some 20,000 bd. Yet more than billion barrels remain in place.

Coincidentally the new 50% owner of Yates, **Kinder Morgan (KMI, KMP, KMR)** is valued in the stock market at an unlevered cash flow multiple at two to three times XTO's multiple. Yet XTO has a longer and stronger historical record. More than a ten-bagger already at a 17 fold gain in stock price in eleven years, XTO seems to have visibility of further gains.

Kurt H. Wulff, CFA

**Research Methodology/Ratings Description:** McDep Associates is an independent research originator focused on oil and gas stocks exclusively. The firm applies the thirty years of experience of its analyst to estimate a present value of the oil and gas resources and other businesses of covered companies. That value is compared with a company's stock market capitalization and debt. Stocks with low market cap and debt relative to present value tend to outperform stocks with high market cap and debt relative to present value. Buy recommendations are expected to deliver a total return better than 7% per year above inflation. Hold recommendations assume the attributes of the underlying business are more than fully reflected in the current price of the stock. Sell recommendations are expected to deliver a negative total return less than 7% per year including the effects of inflation.