McDep Associates
Independent Stock Idea
August 11, 2003

Rating: Buy
S&P 500: 978

Anadarko Petroleum Corporation
Sharks Circling

Symbol	*Price (US$/sh) 8-Aug 2003*	*Shares (mm)*	*Market Cap ($mm)*	*Net Present Value ($/sh)*	*Debt/ Present Value*	*McDep Ratio*	*EV/ Sales NTM*	*EV/ Ebitda NTM*	*P/E NTM*	*Div'd NTM (%)*	*PV/ Ebitda NTM*
APC	41.63	252	10,500	60	0.32	0.79	3.5	5.3	9.3	1.0	6.7

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:	US$mm	17,700
Ebitda = Earnings before interest, tax, depreciation and amortization:	US$mm	3,340
NTM = Next Twelve Months Ended March 31, 2003; P/E = Stock Price to Earnings		
PV = Present Value of energy businesses:	US$mm	22,300

Summary and Recommendation

We recommend current purchase of the common shares of Anadarko Petroleum Corporation as the sharks circle a wounded owner of energy resources of the size and quality to be attractive to the largest acquirers. Falling short of overblown expectations, the company has changed course to emphasize more profitability at the expense of growth, appropriately in our view. Announcement of layoffs prepares employees so that the negative impact of the potential sale of the company would be old news should a deal for the company become apparent. To the potential purchaser, Anadarko represents a surprise chance to gain rare properties at a low McDep Ratio at the beginning of a new long boom in energy commodity value as we see it. Finally, while there can be no assurance that a deal will actually materialize, we believe the odds of investment success are favorable with a "vulnerable value" like Anadarko.

Executive Turnover

Turmoil at the top sends a message that something is amiss. The surprises began in late March when the chief executive officer for the past two years resigned abruptly only a few days after a conference for analysts. The chairman, Bob Allison, who ran the production operations at the parent company before Anadarko was spun off in 1986, resumed the CEO role.

Next, first quarter financial and operating results failed to meet expectations. As the stock declined we concluded its value justified a buy recommendation. While we were too early in our timing, the conclusion has become stronger as the stock has declined further. Second quarter results were consistent with our value conclusion.

On July 31, it was disclosed that two senior officers had resigned and three senior officers were retiring. The retirees included long-time colleague and friend of Mr. Allison, Paul Taylor, well known as Anadarko's investor liaison. The executive departures were announced at the same time as a cost cutting initiative.

On August 7 in Denver, Mr. Allison was the luncheon speaker at an investor conference. Mr. Taylor was also present. Mr. Allison was emphatic that Anadarko's new strategy would be more profitable even though it may deliver less volume growth.

The Energy Growth Delusion

As we have seen with natural gas royalty trusts, simply accepting the cash return from choice assets is often more rewarding than investing in exploration companies that promise growth. The delusion seems to be that managers and investors fail to appreciate the value of existing choice assets and underestimate the difficulty of finding new choice assets.

Anadarko started with a choice asset in the Hugoton field of Kansas, once the largest natural gas field in the U.S. that still throws off bountiful cash flow. Hugoton has diminished in relative importance, as it is part of a region that now accounts for less than 10% of the company's gas production. Canada, East Texas and the Rockies are the leading areas of current production. New projects have created new choice assets, but at a somewhat diluted overall return. Actually Anadarko's record of developing new producing areas is quite impressive considering the true difficulty of the task. Though costs may be somewhat high, a judicious amount of pruning can work wonders.

The company also made a shrewd acquisition when it acquired Union Pacific Resources. Anadarko, in effect, capitalized on the growth delusion of the newly independent owner of the great old railroad land grant assets. Anadarko bought Union Pacific Resources at a time when investor disenchantment depressed the target's stock price.

Better Than a Futures Contract for Major Oil Company

While analysts may disagree over the relative value of Anadarko, the differences may depend more on commodity outlook than on the mix of the company's assets. We attach great significance to merely owning the commodity in a changing economic environment. One might say, for example, that Hugoton is a mature asset and therefore uninteresting. A major oil company buyer might look at Hugoton as a long-term commodity position that is more dependable than a futures contract because virtually all counter parties who take the other side of futures contracts have limited financial strength.

Buy the Land Owner

Energy history is repeating itself in the Rocky Mountains while most of the players have changed ownership. During the last energy boom, the area was one of the most exciting growth provinces while Union Pacific and Amoco were two of the most exciting stocks. Recall that Abraham Lincoln granted more eight million acres of land in alternating square mile sections along the right of way as an inducement for Union Pacific to undertake construction of a transcontinental railroad.

Union Pacific in turn granted Amoco rights to develop the oil and gas potential on that acreage. Anadarko has now succeeded to Union Pacific's position and BP has succeeded to Amoco's position until next year.

The land grant acreage is still highly prospective and productive. Advances in technology continually make the tight formations with blanket natural gas accumulation more valuable. In a new twist, Mr. Allison reminds us that the railroad company chose its lands to be close to coal so that energy would be readily available to run the trains. That seems fortuitous as only in little more than the past decade has natural gas production from coal seams become a rapidly growing economic resource.

The checkerboard pattern of Anadarko's lands insures long-term participation in any discovery at the same time it probably discourages rapid development by others. Union Pacific took the passive approach by farming out as the industry terminology has it. Yet Amoco has only had spurts of aggressive activity leaving much of the lands still undeveloped.

Meanwhile, the long-term deal that gave Amoco, now **BP (BP)**, the right to develop the railroad property expires next year if we understood Mr. Allison correctly. Apparently BP is aggressively drilling natural gas prospective acreage on the properties now owned by Anadarko to gain control of as much resource as it can before it loses the right. Fortunately for Anadarko, the lands are so vast and rich in resources that BP will still be leaving most of the potential behind.

Theoretically, BP could buy Anadarko and the checkerboard ownership would be concentrated and potentially developed faster. Alternatively another large buyer might trade land grant property to BP or BP might trade its related position to the new owner. **ExxonMobil (XOM)** and **Royal Dutch (RD)** are both active in the Rockies, but are not the leading players now.

Besides North American natural gas that accounts for some 55% of next twelve months revenue, Anadarko has valuable oil properties in Algeria as well as in North America. The aggregate value of oil and gas resources may be summed up in a cash flow multiple of little more than five times and an adjusted reserve life index of ten years.

An asset purchased at five times cash flow would return 20% in cash the first year. An oil and gas asset with a longer-than-average ten-year life index would produce 10% of reserves in the first year and declining amounts over about a 20-year period. Assuming constant percentage decline and constant cash flow per unit of volume, such an investment would produce an attractive rate of return of 13% per year. We discuss valuation further below.

Projecting Next Twelve Months Cash Flow Simplified

Major oil companies apparently analyze new investments by examining the present value of future cash flows as we do in our work. More sophisticated refinements may apply simulation, consider option value and work with portfolio theory. Overall interpretation ultimately relies on judgment including how well mathematical techniques capture reality.

While reserving final judgment, valuation does not have to be complex. It is history that Anadarko's cash flow in the latest quarter approached $900 million as we show in the line labeled "Ebitda" (see Table). For the next twelve months we are looking at more than $3300 million, somewhat less than 4 times the latest quarter. Oil and gas price from the futures market for the next four quarters is somewhat less than for the quarter just ended. We project constant volume while management guides higher. We project costs near the current level though management promises lower costs. In contrast we leave out the costs of hedging in future quarters although some of the past costs remain embedded in our cost projections.

A buyer of Anadarko as a company could save operating costs and hedging costs. We share the opinion that seems to be held by major oil company managers that hedging of production should be limited to special cases and financially weak companies. Though we have a low opinion of the value of hedging to soundly financed producers, we have a high opinion of the value of commodity markets as a means of discovering consensus price expectations. Hedging losses seem to be further depressing Anadarko's stock, marking another sign of potential opportunity for an acquirer.

Cash Flow Multiple Low for Anadarko

The present value of future cash flows covering many years implies a simple multiple of year ahead cash flow that a manager or investor can contemplate as to its reasonableness. Our estimate of Anadarko's present value of $60 a share times shares and adding debt implies a multiple of 6.7 times cash flow. That seems cautious compared to a median 7.6 times cash flow that is implied by our analysis of mega cap oil companies. On the most important quantitative differentiating factor, adjusted reserve life, Anadarko scores 10.0 years while the median for mega caps is 10.2 years in our current comparisons.

Regardless of our assessments, the market puts a median multiple of 6.7 times on cash flow for mega cap energy stocks compared to 5.3 times for Anadarko. Thus if Anadarko were acquired for 6.7 times cash flow, $60 a share, the acquisition price would be no more than the median market multiple for mega cap energy stocks assuming recent commodity futures prices. More importantly the acquirer could point to higher cash flow from the Anadarko properties in the newly combined form.

Good Timing for Energy Resource Deals

The overriding valuation consideration may be the trend rather than the precise level. If the economic conditions of the past twenty years are about to be repeated then commodity prices may be stable to declining and there may be no urgency to buy Anadarko. Instead we believe a different environment is signaled by interest rates below the rate of inflation. That suggests higher rates of inflation down the road than recently experienced. Energy prices are likely to inflate more than prices generally. During the 1970s inflation was 8% per year and oil and gas prices appreciated 25% per year. Say inflation for the 2000s becomes 5% per year. Oil and gas price increases may be 10-15% per year. Even though no one knows whether that much inflation will materialize, we believe that it is only prudent that diversified portfolios have inflation protection.

The managers of major oil companies look at the same trends and have intimate knowledge of their own businesses. The largest companies apparently contemplate enormous investments in liquefied natural gas. Long lead times make the economics of capital intensive projects sensitive to inflation in the cost of building the new plants and to the market price of the product when the plants finally come on line. As those managers contemplate inflation and future energy prices, the conventional resources in a stock like Anadarko are likely to look increasingly attractive in comparison.

Kurt H. Wulff, CFA

Anadarko Petroleum Corporation
Next Twelve Months Operating and Financial Estimates

	Q1 3/31/03	*Q2 6/30/03*	*Q3E 9/30/03*	*Q4E 12/31/03*	***Year 2003E***	*Q1E 3/31/04*	*Q2E 6/30/04*	***Next Twelve*** *Months 6/30/04*
Volume								
Natural Gas (mmcfd)	1,705	1,791	1,791	1,791	**1,770**	1,791	1,791	**1,791**
Oil (mbd)	214	237	237	237	**231**	237	237	**237**
Total gas & oil (bcf)	279	292	296	296	**1,162**	289	292	**1,173**
Price								
Natural gas ($/mcf)								
Henry Hub ($/mmbtu)	6.38	5.63	4.83	5.04	**5.47**	5.34	4.76	**4.99**
U.S. (or North America)	4.62	4.54	4.14	4.25	**4.38**	4.40	4.10	**4.22**
Oil ($/bbl)								
WTI Cushing	34.03	29.07	31.57	30.92	**31.40**	29.28	27.89	**29.92**
Worldwide	27.54	25.41	26.66	26.34	**26.46**	25.51	24.82	**25.84**
Total gas & oil ($/mcf)	4.51	4.41	4.28	4.31	**4.36**	4.33	4.12	**4.26**
Revenue ($mm)								
Natural Gas	709	740	682	700	**2,831**	709	669	**2,760**
Oil	530	548	581	574	**2,234**	544	535	**2,235**
Other	18	(11)		-	**7**	-	-	**-**
Total	1,257	1,277	1,264	1,274	**5,071**	1,253	1,204	**4,995**
Expense								
Fixed	154	209	209	209	**783**	209	209	**837**
Variable	154	209	205	207	**776**	204	197	**813**
Other	18	(11)	-	-	**7**	-	-	**-**
Ebitda ($mm)	931	869	849	857	**3,506**	840	798	**3,344**
Deprec., Deplet., & Amort.	290	323	323	323	**1,259**	323	323	**1,292**
Other non cash	5	13		-	**18**	-	-	**-**
Ebit	636	533	526	534	**2,229**	517	475	**2,052**
Interest	60	68	68	68	**264**	68	68	**272**
Ebt	576	465	458	466	**1,965**	449	407	**1,780**
Income Tax	201	163	160	163	**688**	157	142	**623**
Net Income ($mm)	374	302	298	303	**1,277**	292	264	**1,157**
Shares (millions)	258	252	252	252	**254**	252	252	**252**
Per share ($)	1.45	1.20	1.18	1.20	**5.03**	1.16	1.05	**4.59**
Ebitda Margin	74%	68%	67%	67%	**69%**	67%	66%	**67%**
Tax Rate	35%	35%	35%	35%	**35%**	35%	35%	**35%**