McDep Associates
Independent Stock Idea
July 2, 2003

Rating: Buy
S&P 500: 982

Encore Acquisition Corporation
Small Cap, Long-Life Oil, Management Record

Symbol	*Price (US$/sh) 1-Jul 2003*	*Shares (mm)*	*Market Cap ($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*
EAC	19.15	11.2	210	24.00	0.18	0.83	3.2	4.6	9.5	-	5.6

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$mm	274
Ebitda = Earnings before interest, tax, depreciation and amortization:	US$mm	59
NTM = Next Twelve Months Ended March 31, 2003; P/E = Stock Price to Earnings		
PV = Present Value of energy businesses:	US$mm	329
Absolute valuation measures represent just the 40% of EAC that is publicly held.		

Summary and Recommendation

We recommend current purchase of the shares of Encore Acquisition Corporation as a small cap participation in long-life oil resources at attractive valuation and under sound management. We believe it is timely to own oil reserves in the unfolding environment of free money where short-term interest rates are less than the rate of inflation. The company's long reserve life of 12.6 years compares to a median of 9.6 years for peers Yet, Encore stock is valued in the market place at an unlevered cash flow multiple (EV/Ebitda) of only 4.6 times compared to 5.1 for peers. Long reserve life justifies a higher multiple for Encore, in our opinion. Meanwhile, the chairman of the three-year old company, Jon Brumley, has a unique record of being the driving force, or founder, of four all-time most successful small cap energy investments. Finally, the main risk is that short-term oil price can be volatile and thereby have an exaggerated impact on stock price.

Riding on the Oil Field They Call the CCA

Encore's most important real asset is the Cedar Creek Anticline (CCA) property in the Williston Basin of Montana and the Dakota's acquired from **Royal Dutch/Shell (RD)**. At 75% of Encore's reserves and 61% of 2002 production, Cedar Creek Anticline accounts for most of the long life in the company's portfolio. As we calculate it on annualized production at the most recent quarterly rate and counting undeveloped reserves at half the weight per barrel of developed reserves, Encore's reserve life index is

12.6 years (see table). That compares to a median 9.6 years for 31 small cap independent producers.

Natural Gas and Oil Reserves

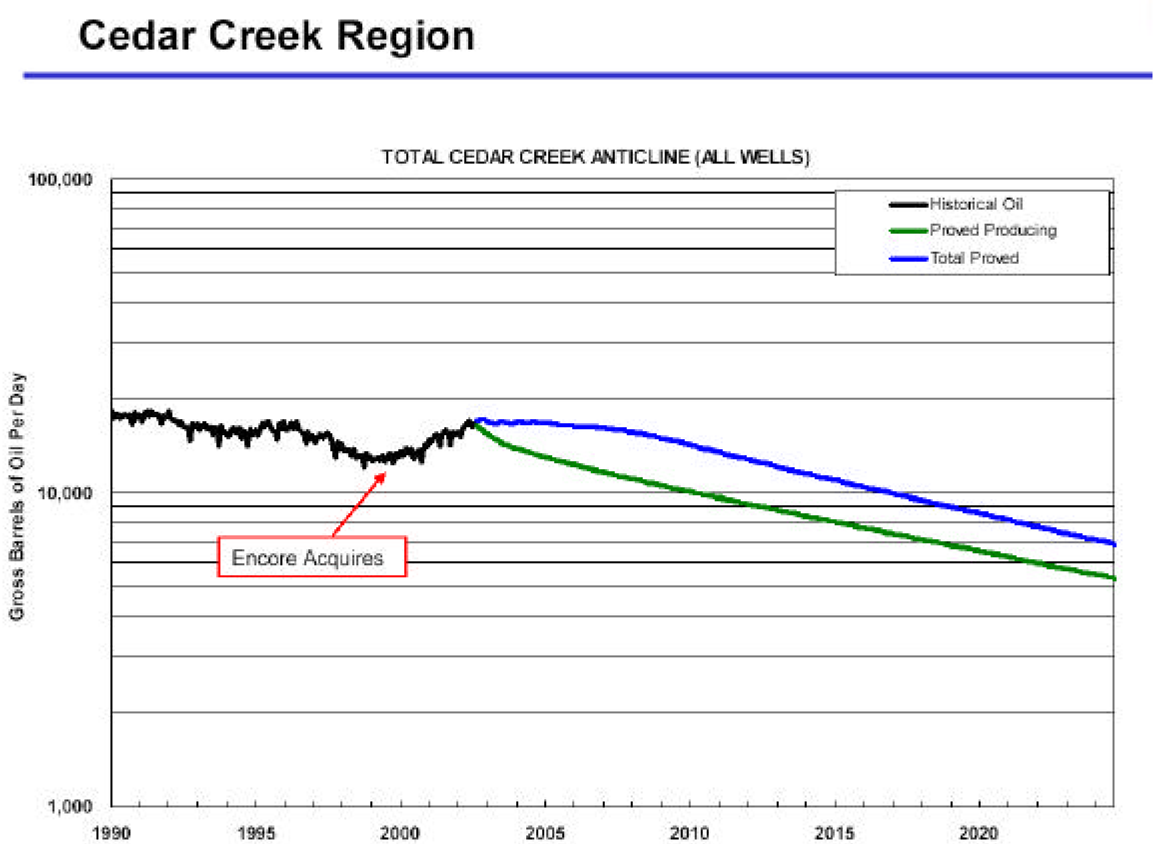
	Natural Gas	Oil	Total	
	(bcf)	(mmb)	(bcf)	(mmb)
Reserves (bcf or mmb)				
Proven (P)	100	112	772	129
Proven Developed (PD)	82	94	646	108
Proven Undeveloped (PUD)	18	18	126	21
Production, Next Twelve Months	7.8	8.1	56.2	9.4
Reserve Life Index (years)				
R/P P	12.8	13.9	13.7	13.7
R/P PD	10.5	11.7	11.5	11.5
R/P PUD	2.3	2.2	2.2	2.2
R/P PD+.5PUD	11.6	12.8	12.6	12.6

The Cedar Creek properties are on the crest of a long geological feature that created the giant old oil field. Though the field had more than three billion barrels of original oil in place the amount recovered so far is a low 12% or so. The global giant Shell apparently was willing to part with its premier position at a time when it may not have been sufficiently confident about the economics of future recovery under its conservative oil price forecast. Nor did the CCA seem important enough to RD to get the creative attention a competent small cap producer could give it. In any event, Encore appears to have made an astute purchase.

A low percentage of oil recovered implies more potential for future activity. Already Encore has been able to boost production since the property was acquired (see graph on next page extracted from a recent presentation reprinted on the company's web site http://www.encoreacq.com/bearstearns0603.pdf). Management further suggests that conventional techniques including more water flooding and horizontal drilling could add 42 million barrels to the 93 million barrels proven on the CCA for the company.

Hot Air Injection Might Double Recoverable Reserves

Also known as an air flood, the tertiary recovery procedure involves compressing air at the surface and injecting it in the producing formation where the temperature is high enough to cause oil in contact with the oxygen in the air to ignite spontaneously. The expanding gases provide the energy to drive more oil to the surface as we understand it. The technique has been known for more than a decade and its application has become promising in specific instances. The company is testing the method on its Pennel and Coral Creek properties.



Capital costs for the air injection are not particularly high at $2 to $3 a barrel, but the economics are sensitive to operating costs and it takes time for the project to deliver the increased oil. Federal tax credits for enhanced oil recovery help.

Ironically, low cost electricity generated from coal increases the attractiveness of the technique. Electricity runs the motors that run the compressors that inject the air. Environmentally, one might look carefully at how much coal would be burned relative to the amount of oil produced. The long-term availability of cheap coal generated electricity may be questionable. Yet a small amount of electrical energy can have a magnified impact in a large amount of energy released underground that drives a valuable commodity to the surface.

Valuation Builds on Estimated Next Twelve Months Cash Flow

Cash flow times cash flow multiple is a useful simplification for valuing energy producers. The cash flow part is fairly straightforward; the multiple is more subjective. We interject an intermediate step by estimating present value as a multiple of cash flow and then use that present value to calculate a McDep Ratio. In either case we need an estimate of cash flow as a starting point.

Our model of next twelve months cash flow can accommodate fine tuning, but we try to keep it simple. Volumes are estimated at the same daily rate as for the quarter just ended (see table).

Encore Acquisition Corporation
Quarterly Results

	Q1 *3/31/03*	*Q2E* *6/30/03*	*Q3E* ***9/30/03***	*Q4E* ***12/30/03***	***Year 2003E***	*Q1E* ***3/31/04***	*Q2E* *6/30/04*	***Next Twelve*** *Months* *6/30/04*
Volume								
Natural Gas (bcf)	1.93	1.95	1.98	1.98	**7.84**	1.93	1.95	**7.84**
Natural Gas (mmcfd)	21.5	21.5	21.5	21.5	**21.5**	21.5	21.5	**21.5**
Days	90	91	92	92	**365**	90	91	**365**
Oil (mb)	1,666	1,684	1,703	1,703	**6,756**	1,666	1,684	**6,756**
Oil (mbd)	18.51	18.51	18.51	18.51	**18.51**	18.51	18.51	**18.51**
Total (mb)	1,988	2,010	2,032	2,032	**8,063**	1,988	2,010	**8,063**
Total (mbd)	22.1	22.1	22.1	22.1	**22.1**	22.1	22.1	**22.1**
Price								
Henry Hub ($/mmbtu)	6.38	5.66	5.85	6.04	**5.98**	6.14	5.06	**5.77**
Differential ($/mmbtu)	1.04	0.92	0.95	0.98	**0.97**	0.98	0.82	**0.94**
EAC ($/mcf)	5.34	4.74	4.90	5.05	**5.00**	5.14	4.23	**4.83**
WTI Cushing ($/bbl)	34.03	29.09	29.86	28.43	**30.35**	27.19	26.20	**27.92**
Differential	2.69	2.30	2.36	2.25	**(2.43)**	2.25	2.07	**2.20**
EAC	31.34	26.79	27.50	26.19	**32.78**	25.05	24.13	**25.72**
Total ($/bbl)								
Revenue ($mm)								
Natural Gas	10	9	10	10	**39**	10	8	**38**
Oil	52	45	47	45	**189**	42	41	**174**
Other	(7)				**(7)**			
Total	56	54	57	55	**221**	52	49	**212**
Expense								
Lease operating	9	9	9	9	**36**	9	9	**36**
Production taxes	6	5	6	5	**22**	5	5	**21**
General and administrative	3	2	2	2	**8**	2	2	**7**
Total	18	16	16	16	**67**	16	16	**64**
Ebitda	38	38	40	38	**155**	36	33	**148**
Deprec., Deplet., & Amort.	8	9	9	9	**35**	9	9	**36**
Other Non Cash	2	2	2	2	**8**	2	2	**8**
Ebit	29	27	29	27	**112**	25	22	**104**
Interest	4	4	4	4	**17**	4	4	**17**
Ebt	25	23	25	23	**95**	21	18	**87**
Income Tax	9	8	9	8	**33**	7	6	**30**
Net Income ($mm)	16	15	16	15	**62**	14	12	**56**
Per Share ($)	0.57	0.54	0.58	0.53	**2.22**	0.48	0.42	**2.02**
Shares (millions)	28	28	28	28	**28**	28	28	**28**

For price we start with the most recent results before the impact of hedging. Encore, like most producers, tries to insure against abnormally low prices and for that it is willing to give away some of the near term upside in price. Thus our projections may be different than what the company actually experiences near term. Yet the purpose of our projections is to help estimate long-term value. For that purpose we do not want to use prices that may be distorted by short term hedging. Base prices are then adjusted with recent futures market prices to estimate realizations for the next four quarters.

Future costs are estimated in line with recent experience. We pay attention to management guidance to identify any unusual factors.

Low Cash Flow Multiple Implies Undervaluation

The current market multiple for an independent producer conforms to a linear relation to reserve life in a formula that has an intercept of 2.71, a slope of 0.32 and a correlation coefficient of 0.48. Plug in Encore's reserve life of 12.6 years and the formula says the cash flow multiple should be 6.7 times compared to 4.6 times implied by Encore's current stock price. We split the difference and estimate a present value of 5.6 times. Present value becomes the denominator of the McDep Ratio. Encore's McDep Ratio of 0.83 compared to a median 0.93 for peers also implies appreciation potential.

Some long life producers like Encore do not seem to be getting much credit for their longer life. That may have been partly justified in the past two decades, as the real price of energy was stable and even declining from time to time. Now with interest rates below inflation rates the likelihood seems greater that real energy price will be higher in a few years. Oil would have to be a third higher on a six-year basis to reach the inflation-adjusted average of the past 35 years or so. In a rising oil price environment, long life producers can get a magnified valuation increase.

Encore Founder a Money-Maker for Small Cap Oil and Gas Investors

Mr. Brumley has a long, distinguished career spanning practically a full 35-year cycle of the stock market. He was the driving force as president of Southland Royalty when its stock multiplied in the 1970s, the founder of **San Juan Basin Royalty Trust (SJT)** in 1980, **Cross Timbers Royalty Trust (CRT)** in 1992 and **XTO Energy (XTO)** which first went public in 1993.

Mr. Brumley has a sharp eye for quality oil and gas assets and the patience to wait for a payoff. Southland Royalty's major asset was the mineral rights under the Waddell Ranch in West Texas. Mr. Brumley wasn't there in 1925 when Gulf Oil signed a 50 year lease paying an eighth royalty to Southland. Mr. Brumley was there in 1975 when the lease expired in Southland's favor giving Southland the full volume of the field while Gulf Oil challenged unsuccessfully the expiration of lease terms.

Redeploying his company's new financial strength, Mr. Brumley acquired a new undervalued asset, Aztec Oil & Gas, which owned gas properties in the San Juan Basin. We thought Mr. Brumley overpaid when Southland acquired Aztec for a price in 1976 that was 88% higher than less than a year earlier on May 16, 1975. As he would do repeatedly, Mr. Brumley paid a little more to make what he thought was an exceptional purchase.

In November 1980, Southland spun off the Aztec natural gas properties as the San Juan Basin Royalty Trust and the Waddell oil properties in the Permian Basin Royalty Trust. Southland stock was a ten-bagger as it appreciated from a split-adjusted $2.8 on May 16, 1975 to $38 in December 1980 counting the value of the royalty trusts. A few years later Burlington Resources acquired the remaining Southland Royalty.

After oil peaked in price, the royalty trusts went on to deliver a higher return than most independent producers. That was probably in part because the cash flow was returned to the owners rather than being reinvested by managers who did not always make wise decisions.

Out of a job after Southland was acquired, Mr. Brumley founded a private company that sought to acquire long life oil and gas producing assets with more potential than other buyers were willing to recognize. That company's first public effort was Cross Timbers Royalty Trust. The new entity packaged overriding royalty interests in San Juan Basin natural gas with some long life oil assets in West Texas and Oklahoma.

The private company then went public as Cross Timbers Oil Company. After a few more years Mr. Brumley retired, voluntarily this time. His legacy was renamed XTO Energy and continues to be managed by long-time former colleagues.

Now Mr. Brumley is back again with the descriptively named Encore Acquisition Corporation. In its largest purchase to date, Encore overpaid for its CCA property, at least in the minds at the time of the competing bidders who did not get the transaction. Whether Encore will pay off for investors like Southland Royalty, San Juan Basin Royalty Trust, Cross Timbers Royalty Trust and XTO Energy, we cannot say. It seems like we have seen it before and we are inclined to think it might happen again with a little bit of luck.

Kurt H. Wulff, CFA