Meter Reader
A Weekly Analysis of Energy Stocks Using the McDep Ratio
March 26, 2001

Energize Your Portfolio

Summary and Recommendation

Five stocks for energy exposure in a diversified portfolio might include **Royal Dutch Petroleum**, **Phillips Petroleum**, **USX-Marathon Group**, **Energy Partners, Ltd.** and **Burlington Resources**. The first three are drawn from Mega Cap, Large Cap, and Mid Cap groups that expand Meter Reader's coverage globally (see table below). Other stocks from the newly added issues might be just as suitable. We have long known most of the companies, but our current analysis is still in progress. Read on for more of our research to manage your energy investments and check back regularly at www.mcdep.com.

Be Exposed To The Upside In Energy

As the outlook for other sectors of the stock market has become less ebullient, the value of energy representation has become more evident. Energy stocks did pretty well during the 1970s, for example, when the stock market as whole went nowhere. The past year in natural gas felt a lot like the 1970s. Thoughtful investors were rewarded at the same time consumers faced steep increases in energy bills.

Meter Reader's narrow initial focus on four natural gas producers turned out surprisingly well in stock market performance. In fact one of the best winters ever for natural gas price is now behind us. That makes it timely for Meter Reader to broaden its coverage. In our opinion, the whole energy sector offers superior investment potential after a long period of economic and political neglect.

The strength in energy stocks has not yet been that great. Many of the stocks now being added to Meter Reader have barely moved. Indeed there is always some risk of decline before further advance. Yet the downside seems limited. The upside could still be multiples of today's stock prices judging by past experience.

Gains in the stock market from time to time can be disproportionately confined to a few stocks or a few sectors. Investors almost have to be in those stocks or sectors just to keep up with average performance. Energy's time may be here or may be coming in the next few years.

Overweight Smaller Size for Higher Expected Return

During the 1970s, small companies outperformed large companies among energy stocks. During the 1980s and 1990s, the reverse was true. During 2000, small companies outperformed large companies again. Smaller companies currently offer better value by several measures.

Rank by McDep Ratio	*Symbol*	*Price ($/sh) 23-Mar 2001*	*Shares (mm)*	*Market Cap ($mm)*	*Net Present Value ($/sh)*	*Debt/ Present Value*	*McDep Ratio*
Mega Cap							
Exxon Mobil Corporation	XOM	76.90	3,520	271,000	72.10	0.16	1.06
BP Amoco p.l.c.	BP	46.64	3,720	174,000	48.90	0.17	0.96
TOTAL Fina Elf S.A.	TOT	65.97	1,400	92,000	72.00	0.16	0.93
Royal Dutch/Shell	RD	54.89	3,580	197,000	60.80	0.09	0.91
Total or Median				*734,000*		*0.16*	*0.95*
Large Cap							
Enron Corp.	ENE	59.40	795	47,200	44.40	0.43	1.19
Chevron (incl. Texaco)	CHV	86.70	1,060	91,900	103.40	0.15	0.86
Burlington Resources, Inc	BR	45.02	216	9,700	60.50	0.17	0.79
Anadarko Petroleum Corp.	APC	62.60	249	15,600	90.90	0.17	0.74
ENI S.p.A.	E	60.42	800	48,300	91.90	0.10	0.69
Conoco Inc.	COC.B	28.50	623	17,800	48.00	0.21	0.68
Phillips (incl. Tosco)	P	54.40	379	20,600	102.10	0.27	0.66
Total or Median				*251,000*		*0.17*	*0.74*
Mid Cap							
Barrett Resources Corporation	BRR	61.70	34	2,100	53.80	0.21	1.12
Occidental Petroleum	OXY	23.72	370	8,800	35.60	0.46	0.82
Unocal Corporation	UCL	34.16	256	8,700	51.90	0.27	0.75
Norsk Hydro ASA	NHY	40.19	262	10,500	65.90	0.15	0.67
Devon Energy Corporation	DVN	60.00	135	8,100	99.30	0.14	0.66
Valero Energy Corp.	VLO	34.18	64	2,200	65.00	0.25	0.64
Petro-Canada	PCZ	22.18	272	6,000	38.70	0.08	0.61
USX-Marathon Group	MRO	26.50	310	8,200	58.10	0.21	0.57
Total or Median				*43,700*		*0.21*	*0.66*
Small Cap							
Dorchester Hugoton, Ltd.	DHULZ	13.75	10.7	148	13.40	-	1.03
Cross Timbers Royalty	CRT	17.89	6.0	107	19.60	-	0.91
San Juan Basin Royalty	SJT	15.87	46.6	740	17.60	-	0.90
Hugoton RoyaltyTrust	HGT	15.30	40.0	610	18.70	-	0.82
Energy Partners Ltd.	EPL	10.40	27.1	280	19.40	-	0.54
Total or Median				*1,890*		-	*0.90*

Median McDep Ratios are highest for Mega Cap stocks, next highest for Large Cap, and lowest for Mid Caps. Valuation by the McDep Ratio is the principal quantitative feature of Meter Reader. We have found the McDep Ratio to be our most useful tool for identifying relative opportunity for the past two decades. A similar pattern of valuation by size is evident by more conventional valuation measures (see table below).

Rank by EV/Ebitda	*Symbol*	*Price ($/sh) 23-Mar 2001*	*EV/ Sales 2001E*	*EV/ Ebitda 2001E*	*P/E 2001E*	*Indicated Annual Dividend (%)*	*PV/ Ebitda*
Mega Cap							
Exxon Mobil Corporation	XOM	76.90	1.4	7.4	16	2.3	7.0
BP Amoco p.l.c.	BP	46.64	1.2	6.7	11	3.0	7.0
TOTAL Fina Elf S.A.	TOT	65.97	1.0	6.5	15	1.7	7.0
Royal Dutch/Shell	RD	54.89	1.4	6.4	14	2.6	7.0
Median			*1.3*	*6.6*	*15*	*2.4*	*7.0*
Large Cap							
Enron Corp.	ENE	59.40	0.5	14.3	36	0.8	12.0
Chevron (incl. Texaco)	CHV	86.70	1.0	5.2	10	3.0	6.0
Burlington Resources, Inc	BR	45.02	3.3	4.7	9	1.2	6.0
Anadarko Petroleum Corp.	APC	62.60	2.1	4.4	9	0.3	6.0
Conoco Inc.	COC.B	28.50	0.6	4.1	8	2.7	6.0
Phillips (incl. Tosco)	P	54.40	0.7	4.0	7	2.5	6.0
ENI S.p.A.	E	60.42	1.1	3.5	6	2.6	5.0
Median			*1.0*	*4.4*	*9*	*2.5*	*6.0*
Mid Cap							
Barrett Resources Corporation	BRR	61.70	4.8	6.7	14	-	6.0
Occidental Petroleum	OXY	23.72	1.2	4.9	7	4.2	6.0
Unocal Corporation	UCL	34.16	1.6	4.5	12	2.3	6.0
Devon Energy Corporation	DVN	60.00	3.0	3.9	8	0.3	6.0
Valero Energy Corp.	VLO	34.18	0.2	3.9	5	0.9	6.0
Petro-Canada	PCZ	22.18	0.9	3.6	8	1.2	6.0
Norsk Hydro ASA	NHY	40.19	0.8	2.7	6	2.6	4.0
USX-Marathon Group	MRO	26.50	0.4	2.3	5	3.5	4.0
Median			*1.1*	*3.9*	*7*	*1.8*	*6.0*
Small Cap							
Cross Timbers Royalty	CRT	17.89	4.3	6.7	7	14.1	7.4
San Juan Basin Royalty	SJT	15.87	4.7	5.6	7	14.1	6.3
Dorchester Hugoton, Ltd.	DHULZ	13.75	4.4	5.5	6	7.9	5.3
Hugoton RoyaltyTrust	HGT	15.30	3.8	5.1	6	15.5	6.2
Energy Partners Ltd.	EPL	10.40	1.5	2.3	8	-	4.3
Median			*4.3*	*5.5*	*7*	*14.1*	*6.2*

Because we cannot be sure which size group will perform better in the future we believe that investors should diversify by size and own a stock from each group. Because we expect that smaller stocks will outperform larger stocks we recommend relative emphasis away from Mega Cap stocks. An equal weighting in each stock would accomplish that. For example, if only one of five stocks is from the Mega Cap group, the weighting of the Mega Cap group would be about 20%. Yet Mega Cap stocks account for more than $700 billion of market cap, or 70% of market cap for the stocks covered. If we could allow for all the energy stocks not in our coverage, the Mega Caps would still probably account for half of the industry.

Diversify by Industry Segment

In the future it will be easier to identify in our tables each company's concentration by industry function. For now we will think of just three segments – North American Natural Gas, Oil and Overseas Gas, and Industrial Businesses. To be sure of strong exposure in North American Natural Gas, our fifth stock suggested for new money in an energy portfolio, Burlington Resources, is concentrated in that function. After that we will just try to assure that the remaining stocks are well represented in Oil and Overseas Gas. Industrial Businesses will then take care of itself. We aim to add Power and Oil Service representation over the next several months.

Use the McDep Ratio

Most analysts and investors pay careful attention to relative value in energy, but few express the relationships in a consistent quantitative fashion. Some put a great deal of weight on reported earnings for Mega Cap stocks. The more useful technique for smaller companies is cash flow. Target prices are also commonly used to communicate relative appreciation potential. Those who classify stocks for risk add a necessary qualifying measure.

The McDep Ratio provides a single measure of quantitative potential that also neutralizes for financial risk. The numerator is Market Cap and Debt (McDe), or enterprise value (EV). The denominator is Present Value (p or PV). Present Value for Small Cap stocks previously covered in Meter Reader is recalculated weekly by discounting future cash flows. PV for the companies being added is approximated for now as a multiple of Earnings before Interest, Tax, Depreciation and Amortization (Ebitda). Estimated Ebitda will also be refined as we have more time to update each company.

Regular ranking is also part of the usefulness of the technique. Frequent readings give a sense of whether a stock is outperforming or underperforming peers on an unlevered, or debt-adjusted, basis. There is also a reason for sorting in descending order. The suggestion is to buy a stock near the low end of the McDep Ratio ranking and watch it move up as it hopefully outperforms.

Adjust Positions for Financial Risk

For investors the choice of leverage is a risk preference and not a valuation issue. Accordingly one should not expect the stock of a highly levered company to be a better investment than the stock of an unlevered company simply because it is more sensitive to business changes. The greater or lesser use of debt has little if any bearing on the inherent profitability of a business. It matters little fundamentally whether leverage is applied by corporate managers or by investment managers. The important issue is how much is applied.

To keep matters simple, we suggest that energy investment positions be equally weighted after including an allowance for debt. Investors might hold an extra quarter position in a stock with no debt and only half a position in a stock with a debt ratio of 0.40. When investing in stocks with high debt ratios investors must also be confident that the increased risk of losing control is justified.

Be Tax-Efficient

One of the simplest steps most investors can take to minimize taxes is to let taxable gains compound as long as possible. A difference in McDep Ratio of 0.10 is not sufficient to justify selling a higher McDep Ratio stock if the sale is taxable. The tax due may exceed the valuation difference.

A wider difference might justify a taxable event. Even then some stocks might keep a premium or a discount valuation for a long time.

Use the Framework

Meter Reader with the McDep Ratio is a framework for interpreting new information. Bad news, for example, concerning a low McDep Ratio stock may not have much impact.

The technique is particularly useful in making sense out of deals. Consider that Royal Dutch/Shell is offering $55 a share for Barrett Resources. The target company stock has traded up to a premium to the offer at $62 a share. At that price the McDep Ratio is 1.12 (see table on page 2). Supposedly Shell or another company will buy Barrett near that price. The implication is that other stocks might also be worth a McDep Ratio of 1.12 in a takeover.

Here is one of several ways we might calculate the equivalent stock price for Burlington Resources, for example. Remember that the McDep Ratio is 1.0 when stock price equals Net Present Value. If BR stock price were to increase by $15.48 a share from the current quote to Net Present Value, the McDep Ratio would increase 0.21 to get to 1.00. A further increase in McDep Ratio of 0.12 to1.12 implies a further increase in stock price of (0.12/0.21) times $15.48, or $8.85. The resulting equivalent stock price would be about $69.

If you are skeptical about that conclusion here is how we might look further into the calculation. From the table on page 3 we see that PV is 6.0 times Ebitda for both stocks. Our two tables allow Ebitda to be back calculated for each company. Ebitda estimates might be compared to those of other analysts.

One of the most important determinants of the PV/Ebitda multiple is reserve life. BR's is longer than Barrett's although that is not evident from our summary statistics. Then there is always the question whether one company has hidden value another does not have. In any event, the McDep Ratio is a convenient technique to use in developing a quick reaction to unfolding developments.

Distribution Blowout for Royalty Trusts

Hugoton Royalty Trust and **San Juan Basin Royalty Trust** declared monthly distributions of $0.42 and $0.40, respectively. We can remember a time when SJT paid less than that in a whole year. Better to be lucky than smart. Our estimates of monthly payout had been only $0.27 and $0.25. Disappointed until now that producers were not actually receiving the high prices quoted, we are gratified that more of the gains are going to the wellhead.

Despite the great feeling of a big payoff we have to remind ourselves that the good news is now out at least for a few months. Natural gas quotes are currently about $5 a million Btus after peaking around $10 in the depth of winter. The latest declarations for HGT and SJT reflect near peak commodity price.

SJT has been practically the best performing energy stock in recent weeks. Moreover royalty trusts exhibited their low risk characteristics by holding up while most energy stocks have declined with the recent dip in the Dow. Meanwhile estimates of both present value and distributions increased during the past week. We will continue to reflect the weekly change for the small cap stocks in the tables above. Models for each of the small stocks are now in the Appendix to Meter Reader.

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