

## **Energy Partners, Ltd. (EPL – 14.50) Harvesting Giant Oil Fields Offshore Louisiana**

### **Summary and Recommendation**

We believe the shares of Energy Partners, Ltd. are an attractive investment in growing oil and gas production from giant fields offshore Louisiana originally developed by major oil companies. Concentrating on new discoveries elsewhere, Royal Dutch/Shell, Chevron and others have essentially outsourced the exploitation of properties that have produced billions of barrels. Through EPL, the original owners pool their separate properties and share information that was previously protected. Those arrangements make new technology all the more successful in exploiting deeper and subtler hydrocarbon accumulations that abound in places that have historically produced a lot. Formed only two years ago and having just completed an initial public offering of its stock, EPL has already developed production of 16,000 barrels a day that we think can grow 15% per year without dilution to current shareholders. The stock is valued at a McDep Ratio of .75 and at just 3 times next twelve months cash flow (see valuation ranking tables on page 4 in the format of Meter Reader, a weekly analysis). Of course valuation depends on politics, economics, industry conditions, company performance and analyst judgment.

### **Present Value Depends on Volume, Price, Costs, Reinvestment, Taxes and Interest Rates**

A discounted cash flow model is the mechanism for measuring the impact of weekly changes in inputs on fundamental value. We may not have commentary every week on EPL, but we do intend to post a recalculation regularly on [mcdep.com](http://mcdep.com). We can touch on important parameters in the company's outlook while reviewing the highlights of the model by column from left to right (see Table EPL-1).

EPL adds reserves to its own account by outright purchase of properties and by drill-to-earn arrangements. As an example of the latter, if EPL funds 100% of a project, it will be credited with 75% of the new production developed. In our table, the Volume - Basic column plays out the production from reserves proven in projects already completed. Wells typically produce at capacity and volume declines continuously. The Volume – Enhanced column reflects the results of spending on new projects (Capex). We input to the model a Volume Enhancement factor that we believe can be achieved by a specific degree of regular reinvestment (Capex/Cash Flow). A successful company might keep its production flat while reinvesting half of cash flow. We see EPL reinvesting practically all of its cash flow and thereby achieving nice growth.

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Thanks to the development of a futures market we can continuously view a consensus price forecast. The prices to 2006 are available in digital form from nymex.com among other sources. To recognize an early exception, EPL's oil price is dampened through May of next year by hedges required by its bank lender. After 2006 we escalate crude price with the inflation rate implied by comparing the price of a ten-year U.S. Treasury note with that of a ten-year U.S. Treasury Inflation Protected Security (TIPS). As a result we have a price projection tied to market that we use to update EPL value regularly. Of course, we don't necessarily agree with the futures market or the ability or willingness of the government to measure inflation correctly.

Costs are either fixed or variable for purposes of the DCF model. We just divide the current total and keep part of it constant and vary the rest with revenue. The current level ties to the quarterly model to be discussed below.

Finally, we tie the discount rate to that of a ten-year treasury note plus 1.4 percentage points, or 140 basis points as the fixed income investors say. That might seem like a low rate for a risky business. Yet in our mind a large oil or gas field is a low risk investment comparable to a high quality bond. In fact the field is better than a bond in terms of its long-term protection against inflation.

The largest source of risk specific to EPL is the relationship between spending and new production. Rather than using the blunt tool of a high discount rate, we deal with that by doing sensitivity analyses, a good topic for further exploration as the company's history unfolds.

### **Cash Flow Projected in Detail for Next Twelve Months**

Of course Wall Street and some investors exaggerate the impact of quarterly earnings. We will further dismiss a focus on earnings for oil and gas producers as too fraught with artificial accounting factors like historic cost. What does count in oil and gas is cash flow. Quarterly cash flow projections are a particularly sensitive mechanism for understanding how a company is progressing.

Here then is the cash flow model that translates recent history into projections (see Table EPL-2). The most important number is cash flow of \$5.14 per share for the twelve months ending 9/30/01. That would be impressive progress not fully reflected in a multiple of only 4 times implied by current stock price. The most important EPL-specific input to get to that estimate is 18,300 barrels daily oil equivalent production. We are targeting 20,000 bd for the calendar year 2001. On the basis of recent activity it appears that production in the quarter that we are now in may already be 16,000 bd. As a result the target level seems achievable considering plans for a continued high rate of spending and the quality of the fields in which EPL is working.

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Other elements of future cash flow will become more refined as the company reports quarterly progress. For example, lease operating costs per barrel ought to decline as volume picks up even though we project them to be flat.

Just as we use the oil futures settlement prices for the latest week in projecting cash flow for future years, we also use those prices in projecting cash flow for future quarters. Over time we anticipate that futures traders will bid up oil prices for future months and years closer to the current quotes. In that way the long-term oil price structure will move up considerably. For example, oil for 2006 is quoted at less than \$20 a barrel. That should be more like \$30 by the time we get to 2006. As we progress in that direction we expect a continuing positive bias for oil investments.

### **High Production Rates Generate Cash Flow for Growth**

The ranking tables highlight the valuation measures that characterize EPL. The low McDep Ratio implies that we see strong appreciation potential. Notice that EPL also has no debt assuming the proceeds of the IPO are used to repay all borrowings.

The unusually low cash flow multiple is the strongest indicator of EPL's investment appeal. An explanation of the low multiple highlights the opportunity. First, estimated cash flow is tied to future volume as opposed to historical volume. A low multiple of stock price to our estimate implies that investors are looking for confirmation that projected levels will really be achieved. Second, consistent with the characteristics of production in the Gulf region, reserve life is short at 5 years. Without new drilling, cash flow in the Gulf would not last as long as cash flow in Hugoton or San Juan. Investors tend to pay a lower multiple for shorter reserve life. The inverse of a short life is a high rate of production and a quicker payback of cash flow. Companies that can reinvest effectively can grow faster if their source of funds is from rapidly producing properties. Accordingly, much of the investment potential in EPL hinges on how rapidly the company can develop new production.

### **Management is Well-Qualified**

Rick Bachmann and his team are well respected in the oil patch having been previously associated with major oil companies and a leading independent. Mr. Bachmann, an MBA from Wisconsin, was president of Louisiana Land when Burlington Resources acquired that company.

(Robert Gershen of Associated Energy Managers backed Mr. Bachmann financially in the founding of EPL with an investment by Energy Income Fund. Kurt Wulff introduced Mr. Bachmann and Mr. Gershen)

Kurt H. Wulff, CFA

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<b>Rank by McDep Ratio</b>		<i>Price</i> (\$/sh)	<i>Market</i>			<i>Net</i> <i>Present</i>	
	<i>Symbol</i>	<i>2-Nov</i> <i>2000</i>	<i>Shares</i> <i>(mm)</i>	<i>Cap</i> <i>(\$mm)</i>	<i>Debt</i> <i>(\$mm)</i>	<i>Value</i> <i>(\$/sh)</i>	<i>McDep</i> <i>Ratio</i>
Dorchester Hugoton, Ltd.	DHULZ	13.38	10.7	144	-	15.30	0.87
Hugoton RT (42.5%)	HGT	13.38	17.0	227	-	15.90	0.84
Burlington Resources	BR	36.56	216	7,900	3,200	51.40	0.78
Cross Timbers Royalty Trust	CRT	14.44	6.0	87	-	18.80	0.77
San Juan Basin Royalty Trust	SJT	10.81	46.6	500	-	14.30	0.75
Energy Partners, Ltd.	EPL	14.50	24.5	400	-	21.70	0.75

<b>Rank by Cash Flow Multiple</b>		<i>Price</i> (\$/sh)	<i>Ebitda Next 12 Months</i>			<i>Cash</i> <i>Flow</i>	
	<i>Symbol</i>	<i>2-Nov</i> <i>2000</i>	<i>N Am</i> <i>Gas</i>	<i>Oil &amp;</i> <i>OS Gas</i>	<i>Other</i> <i>(\$mm)</i>	<i>(\$/sh)</i>	<i>EV/</i> <i>Ebitda</i>
Dorchester Hugoton, Ltd.	DHULZ	13.38	21	-	-	1.97	6.8
Cross Timbers Royalty Trust	CRT	14.44	12	3	-	2.45	5.9
Hugoton RT (42.5%)	HGT	13.38	41	-	-	2.42	5.5
Burlington Resources	BR	36.56	1,746	308	-	7.89	5.4
San Juan Basin Royalty Trust	SJT	10.81	101	-	-	2.17	4.9
Energy Partners, Ltd.	EPL	14.50	25	101	-	4.12	3.2

<b>Rank by Distributions</b>		<i>Price</i> (\$/sh)	<i>Earnings NTM</i>			<i>Distribution NTM</i>	
	<i>Symbol</i>	<i>2-Nov</i> <i>2000</i>	<i>Price/</i> <i>Sales</i>	<i>(\$/sh)</i>	<i>P/E</i>	<i>(\$/sh)</i>	<i>(%)</i>
Energy Partners, Ltd.	EPL	14.50	2.1	1.98	7.3	-	-
Burlington Resources	BR	36.56	4.0	3.05	12.0	0.55	1.5
Dorchester Hugoton, Ltd.	DHULZ	13.38	5.4	1.79	7.5	1.59	11.9
Hugoton RT (42.5%)	HGT	13.38	4.2	2.08	6.4	2.08	15.5
San Juan Basin Royalty Trust	SJT	10.81	4.0	1.77	6.1	1.77	16.3
Cross Timbers Royalty Trust	CRT	14.44	4.2	2.36	6.1	2.36	16.4

<b>Rank by PV/Ebitda</b>		<i>Prod</i> <i>NTM/</i>	<i>Ebitda Margin</i>		<i>Present Value</i>		
	<i>Reserves/</i> <i>Prod NTM</i>	<i>Prod</i> <i>1999</i>	<i>(\$/mcfe)</i>	<i>(\$/boe)</i>	<i>(\$/mcfe)</i>	<i>(\$/boe)</i>	<i>PV/</i> <i>Ebitda</i>
Dorchester Hugoton, Ltd.	9	0.93	3.30	19.82	2.80	17	7.8
Cross Timbers Royalty Trust	13	0.86	3.53	21.18	2.10	13	7.7
Burlington Resources	13	0.89	2.49	14.93	1.30	8	7.0
Hugoton RT (42.5%)	12	0.96	3.16	18.95	1.70	10	6.6
San Juan Basin Royalty Trust	11	1.05	3.20	19.18	1.90	11	6.6
Energy Partners, Ltd.	5	1.32	3.15	18.90	2.80	17	4.2

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**Table EPL-1**  
**Energy Partners, Ltd.**  
**Present Value**

Volume Decline (%/yr):	15	Price Escalation post 2006 (%/yr):	3.8
Volume Enhancement (%/yr):	30	Discount rate (%/yr):	7.1
Capex/Cash Flow (%):	95	U.S. TIPS Inflation (%/yr):	3.8
Variable Cost (%):	18	U.S. 10 Year Yield (%/yr):	5.7

Year	Volume			Price (\$/bbl)	Revenue (\$mm)	Fixed Cost (\$mm)	Var Cost (\$mm)	Cap Ex (\$mm)	Pre- Tax (\$mm)	Income Tax (\$mm)	Cash Flow (\$mm)	Disc Factor	Present Value (\$mm)
	Basic (mb)	Enhanced (mb)	Total (mb)										
Total 2000 through 2014													
	30101	122034	152134	24.25	3689	359	664	1331	1335	222	1113	0.40	533
1999	5055		5055	15.51	78.4	17.0	14.1		47.4	0.0	47.4		
2000	4396	390	4786	26.74	128.0	22.4	23.0	78.4	4.1	0.0	4.1	0.97	4.0
2001	3823	3118	6941	26.90	186.7	22.4	33.6	124.1	6.5	1.1	5.4	0.90	4.9
2002	3324	4733	8057	25.58	206.1	22.4	37.1	139.2	7.3	1.2	6.1	0.84	5.1
2003	2890	6440	9331	23.68	220.9	22.4	39.8	150.8	7.9	1.3	6.6	0.79	5.2
2004	2513	8273	10787	22.77	245.6	22.4	44.2	170.0	8.9	1.5	7.5	0.73	5.5
2005	2186	10268	12454	21.37	266.1	22.4	47.9	186.0	9.8	1.6	8.2	0.68	5.6
2006	1900	12464	14365	21.37	307.0	22.4	55.3	217.8	11.5	1.9	9.6	0.64	6.1
2007	1653	14904	16557	22.19	367.4	22.4	66.1	264.9	13.9	2.3	11.6	0.60	6.9
2008	1437	12668	14105	23.04	325.0	22.4	58.5		244.1	40.7	203.4	0.56	113.2
2009	1250	10768	12018	23.93	287.6	22.4	51.8		213.4	35.6	177.8	0.52	92.3
2010	1087	9153	10239	24.85	254.4	22.4	45.8		186.2	31.0	155.2	0.48	75.2
2011	945	7780	8725	25.80	225.1	22.4	40.5		162.2	27.0	135.1	0.45	61.1
2012	822	6613	7435	26.79	199.2	22.4	35.9		140.9	23.5	117.4	0.42	49.6
2013	714	5621	6335	27.82	176.3	22.4	31.7		122.1	20.3	101.7	0.39	40.1
2014	621	4778	5399	28.89	156.0	22.4	28.1		105.5	17.6	87.9	0.37	32.3
2015	540	4061	4601	30.00	138.0	22.4	24.8		90.8	15.1	75.6	0.34	26.0

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**Table EPL-2**  
**Energy Partners, Ltd.**  
**Cash Flow**

	<i>Year</i>	<i>H1</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	<i>12Months</i>
	<i>1999</i>	<i>6/30/00</i>	<i>9/30/00</i>	<i>12/31/00</i>	<i>2000E</i>	<i>3/31/01</i>	<i>6/30/01</i>	<i>9/30/01</i>	<i>9/30/01</i>
<b>Highlights</b>									
Revenue (\$mm)	78.7	56.4	28.4	43.2	128.0	44.8	47.7	54.1	190
EBITDAX (\$mm)	47.4	35.0	18.3	29.2	82.5	29.9	31.2	35.9	126
Cash Flow (\$mm)	47.4	35.0	18.3	29.2	82.5	29.9	31.2	35.9	126
Per share (\$)	1.68	1.43	0.74	1.19	3.36	1.22	1.27	1.47	5.14
Net Income (\$mm)	(27.4)	20.6	(21.7)	11.4	10.3	11.5	11.7	14.0	49
Per share	(0.97)	0.84	(0.88)	0.47	0.42	0.47	0.48	0.57	1.98
Shares (millions)	28.2	24.5	24.5	24.5	24.5	24.5	24.5	24.5	24.5
<b>Volume</b>									
Natural Gas (bcf)	7.43	2.88	1.33	1.77	5.98	1.88	2.08	2.29	8.01
Natural Gas (mmcf)	20.4	15.8	14.5	19.2	16.3	20.9	22.8	24.9	22.0
Days	365	182	92	92	366	90	91	92	365
Oil (mb)	3,817	1,770	842	1,178	3,789	1,256	1,384	1,525	5,342
Oil (mbd)	10.46	9.73	9.15	12.80	10.35	13.95	15.21	16.58	14.64
Total (mb)	5,055	2,250	1,064	1,472	4,786	1,570	1,730	1,906	6,678
Total (mmbd)	13.9	12.4	11.6	16.0	13.1	17.4	19.0	20.7	18.3
<b>Price</b>									
Natural Gas									
Henry Hub (\$/mmbtu)	2.24	3.13	4.49	5.05	3.95	4.86	4.35	4.32	4.64
Differential (\$/mmbtu)	0.31	(0.08)			(0.09)				0.03
EPL (\$/mcf)	1.93	3.21	4.49	5.05	4.04	4.86	4.35	4.32	4.61
Oil (\$/bbl)									
WTI Cushing	19.24	28.81	31.49	33.57	30.67	31.78	30.47	28.99	30.41
Differential	2.45	2.20	4.87	4.43	3.28	3.39	2.57	-	1.81
EPL	16.79	26.61	26.61	29.13	27.39	28.39	27.90	28.99	28.60
Total (\$/bbl)	15.51	25.04	26.68	29.36	26.74	28.54	27.55	28.37	28.42
<b>Revenue (\$mm)</b>									
Natural Gas	14.3	9.2	6.0	8.9	24.1	9.2	9.0	9.9	37.0
Oil	64.1	47.1	22.4	34.3	103.8	35.6	38.6	44.2	152.8
Total	78.4	56.3	28.4	43.2	128.0	44.8	47.7	54.1	189.8
<b>Cost (\$mm)</b>									
Lease operating	27.3	15.9	7.5	10.4	33.8	11.1	12.2	13.4	47.1
General and administrative	4.1	5.5	2.6	3.6	11.8	3.9	4.3	4.7	16.4
Other	(0.3)	(0.1)							
Total	31.1	21.3	10.1	14.0	45.5	14.9	16.5	18.1	63.5
<b>EBITDAX (\$mm)</b>									
Exploration	1.6	0.8	0.7	1.2	2.7	1.2	1.2	1.4	5.0
Deprec., Deplet., & Amort.	23.3	12.5	5.9	8.2	26.7	8.7	9.6	10.6	37.2
Net interest									
Other non cash	65.3	(10.5)	45.5	2.0	37.0	2.0	2.0	2.0	8.0
Income before income tax	(42.8)	32.2	(33.9)	17.9	16.2	17.9	18.3	21.9	76.0
Income tax	(15.4)	11.6	(12.2)	6.4	5.8	6.5	6.6	7.9	27.4
<b>Net income (\$mm)</b>	<b>(27.4)</b>	<b>20.6</b>	<b>(21.7)</b>	<b>11.4</b>	<b>10.3</b>	<b>11.5</b>	<b>11.7</b>	<b>14.0</b>	<b>48.6</b>
<b>Costs (\$/bbl)</b>									
Lease operating	5.40	7.05	7.05	7.05	7.05	7.05	7.05	7.05	7.05
General and administrative	0.81	2.46	2.46	2.46	2.46	2.46	2.46	2.46	2.46
Deprec., Deplet., & Amort.	4.61	5.57	5.57	5.57	5.57	5.57	5.57	5.57	5.57
<i>EBITDAX margin</i>	60%	62%	64%	68%	64%	67%	65%	66%	67%
<i>Tax rate</i>	36%	36%	36%	36%	36%	36%	36%	36%	36%

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