***McDep Associates***
***Stock Idea***
March 18, 2002

Buy/Sell Rating: 2 – Buy
S&P 500: 1166

# ConocoPhillips
## Initiate Buy Recommendation

| *Symbol* | *Price ($/sh) 15-Mar 2002* | *Shares (mm)* | *Market Cap ($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* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| P | 62.72 | 680 | 42,700 | 80.00 | 0.32 | 0.85 | 0.9 | 6.1 | 13 | 2.3 | 7.2 |
| COC | 28.99 | | | | | | | | | | |

| | | |
|---|---|---|
| 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: | $mm | 68,400 |
| Ebitda = Earnings before interest, tax, depreciation and amortization: | $mm | 11,190 |
| NTM = Next Twelve Months Ended March 31, 2003; P/E = Stock Price to Earnings | | |
| PV = Present Value of energy businesses: | $mm | 80,100 |
| Present Value of Equity: | $mm | 54,400 |

### Summary and Recommendation

We recommend current purchase of the common stock of Phillips Petroleum and/or Conoco Inc. because the combined entity ConocoPhillips promises the attractive long-term return in oil, infrastructure and natural gas of a Mega Cap energy company at a lower McDep Ratio. Oil production has strategic value often underestimated by investors that may be tested in the next few months as efforts advance to purge a bad guy from Iraq. COC/P has the leading oil position in Alaska with ExxonMobil (XOM) and BP as well as the fifth ranking position in the North Sea. Refining, where COC/P has the number one position in size in the U.S., is becoming more profitable as capacity is tight and demand for clean fuels is rising. The Federal Trade Commission may require some divestitures in the latter business before issuing its approval for the merger to go ahead in the second half of 2002. Natural gas producing properties in North America and overseas offer large profits signaled by rising long-term natural gas futures prices. COC/P has a reasonable ratio of debt, an increasingly important advantage when energy infrastructure companies are bloated with too much debt. Chief Executive Officer James Mulva has a distinguished record of creating value in a mature industry. The stock could potentially be $100 a share to be valued like a Mega Cap today and could offer a normal return from that level subject to political, economic, financial and business risk.

 

## Oil Has Strategic Value

Six-year quotes for Light Sweet Crude Oil are currently about $22 a barrel. The one-year quotes for the same commodity are currently about $24 a barrel. More often than not crude oil futures have been in backwardation implying that the price in the future will be lower than today. In that sense, expectations for crude oil prices are about normal for the recent past. By extension, oil stocks are valued with about the same oil price expectations. The expected rate of return to investors ought to be about normal if prices actually materialize as the futures market implies.

Considering how important oil is to economic activity it is fundamentally cheap. The best evidence of that is the high taxation that European countries apply to oil products. Thus, whenever oil supplies get a little tight, the low untaxed prices respond sharply. Those characteristics imply that oil is a strategic business. Profits are modest normally, but especially rewarding occasionally. As a result a long-term diversified investment portfolio should have representation in strategic businesses.

Meanwhile we may be facing a time in the near future when the strategic value of oil becomes more evident. Already some investors might conclude that the potential for military action in Iraq is driving up oil prices. We agree, but conclude the effect is not as pronounced as it could become. Only a year or so ago, the near term price was above $30 a barrel. At some higher level of oil price we would worry about the downside. We don't seem to be there now.

## ConocoPhillips Oil Concentrated in North America and Europe

It seems quite remarkable that Phillips, a pioneer in the Norwegian North Sea, now is also the leading producer in Alaska. Many times in decades past we emphasized the strategic value of owning production in “safe” areas. Conoco weighs in with its strong North Sea position and its Canadian properties. As a result among the industry’s largest companies, COC/P has its oil position more concentrated in the political jurisdiction of the consuming countries, which thirst for energy.

Inevitably production has matured in COC/P’s main areas and the company looks more for growth elsewhere. Prospects are promising in China. Both companies have investment in Venezuela whose economic potential is threatened by the increasingly extreme politics of that country. Fortunately COC/P is strong enough to withstand potential adversity in the land of Bolivar and indirectly may benefit from the higher oil price that political instability brings.

 

**Consolidation A Boon For Valuation**

Investors accord higher valuation to the largest companies among energy stocks. The consolidation trend of the past few years justified some of that higher valuation as the combined companies committed to cost saving efficiencies from eliminating duplicated efforts in previously separate entities.

The new ConocoPhillips will be about four times the size of Conoco or Phillips individually just a few years ago. Conoco acquired Gulf Canada only last year, ironically reacquiring properties it owned until shortly before its takeover by DuPont in 1981. Phillips practically doubled its size in two years by acquiring the Alaska oil properties formerly owned by Atlantic Richfield and further acquiring the refiner, Tosco. Recall that regulatory approval of BP's acquisition of Arco was conditioned on divesting Arco's Alaskan business because BP was already dominant there.

Eventually ConocoPhillips is likely to be part of a Mega Cap company defined by us as having a market cap greater than $100 billion. COC/P may get there as a surviving entity or it may get there as part of an existing Mega Cap. In either case we expect COC/P to outperform as an energy investment while its valuation advances to Mega Cap level.

**Cash Flow Might Support $100 a Share**

Our valuation starts with the projection of cash flow for the next twelve months using futures prices for natural gas, oil and refinery margins (see table). Comparing cash flow (Ebitda) to enterprise value, or market cap and debt, gives us a multiple of only 6.3 times. That compares to a median of about 9 times for Mega Cap Energy companies.

Should the properties in COC/P be worth the same multiple as the properties in the median Mega Cap? Why not? Taking reported reserves at face value, COC/P's life index on our adjusted basis is about 11years, nearly the same as for the median Mega Cap. Is COC/P's downstream business as good as that of the Mega Caps? COC in particular tended to emphasize intensive processing for more value added.

A $100 value for COC/P corresponds to EV/Ebitda of 8.7 times. In assessing present value for determining a McDep Ratio, we value COC/P's Ebitda at just 7.4 times compared to 9.0 for Mega Caps. That seems quite cautious leaving ample room for increasing the relative estimate. Even that cautious estimate leads to a McDep Ratio as low as 0.85, near the low end of the range for Large Cap stocks.

 

**Management is Bold and Competent**

One test of whether Phillips is Mega Cap material is the decision to move the corporate headquarters from Bartlesville, Oklahoma to Houston. And we mean no slight to Bartlesville. A picture from the home of Frank Phillips, circa 1975, hangs in a prominent position on our office wall.

Through a stock ownership program, the employees of Phillips and thereby many of the residents of Bartlesville, own a disproportionate share of the company. Moreover, chief executive officer, James Mulva, scored a coup in Phillip's acquisition of the Alaskan properties of Atlantic Richfield. That has helped the stock to outperform. Now the COC/P deal at no premium is another coup. CEO Mulva has earned the respect of investors to such a degree that he could propose the departure of the native son for the big city.

**The Stock Has Favorable Price Momentum**

Divining future price action from charts of past prices is bit like witchcraft. Nonetheless the perspective is useful. Moreover given a choice between two stocks of equal value we would prefer the one with the more promising chart pattern.

Phillips stock has moved above its 200-day average of about 57 and the 200-day trend is rising. A pullback to the 50-day average at 59 would present no great surprise. Except for its recent upturn, the 200-day trend has been flat for a year. Thus the stock seems to be breaking out of a long period of consolidation. Charts of fundamental industry indicators show similar signs (see *Meter Reader*, March 11, 2002).

Kurt H. Wulff, CFA

 

**ConocoPhillips**
**Next Twelve Months Operating and Financial Estimates**

| | *Q4 12/31/01* | *Q1E 3/31/02* | *Q2E 6/30/02* | *Q3E 9/30/02* | *Q4E 12/31/02* | ***Year 2002E*** | *Q1E 3/31/03* | *Next Twelve Months 3/31/03* |
|---|---|---|---|---|---|---|---|---|
| **Volume** | | | | | | | | |
| Natural Gas (mmcfd) | | | | | | | | |
| U.S. (or North America) | 2,256 | 2,167 | 2,167 | 2,167 | 2,167 | **2,167** | 2,167 | **2,167** |
| Overseas (or Int'l) | 1,536 | 1,599 | 1,599 | 1,599 | 1,599 | **1,599** | 1,599 | **1,599** |
| Total | 3,792 | 3,766 | 3,766 | 3,766 | 3,766 | **3,766** | 3,766 | **3,766** |
| Oil (mbd) | 1,064 | 1,104 | 1,104 | 1,104 | 1,104 | **1,073** | 1,104 | **1,073** |
| Total gas & oil (bcf) | 936 | 926 | 930 | 934 | 934 | **3,724** | 926 | **3,724** |
| **Price** | | | | | | | | |
| Natural gas ($/mcf) | | | | | | | | |
| Henry Hub ($/mmbtu) | 2.41 | 2.48 | 3.11 | 3.20 | 3.45 | **3.06** | 3.69 | **3.36** |
| U.S. (or North America) | 2.13 | 2.19 | 2.75 | 2.82 | 3.05 | **2.70** | 3.26 | **2.97** |
| Overseas (or Int'l) | 2.83 | 2.98 | 3.43 | 3.41 | 3.34 | **3.29** | 3.28 | **3.37** |
| Total | 2.41 | 2.53 | 3.04 | 3.07 | 3.17 | **2.95** | 3.27 | **3.14** |
| Oil ($/bbl) | | | | | | | | |
| WTI Cushing | 20.40 | 21.50 | 24.76 | 24.65 | 24.14 | **23.76** | 23.69 | **24.31** |
| Worldwide | 17.91 | 18.87 | 21.74 | 21.64 | 21.19 | **20.86** | 20.80 | **21.34** |
| Total gas & oil ($/mcf) | 2.77 | 2.92 | 3.41 | 3.41 | 3.40 | **20.32** | 3.39 | **20.44** |
| NY Harbor 3-2-1 ($/bbl) | 3.17 | 3.70 | 6.92 | 5.77 | 4.34 | **5.18** | 4.55 | **5.39** |
| **Revenue** ($mm) | | | | | | | | |
| Natural Gas | | | | | | | | |
| U.S. (or North America) | 441 | 427 | 542 | 562 | 607 | **2,138** | 635 | **2,346** |
| Overseas (or Int'l) | 399 | 429 | 499 | 502 | 492 | **1,922** | 472 | **1,966** |
| Total | 841 | 856 | 1,041 | 1,065 | 1,099 | **4,060** | 1,107 | **4,312** |
| Oil | 1,754 | 1,847 | 2,128 | 2,118 | 2,075 | **8,168** | 2,036 | **8,357** |
| Other | 15,861 | 15,861 | 15,861 | 15,861 | 15,861 | **63,443** | 15,861 | **63,443** |
| Total | 18,455 | 18,564 | 19,029 | 19,043 | 19,035 | **75,671** | 19,004 | **76,111** |
| **Expense** | | | | | | | | |
| Fixed | 649 | 649 | 649 | 649 | 649 | **2,594** | 649 | **2,594** |
| Variable | 649 | 676 | 792 | 796 | 793 | **3,057** | 786 | **3,167** |
| Other | 15,083 | 15,017 | 14,651 | 14,752 | 14,889 | **59,309** | 14,866 | **59,157** |
| **Ebitda** ($mm) | | | | | | | | |
| Exploration and Production | 1,297 | 1,379 | 1,728 | 1,739 | 1,732 | **6,577** | 1,709 | **6,907** |
| Other | 778 | 843 | 1,209 | 1,109 | 972 | **4,133** | 995 | **4,285** |
| Total Ebitda | 2,075 | 2,222 | 2,937 | 2,847 | 2,704 | **10,711** | 2,704 | **11,192** |
| Exploration | 280 | 280 | 280 | 280 | 280 | **1,120** | 280 | **1,120** |
| Deprec., Deplet., & Amort. | 1,027 | 1,027 | 1,027 | 1,027 | 1,027 | **4,108** | 1,027 | **4,108** |
| **Ebit** | 768 | 915 | 1,630 | 1,540 | 1,397 | **5,483** | 1,397 | **5,964** |
| Interest | 217 | 217 | 217 | 217 | 217 | **868** | 217 | **868** |
| **Ebt** | 551 | 698 | 1,413 | 1,323 | 1,180 | **4,615** | 1,180 | **5,096** |
| Income Tax | 193 | 244 | 495 | 463 | 413 | **1,615** | 413 | **1,784** |
| **Net Income ($mm)** | | | | | | | | **-** |
| Exploration and Production | 593 | 630 | 790 | 795 | 792 | **3,007** | 781 | **3,158** |
| Other | (4) | 39 | 277 | 211 | 122 | **648** | 137 | **747** |
| Unallocated | (231) | (215) | (148) | (146) | (147) | **(656)** | (151) | **(592)** |
| Total | 358 | 454 | 919 | 860 | 767 | **3,000** | 767 | **3,313** |
| **Shares** (millions) | 681 | 680 | 680 | 680 | 680 | **680** | 680 | **680** |
| Per share ($) | 0.53 | 0.67 | 1.35 | 1.26 | 1.13 | **4.41** | 1.13 | **4.87** |
| Ebitda Margin (E&P) | 50% | 51% | 55% | 55% | 55% | **54%** | 54% | **55%** |
| Tax Rate | 35% | 35% | 35% | 35% | 35% | **35%** | 35% | **35%** |