



# Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

September 24, 2010

## Big Income in Canada

### Summary and Recommendation

When government securities offer little nominal income and the official policy to devalue the U.S. dollar degrades principal, Canadian income stocks look like an attractive alternative to investors who want a current cash distribution. Indicated distribution yields are 5-10% a year and the assets producing that income tend to retain their real value when currency loses purchasing power. Our buy recommendation, **Canadian Oil Sands Trust (COSWF)**, is a pure play on long-life oil production through its 37% ownership in Syncrude, a massive oil production facility managed under agreement by partner ExxonMobil. COSWF has a McDep Ratio of 0.68 while it currently pays 7.8%, a level widely expected to be adjusted somewhat in 2011 when most income trusts become tax-paying corporations. We also support yield-oriented investor interest in natural gas producer, **Peyto Energy Trust (PEYUF)**, valued at a McDep Ratio of 0.81. Peyto currently pays 10.0%, a level likely to be reduced closer to the peer median. The three traditional oil-oriented producers, **Penn West Energy Trust (PWE)**, **Enerplus Resources Fund (ERF)** and **Pengrowth Energy Trust (PGH)**, valued at McDep Ratios of 0.82-0.97, may need no further adjustment in distributions that yield 5.6-8.9% (see [Tables 1-4](#) on pages 3-6).

### New Income Model Working

As Canada ends the tax practice of encouraging income trusts to make distributions without being taxed at the trust level, all of the trusts will convert to corporate form imminently to minimize taxation of funds to be distributed as dividends. Most Canadian oil and gas corporations seem to pay little current corporate tax because of deductions for reinvestment that the government apparently wants to stimulate. As a result, a high income/moderate growth model may deliver an attractive total return.

The transition to the new model seems to be working so far judging from recent volume trends (see chart [Canadian Income Trusts – Oil and Gas Volume](#) on page 7). PWE, ERF, and PGH each arrested volume decline in the second quarter of 2010. PWE has just declared its first monthly distribution at the low end of its telegraphed range as management believes it has unusual opportunity to drill horizontal wells with multiple fracturing stages on its conventional, light oil properties. In January 2009, ERF was among the first to adjust its distribution to a level it expects to maintain while it has raised reinvestment. PGH made its adjustment in October 2009.

### Peyto May Adjust High Payout

**Peyto Energy Trust (PEYUF)** has delivered surprisingly strong volume growth while maintaining the highest distribution yield of the five trusts. Advantageous hedging has helped to sustain payout at the highest ratio of distribution to equity Ebitda. Our measure of sustainability takes Ebitda estimated without the benefit of hedging and reduces it by the ratio of debt to present value (see fourth column from the right in [Table 3](#)).



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The trust's concentration on natural gas in the Deep Basin where reserve life is long offsets possible trimming of the distribution. Natural gas concentration is unique at 78% (see fifth column from the right in Table 1). Reserve life index by our measure is 21.5 years (see third column from the right in Table 3). Though we know that natural gas usually has lower operating cost than oil and that higher operating costs for oil can be justified by higher price we are still impressed by Peyto's record of keeping cost nearly flat for the past decade (see slide Low Cost Producer on page 7).

## **Canadian Oil Sands Trust Puts Distribution Variables in Focus**

After the market close on September 23, management disclosed a lower Syncrude volume estimate for 2010 of 105 million barrels compared to 110 previously. New guidance was promised to accompany the release of third quarter results on October 27. In their race to deliver capacity operations promised by 2011, the ExxonMobil engineers may be adding modifications that extend the Coker 8-1 turnaround maintenance currently underway.

Management also estimates that when the trust converts to a corporation on January 1, 2011, cash from operating activities will be reduced by about 25% to allow for corporate income tax. Accumulated "tax pools" are expected to be available to "fully shelter taxable income for about a year". In any case, management intends to make capital expenditures from cash flow before paying distributions in 2011. Chief Financial Officer Ryan Kubik's warning "a distribution reduction from current levels is likely" has been disseminated broadly. The distribution is likely to be unchanged for the last quarter of 2010 and the "likely" change would begin with the first quarter of 2011 when final results for 2010 are in and plans for operations and capital expenditures for 2011 are firmer.

Meanwhile, our distribution projection of C\$0.50 a quarter remains the "indicated" rate. Ebitda minus Interest per Unit of about C\$0.90 a quarter next year exceeds distribution by an ample margin (see table Next Twelve Months Operating and Financial Estimates on page 8). Management's 2010 guidance from July also supports continuing the current distribution if we adjust for capacity operations, substitute current oil futures price and allow for capital expenditures near the same level as budgeted for 2010.

Longer-term, the outlook appears bright with plans to expand capacity to 540,000 barrels daily in 2020, up 54% from 350,000 currently. As a result, there is a growth component to add to an attractive return from current income.

Finally, we note the animals apparently like Syncrude's environmental efforts. Rare bison twins were born during the 2010 calving season on land reclaimed from oil sands mining operations (see photo from the Syncrude newsletter, *synergy* on page 9).

Kurt H. Wulff, CFA



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Table 1									
McDep Income and Small Cap Energy Portfolio									
Debt, Business Segments and Income Yield									
Symbol/Rating	Price (US\$/sh)	EV/Market	Enterprise Value (\$mm)	Present Value by Segment (%)			Dist. Yield (%)	Dist. Yield (%)	McDep Ratio
				NAmer. Natural Gas	Oil Prod'n	NTM (\$/un)			
B = Buy CB (see below)	23-Sep 2010	Market Cap	Value (\$mm)	Natural Gas	Oil Prod'n	NTM (\$/un)	Yield (%)	Yield (%)	Ratio
<b>Canadian Income Trusts (US\$)</b>									
Pengrowth Energy Trust	PGH	10.56	1.42	4,400	36	64	0.82	7.7	0.97
Penn West Energy Trust	PWE	18.76	1.39	11,500	22	78	1.05	5.6	0.86
Enerplus Resources Fund	ERF	23.56	1.24	5,200	41	59	2.10	8.9	0.82
Peyto Energy Trust	PEYUF	13.97	1.24	2,070	78	22	1.40	10.0	0.81
Canadian Oil Sands Trust	COSWF CB	24.98	1.12	13,500		100	1.94	7.8	0.68
<i>Total or Median</i>				36,700					0.82
<b>Small Cap Independent Producers</b>									
Whiting Petroleum Corporation	WLL	92.78	1.18	6,730	14	86	-	-	1.01
Denbury Resources Inc.	DNR	15.25	1.56	9,530	16	84	-	-	1.01
Petrohawk Energy Corporation	HK	14.95	1.67	7,800	96	4	-	-	0.98
Range Resources	RRC	35.20	1.34	7,720	82	18	0.04	0.1	0.93
Berry Petroleum Company	BRY	29.84	1.63	2,640	31	69	0.30	1.0	0.90
Cimarex Energy Company	XEC B	66.33	1.11	6,280	59	41	0.32	0.5	0.84
Ultra Petroleum	UPL	39.46	1.22	7,480	94	6	-	-	0.83
Birchcliff Energy Ltd. (US\$)	BIREF CB	8.57	1.24	1,360	68	32	-	-	0.66
<i>Total or Median</i>				49,500					0.92
<b>Top Line Cash Payers</b>									
Sabine Royalty Trust	SBR	51.40	1.00	750	50	50	3.32	6.5	1.14
Permian Basin RT	PBT	19.19	1.00	890	38	62	1.35	7.0	1.07
Cross Timbers Royalty Trust	CRT	35.25	1.00	210	75	25	2.19	6.2	1.04
Freehold Royalty Trust (US\$)	FRHLF	16.32	1.09	1,040	25	75	1.63	10.0	0.96
Dorchester Minerals, L.P.	DMLP B	25.23	1.02	790	66	34	1.67	6.6	0.94
<i>Total or Median</i>				3,700					1.04
<b>Bottom Line Cash Payers</b>									
Linn Energy, LLC	LINE	30.17	1.45	6,430	47	53	2.52	8.4	1.26
Legacy Reserves LP.	LGCY	23.85	1.37	1,310	17	83	2.08	8.7	1.13
Encore Energy Partners, L.P. (52%)	ENP	18.63	1.29	560	25	75	2.00	10.7	1.07
Mesa Royalty Trust	MTR	46.00	1.00	86	75	25	3.58	7.8	0.96
San Juan Basin Royalty Trust	SJT B	23.83	1.00	1,110	100	-	1.13	4.8	0.95
Hugoton Royalty Trust	HGT B	19.22	1.00	770	90	10	1.29	6.7	0.92
<i>Total or Median</i>				10,300					1.02
<b>Composite (excl COSWF)</b>									
<i>Enterprise Value Weighting</i>				86,700	50	50			0.93
<i>Equal Weighting</i>					54	46			0.96
<i>Equal Weighted Buys</i>					68	32			0.86

CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.

McDep Ratio = Market cap and Debt to present value of oil and gas and other businesses.

Present Value presumes long-term prices of \$75 a barrel for oil and \$8 a million btu for natural gas.

Dist. = Income distribution. NTM = Next Twelve Months Ended September 30, 2011. Enterprise Value = Market Cap and Debt.





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			<i>Price</i>	<i>Revenue</i>	<i>Dist/</i>	<i>Adjstd</i>	<i>PV/</i>	<i>EV/</i>
	<i>Symbol/</i>		<i>23-Sep</i>	<i>Royalty</i>	<i>Equity</i>	<i>Prod</i>	<i>Ebitda</i>	<i>Ebitda</i>
	<i>Rating</i>		<i>2010</i>	<i>(%)</i>	<i>Ebitda</i>	<i>NTM</i>	<i>NTM</i>	<i>NTM</i>
<b>Canadian Income Trusts (US\$)</b>								
Peyto Energy Trust	PEYUF		13.97		1.07	21.5	13.7	11.1
Penn West Energy Trust	PWE		18.76		0.46	9.9	10.0	8.6
Canadian Oil Sands Trust	COSWF	CB	24.98		0.63	27.4	12.3	8.4
Enerplus Resources Fund	ERF		23.56		0.62	9.7	8.8	7.2
Pengrowth Energy Trust	PGH		10.56		0.53	9.3	7.2	7.0
	<i>Median</i>					<i>9.9</i>	<i>10.0</i>	<i>8.4</i>
<b>Small Cap Independent Producers</b>								
Range Resources	RRC		35.20		-	12.1	14.0	13.0
Ultra Petroleum	UPL		39.46		-	13.2	13.4	11.1
Birchcliff Energy Ltd. (US\$)	BIREF	CB	8.57		-	21.4	14.6	9.7
Petrohawk Energy Corporation	HK		14.95		-	7.1	9.8	9.6
Denbury Resources Inc.	DNR		15.25		-	12.8	8.5	8.6
Berry Petroleum Company	BRY		29.84		-	11.9	8.5	7.7
Whiting Petroleum Corporation	WLL		92.78		-	9.6	6.8	6.9
Cimarex Energy Company	XEC	B	66.33		-	6.3	7.0	5.9
	<i>Median</i>					<i>12.0</i>	<i>9.2</i>	<i>9.1</i>
<b>Top Line Cash Payers</b>								
Sabine Royalty Trust	SBR		51.40	100	1.00	8.7	13.6	15.5
Cross Timbers Royalty Trust	CRT		35.25	84	0.96	13.7	14.9	15.5
Dorchester Minerals, L.P.	DMLP	B	25.23	77	0.89	6.8	14.4	13.5
Permian Basin RT	PBT		19.19	42	0.94	13.1	12.5	13.3
Freehold Royalty Trust (US\$)	FRHLF		16.32	71	0.94	8.2	9.8	9.4
	<i>Median</i>					<i>8.7</i>	<i>13.6</i>	<i>13.5</i>
<b>Bottom Line Cash Payers</b>								
Linn Energy, LLC	LINE		30.17		1.67	18.4	13.9	17.6
San Juan Basin Royalty Trust	SJT	B	23.83		0.74	14.1	16.4	15.6
Hugoton RoyaltyTrust	HGT	B	19.22		0.88	12.8	14.3	13.1
Mesa RoyaltyTrust	MTR		46.00		0.94	9.0	12.6	12.1
Legacy Reserves L.P.	LGCY		23.85		1.02	12.2	9.8	11.1
Encore Energy Partners, L.P.	ENP		18.63		1.09	13.2	9.3	10.0
	<i>Median</i>					<i>13.0</i>	<i>13.3</i>	<i>12.6</i>
<p>B=Buy; CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.  EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended September 30, 2011; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses  Top Line Cash Payers defined as those having Revenue Royalty (see fifth column from right).</p>								

Please see disclosures on the final page.



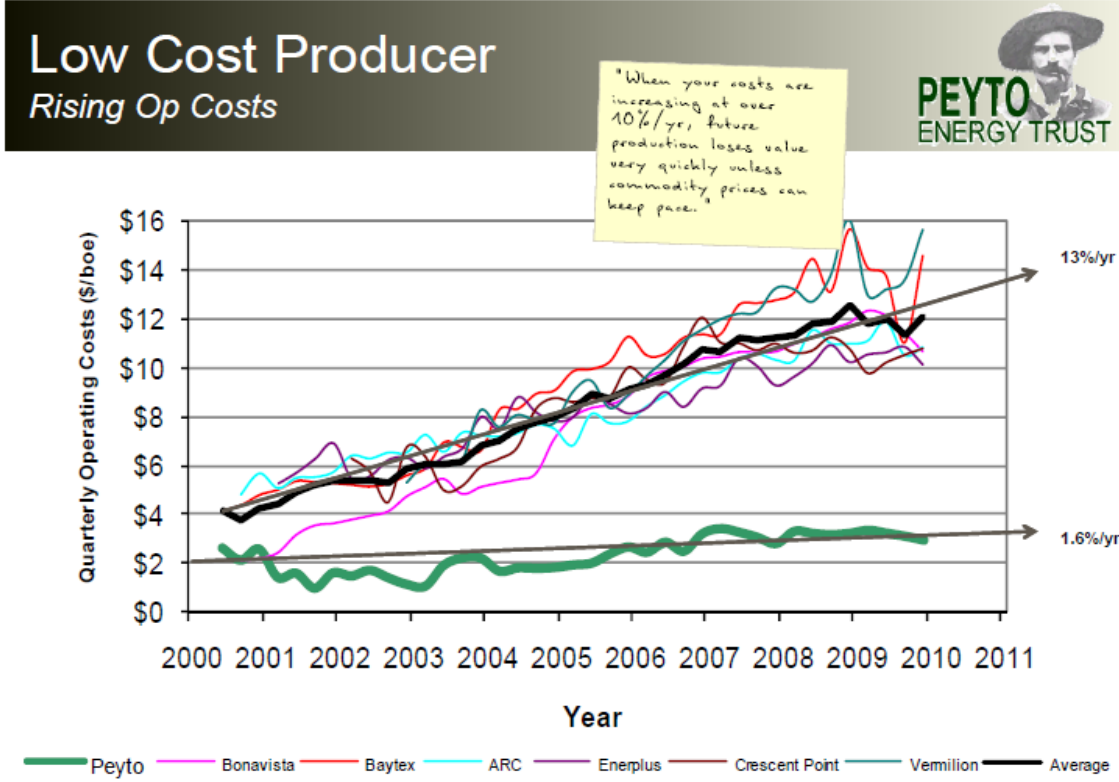
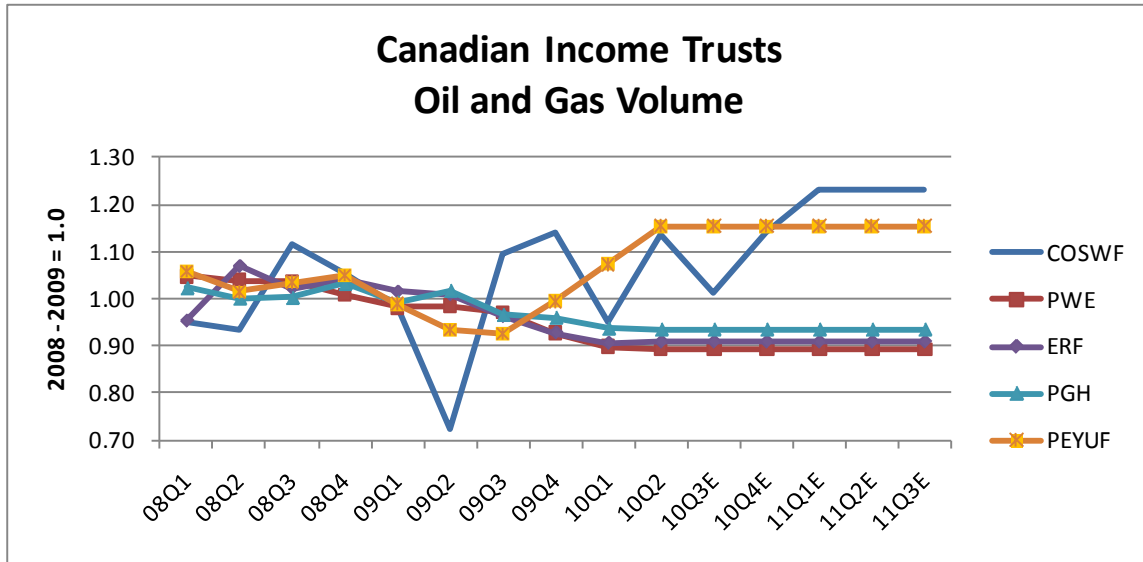
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Table 4									
Oil and Gas Income and Small Cap Stocks									
Rank by Enterprise Value to 200 Day Average									
			Price (\$/sh)	Enterprise Value/					
	Symbol/ Rating		23-Sep 2010	52Wk High	52Wk Low	50 Day Avg.	200 Day Avg.	McDep Ratio	
<b>Canadian Income Trusts (US\$)</b>									
	Peyto Energy Trust	PEYUF	13.97	0.91	1.37	0.98	1.02	0.81	
	Enerplus Resources Fund	ERF	23.56	0.96	1.50	1.02	1.02	0.82	
	Pengrowth Energy Trust	PGH	10.56	0.91	1.73	1.05	1.02	0.97	
	Penn West Energy Trust	PWE	18.76	0.88	1.22	0.98	0.98	0.86	
	Canadian Oil Sands Trust	COSWF	CB	24.98	0.76	1.07	0.98	0.92	0.68
	<i>Median</i>			<i>0.91</i>	<i>1.37</i>	<i>0.98</i>	<i>1.02</i>	<i>0.82</i>	
<b>Small Cap Independent Producers</b>									
	Whiting Petroleum Corporation	WLL	92.78	0.98	1.62	1.07	1.16	1.01	
	Cimarex Energy Company	XEC	B	66.33	0.83	1.64	0.96	1.03	0.84
	Berry Petroleum Company	BRY	29.84	0.92	1.13	1.01	1.01	0.90	
	Denbury Resources Inc.	DNR	15.25	0.85	1.13	0.99	0.98	1.01	
	Birchcliff Energy Ltd. (US\$)	BIREF	CB	8.57	0.84	1.23	0.95	0.97	0.66
	Ultra Petroleum	UPL	39.46	0.74	1.06	0.97	0.89	0.83	
	Range Resources	RRC	35.20	0.67	1.09	0.99	0.84	0.93	
	Petrohawk Energy Corporation	HK	14.95	0.66	1.06	0.97	0.84	0.98	
	<i>Median</i>			<i>0.84</i>	<i>1.13</i>	<i>0.98</i>	<i>0.98</i>	<i>0.92</i>	
<b>Top Line Cash Payers</b>									
	Permian Basin RT	PBT	19.19	0.96	1.63	1.01	1.10	1.07	
	Sabine Royalty Trust	SBR	51.40	0.93	1.34	0.98	1.07	1.14	
	Dorchester Minerals, L.P.	DMLP	B	25.23	0.90	1.25	1.00	1.05	0.94
	Freehold Royalty Trust (US\$)	FRHLF	16.32	0.91	1.23	1.02	1.03	0.96	
	Cross Timbers Royalty Trust	CRT	35.25	0.89	1.25	1.00	1.02	1.04	
	<i>Median</i>			<i>0.91</i>	<i>1.25</i>	<i>1.00</i>	<i>1.05</i>	<i>1.04</i>	
<b>Bottom Line Cash Payers</b>									
	Linn Energy, LLC	LINE	30.17	0.96	1.67	1.01	1.08	1.26	
	Mesa Royalty Trust	MTR	46.00	0.85	1.56	1.02	1.07	0.96	
	San Juan Basin Royalty Trust	SJT	B	23.83	0.84	1.44	0.99	1.06	0.95
	Legacy Reserves L.P.	LGCY	23.85	0.94	1.36	0.99	1.05	1.13	
	Hugoton Royalty Trust	HGT	B	19.22	0.87	1.28	0.98	1.04	0.92
	Encore Energy Partners, L.P. (52%)	ENP	18.63	0.88	1.62	0.99	0.98	1.07	
	<i>Median</i>			<i>0.88</i>	<i>1.50</i>	<i>0.99</i>	<i>1.05</i>	<i>1.02</i>	

CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.



BOE factor - 6 mcf = 1 bbl of oil equivalent  
Note operating costs include transportation





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Canadian Oil Sands Trust									
Next Twelve Months Operating and Financial Estimates									
(Canadian Dollars)									
									<i>Next Twelve Months</i>
	<i>Q3</i>	<i>Q2</i>	<i>Q3E</i>	<i>Q4E</i>	<i>Year</i>	<i>Q1E</i>	<i>Q2E</i>	<i>Q3E</i>	
	9/30/09	6/30/10	9/30/10	12/31/10	2010E	3/31/11	6/30/11	9/30/11	9/30/11
<b>Volume</b>									
Syncrude (mmb)	28.7	29.5	24.6	26.7	<b>105.0</b>	31.5	31.9	32.2	<b>122.3</b>
Syncrude (mbd)	312	324	267	290	<b>288</b>	350	350	350	<b>335</b>
Days	92	91	92	92	<b>365</b>	90	91	92	<b>365</b>
Trust share (%)	36.7	36.6	36.7	36.7	<b>36.7</b>	36.7	36.7	36.7	<b>36.7</b>
Trust Oil (mmb)	10.54	10.79	9.03	9.81	<b>38.6</b>	11.57	11.70	11.83	<b>44.9</b>
Trust Oil (mbd)	114.5	118.6	98.1	106.6	<b>105.7</b>	128.6	128.6	128.6	<b>123.1</b>
<b>Price</b>									
WTI Cushing (US\$/bbl)	68.22	77.85	76.02	76.30	<b>77.21</b>	79.78	81.62	82.68	<b>80.10</b>
Currency (US\$/C\$)	0.91	0.97	0.97	0.97	<b>0.97</b>	0.97	0.97	0.97	<b>0.97</b>
WTI Cushing (C\$/bbl)	74.83	80.05	78.23	78.53	<b>79.66</b>	82.11	84.00	85.08	<b>82.43</b>
Differential	(1.52)	(1.98)	(2.00)	(2.00)	<b>(1.49)</b>	(2.00)	(2.00)	(2.00)	<b>(1.83)</b>
Trust Oil Price (C\$/bbl)	73.31	78.07	76.23	76.53	<b>78.17</b>	80.11	82.00	83.08	<b>80.60</b>
Henry Hub Nat Gas (US\$/mmBtu)	3.39	4.09	4.38	4.03	<b>4.46</b>	4.39	4.33	4.48	<b>4.31</b>
Henry Hub Nat Gas (C\$/mmBtu)	3.72	4.21	4.51	4.15	<b>4.60</b>	4.52	4.46	4.61	<b>4.43</b>
AECO Natural Gas (C\$/GJ)	2.90	3.68	3.94	3.63	<b>4.05</b>	3.96	3.90	4.03	<b>3.88</b>
<b>Revenue (C\$m)</b>									
Oil	773	842	688	751	<b>3,015</b>	927	960	983	<b>3,620</b>
Other	(0)	0							
Total	773	842	688	751	<b>3,015</b>	927	960	983	<b>3,620</b>
<b>Expense (C\$m)</b>									
Production	266	294	320	320	<b>1,241</b>	319	319	320	<b>1,278</b>
Purchased Energy	27	42	38	38	<b>165</b>	49	49	51	<b>187</b>
Crown Royalties	108	85	74	86	<b>323</b>	119	124	128	<b>457</b>
Insurance	2	3	3	3	<b>11</b>	3	3	3	<b>11</b>
Administration	6	8	8	8	<b>32</b>	7	7	7	<b>28</b>
Total	409	432	443	456	<b>1,772</b>	496	501	508	<b>1,961</b>
<b>Ebitda</b>	364	410	245	295	<b>1,243</b>	431	459	475	<b>1,659</b>
Deprec., Deplet., & Amort.	123	94	94	94	<b>385</b>	150	150	150	<b>544</b>
Non-Production	34	19	19	19	<b>93</b>	37	37	37	<b>129</b>
Exchange on U.S. Debt	(90)	38							
Other	25	(0)							
<b>Ebit</b>	272	259	132	182	<b>769</b>	244	272	288	<b>986</b>
Interest	25	22	22	22	<b>92</b>	23	21	21	<b>87</b>
<b>Net Income (C\$m)</b>	247	237	110	160	<b>677</b>	221	251	267	<b>899</b>
Per Unit (C\$)	0.51	0.49	0.23	0.33	<b>1.40</b>	0.46	0.52	0.55	<b>1.86</b>
<b>Units (millions)</b>	484	484	484	484	<b>484</b>	484	484	484	<b>484</b>
Ebitda minus Interest	339	388	223	273	<b>1,151</b>	407	438	454	<b>1,572</b>
Per Unit (C\$)	0.70	0.80	0.46	0.56	<b>2.38</b>	0.84	0.90	0.94	<b>3.25</b>
<b>Distribution (C\$/unit)</b>	0.25	0.50	0.50	0.50	<b>1.85</b>	0.50	0.50	0.50	<b>2.00</b>





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Source: Syncrude newsletter, *synergy*

**Disclaimer:** This analysis was prepared by Kurt Wulff, Manager of McDep LLC. The firm used sources and data believed to be reliable, but makes no representation as to their accuracy or completeness. This analysis is intended for informational purposes and is not a solicitation to buy or sell a security. Past performance is no guarantee of future results.

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