



# Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

January 13, 2012

## Lost Winter for Natural Gas

### Summary and Recommendation

Lower stock prices in the face of warm winter weather trigger the qualification of **Birchcliff Energy (BIREF)** and **Range Resources (RRC)** as Contrarian-Buys at low McDep Ratios of 0.81 in each case (see Tables ISC-1 to ISC-4 on pages 6-9). The contrarian qualifier is automatic for a buy recommendation when stock price is below the 200-day average, a popular measure of price momentum. In fact, all seven of our income and small cap buy recommendations are in the contrarian category. As a result, investors with a longer time horizon may be attracted by lower McDep Ratio, while investors looking for quicker action may seek it elsewhere. Beyond the current winter, high-growth natural gas producers like BIR and RRC are contributing increasing supply of economical clean fuel to the combined benefit of consumers, producers and the North American economy. Meanwhile, oil concentration estimated at 44% for BIR and 34% for RRC cushions the impact of low current natural gas price. The better performance of oil the past few years has offset natural gas weakness in a balanced portfolio. Representation in both fuels is a time-tested strategy that has worked for companies and investors when surprises occur.

### Natural Gas Price Weakens

Unlike most stock market and commodity prices that declined with the financial panic in 2008, natural gas price has continued to decline (see chart Natural Gas Futures on page 3). Moreover the rate of decline accelerated in recent months, weeks and days. Lower price has stimulated record demand growth to take advantage of expanded supply from shale gas. Even those gains have not been enough to offset the absence of normal winter cold at the beginning of the 2011-2012 winter peak season.

Making their own price forecast, U.S. Energy Information Administration (EIA) analysts usually pick a base case near the futures market. To be realistic and recognize that the future often unfolds differently, the EIA adds wide confidence limits, which suggest that the forecast price of little more than \$4 two years from now could be as low as \$2 and as high as \$8 (see chart Henry Hub Natural Gas Price on page 4). In other words, only the market is smart enough to find the price that reflects the dynamic balancing of demand and supply.

### Demand Growing

U.S. natural gas consumption grew 1.8 billion cubic feet daily (bcfd), or 2.7%, to an estimated 66.9 bcfd in 2011. Gains were largest in the power and industrial sectors (see chart U.S. Natural Gas Consumption on page 4). While consumption hovers near 60 bcfd most of the year, it reaches 90 bcfd in winter.



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## **Supply in the U.S. Growing Faster**

EIA emphasizes that U.S. marketed production grew 4.5 bcf/d, or 7.4%, in 2011 for the largest one-year volume increase in history (see chart [U.S. Natural Gas Production and Imports](#) on page 5). To make way for the shale gas that drove that increase, both pipeline imports from Canada and liquefied imports from overseas were reduced and storage increased.

## **Storage at Seasonal High**

Storage statistics are the most sensitive measure of supply and demand balance after price. Lack of normal winter demand because of warm weather contributed to the total of natural gas in seasonal storage breaking out above the five year range in December. In 2012, the weekly statistics are setting a new upper bound for that range (see chart [Working Gas in Underground Storage](#) on the last page where we have regularly reproduced it). Unpredictable wiggles in the storage line as the season progresses seem to have magnified impact on near-term price.

## **Nearly Unlimited Demand**

While it has been difficult for demand to expand fast enough on a short-term basis to absorb all the new supply from the recent technological breakthrough in shale gas, on a long-term basis natural gas has strong growth potential from increasing its 25% share of North American energy (see slide [Vast Displacement Potential for Natural Gas](#) on page 5). As much coal is used for power generation as all of current natural gas production. As much oil is used in the transportation market as all of current natural gas production.

### *Power*

The recent decline in near-month natural gas futures price opens a wide segment of the coal market for displacement. Electric utilities paid a median \$2.60 a million Btu for coal and \$4.70 for natural gas during the first nine months of 2011 according to our interpretation of EIA data. The range for coal of \$0.60 to \$7.50 overlapped the range for natural gas of \$2.20 to more than \$10.00. The coal price does not include incremental costs of pollution reduction. While natural gas has been increasing its share within those price ranges it could gain more considering that natural gas price has declined a third since then. The capacity is already in place to use more natural gas in power generation.

### *Transport*

The transportation fuel equivalent of \$2.77 natural gas is about \$0.40 a gallon. Add \$1 a gallon for transmission and distribution and the cost of natural gas as a transportation fuel is less than half the cost of gasoline or diesel. A fleet owner converting delivery trucks that use 12,000 gallons a year to natural gas would save \$50,000 or more in two years to cover the cost of conversion and generate savings after that.



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January 13, 2012

## *Industrial*

Cheap natural gas helped the U.S. petrochemical and fertilizer industries to become world leaders forty years ago. It is happening again with mothballed fertilizer plants restarting and plans being made to build new petrochemical capacity to take advantage of low cost fuel and low cost feedstock from the associated liquids produced with natural gas. Newly inexpensive energy and the ready availability of labor can be the basis for an industrial renaissance.

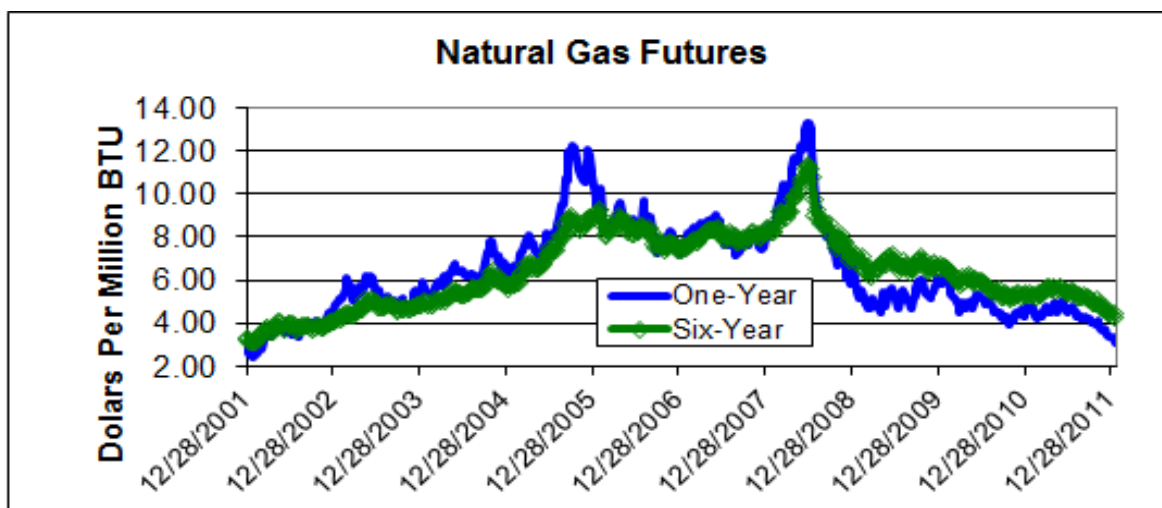
## *Exports*

A widening differential between natural gas price and oil price raises the attractiveness of export projects. The proposed Kitimat, British Columbia, Liquefied Natural Gas terminal and liquefaction plant may get a Final Investment Decision in the current quarter. LNG is priced in Asia near the price of oil. Plans are also in the works to enable export of domestic gas through U.S. terminals originally built to receive imports.

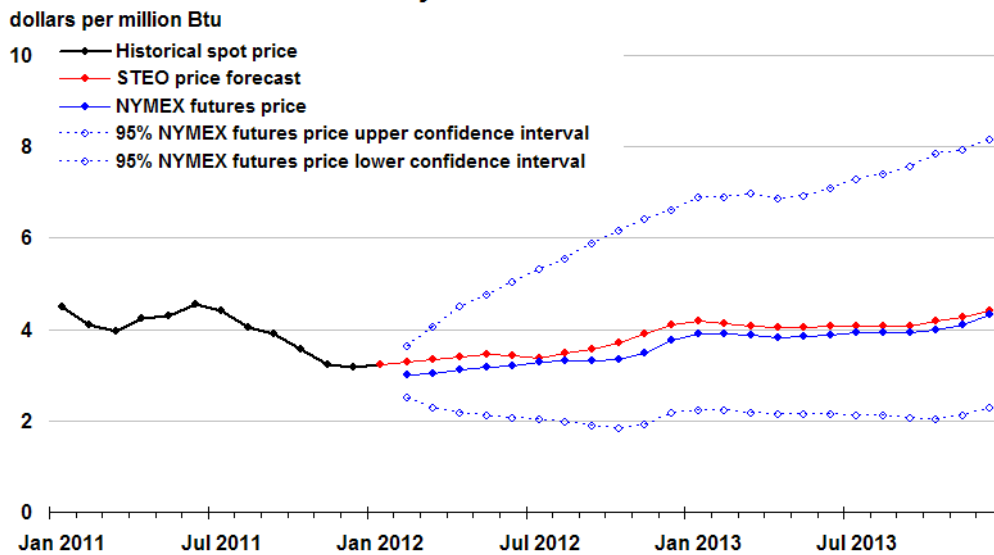
## **Abundant Low Cost Supply**

While demand expands to catch supply, the shale gas boom is slowing in response to price. At the same time, some natural gas drilling is driven by the need to hold a lease by completing a minimum number of wells to fulfill the terms, particularly in the newer plays like the Marcellus shale in Appalachia. Moreover, that drilling might be financed by an overseas major company partner eager to learn the technology. There is also a backlog of wells drilled, but not yet completed or connected. Finally, an oil shale boom in response to higher oil price is also contributing new gas supply as a byproduct.

Kurt H. Wulff, CFA



## Henry Hub Natural Gas Price

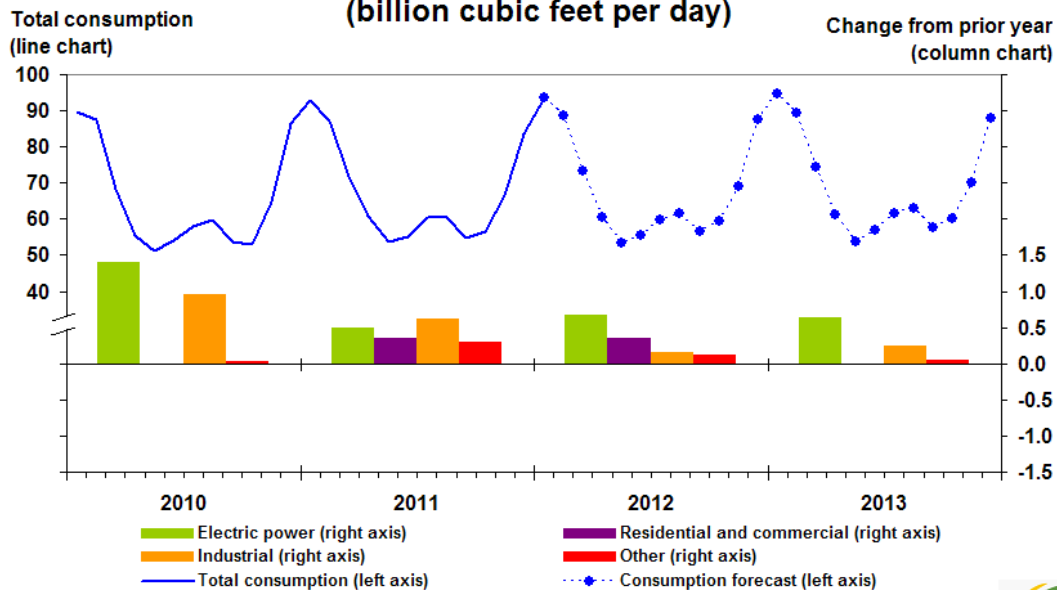


Note: Confidence interval derived from options market information for the 5 trading days ending January 5, 2012  
Intervals not calculated for months with sparse trading in "near-the-money" options contracts

Source: Short-Term Energy Outlook, January 2012

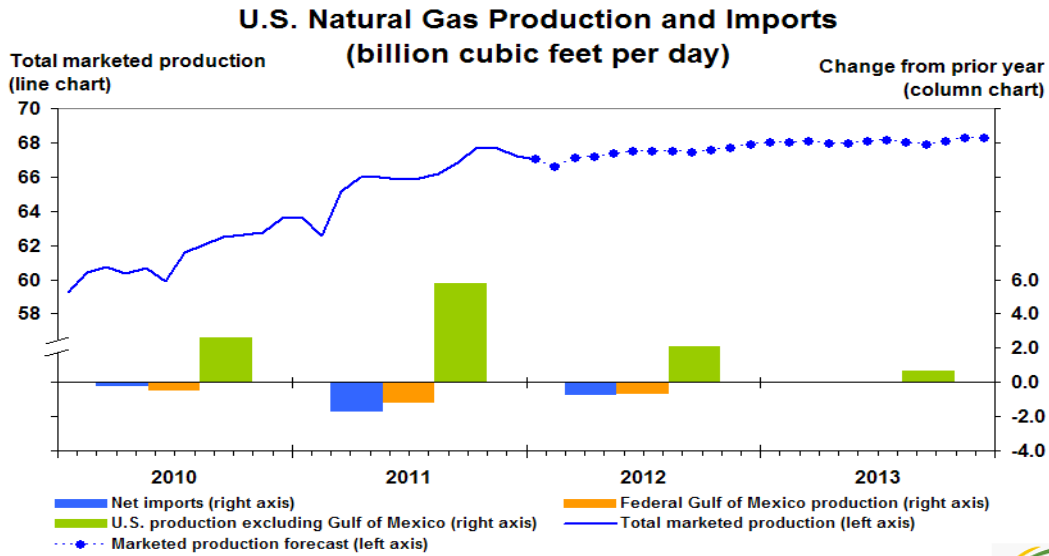


## U.S. Natural Gas Consumption (billion cubic feet per day)

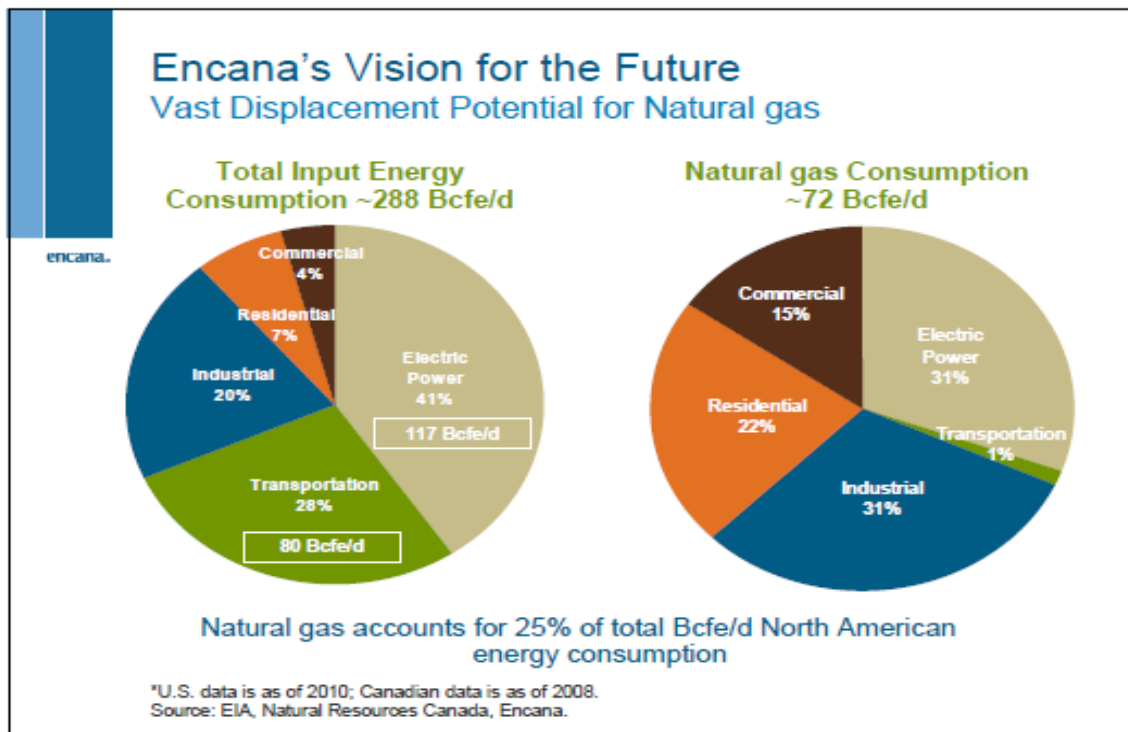


Source: Short-Term Energy Outlook, January 2012





Source: Short-Term Energy Outlook, January 2012





# Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

January 13, 2012

Table ISC-1										
McDep Income and Small Cap Energy Portfolio										
Debt, Segments, Cash Flow, Income and McDep Ratio										
		Price								
Symbol/Rating		(US\$/sh)	EV/	Enterprise	PV(%)		EV/	Dist.	Dist.	
B = Buy		12-Jan	Market	Value	Nat		Ebitda	NTM	Yield	McDep
CB (see below)		2012	Cap	(\$mm)	Gas	Oil	NTM	(\$/un)	(%)	Ratio
<b>Small Cap Independent Producers</b>										
PDC Energy	PETD	31.29	1.74	1,280	57	43	7.9	-	-	0.92
Peyto Exploration and Developmen	PEYUF	20.82	1.19	3,310	75	25	11.0	0.71	3.4	0.89
Range Resources	RRC CB	54.36	1.25	10,840	66	34	14.3	0.16	0.3	0.81
Birchcliff Energy Ltd.	BIREF CB	12.35	1.25	2,030	56	44	12.3	-	-	0.81
Berry Petroleum Company	BRY	45.23	1.58	3,910	17	83	6.1	0.32	0.7	0.74
Denbury Resources Inc.	DNR	17.63	1.35	9,590	4	96	6.0	-	-	0.70
Whiting Petroleum Corporation	WLL CB	50.31	1.27	7,600	9	91	4.4	-	-	0.63
Cimarex Energy Company	XEC CB	60.80	1.14	6,000	41	59	4.8	0.40	0.7	0.59
<i>Total or Median</i>				44,600			7.0			0.78
<b>Top Line Cash Payers</b>										
Cross Timbers Royalty Trust	CRT	47.33	1.00	280	87	13		2.57	5.4	1.08
Permian Basin RT	PBT	19.75	1.00	920	37	63		1.50	7.6	0.99
Sabine Royalty Trust	SBR	62.91	1.00	920	55	45		4.01	6.4	0.97
Freehold Royalties Ltd.	FRHLF	19.18	1.06	1,190	14	86		1.65	8.6	0.92
Dorchester Minerals, L.P.	DMLP CB	22.50	1.00	690	57	43		1.76	7.8	0.83
<i>Total or Median</i>				4,000					7.6	0.97
<b>Bottom Line Cash Payers</b>										
Linn Energy, LLC	LINE	35.95	1.47	9,290	29	71	13.3	2.76	7.7	1.13
Vanguard Natural Resources, LLC	VNR	27.77	1.54	2,080	26	74	10.2	2.31	8.3	1.07
San Juan Basin Royalty Trust	SJT CB	20.94	1.00	980	100	-	15.5	1.02	4.9	1.00
Legacy Reserves L.P.	LGCY	28.93	1.41	1,770	19	81	8.6	2.18	7.5	0.97
Enduro Royalty Trust (40%)	NDRO	20.38	1.00	270	45	55	8.6	1.66	8.1	0.97
Hugoton RoyaltyTrust	HGT	15.75	1.00	630	87	13	15.1	0.91	5.8	0.93
Mesa RoyaltyTrust	MTR	39.75	1.00	74	75	25	11.0	3.18	8.0	0.83
Enerplus Corporation	ERF CB	24.22	1.30	5,700	26	74	7.4	2.12	8.8	0.74
<i>Total or Median</i>				20,800			10.6		7.8	0.97
<b>Composite</b>										
<i>Enterprise Value Weighting</i>				69,400	35	65				0.79
<i>Equal Weighting</i>					47	53				0.88
<i>Equal Weighted Buys</i>					41	59				0.76

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 (PV) presumes long-term prices of \$100 a barrel for oil and \$6 a million btu for natural gas.

Dist. = Income distribution. NTM = Next Twelve Months Ended December 31, 2012. Enterprise Value = Market Cap and Debt.



# Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

January 13, 2012

Table ISC-2							
McDep Income and Small Cap Energy Portfolio							
Net Present Value and McDep Ratio							
		Price			Net		
		(\$/sh)		Market	Present	Debt/	
	Symbol/	12-Jan	Shares	Cap	Value	Present	McDep
	Rating	2012	(mm)	(\$mm)	(\$/un)	Value	Ratio
<b>Small Cap Independent Producers</b>							
PDC Energy	PETD	31.29	23.8	740	36.00	0.39	0.92
Peyto Exploration and Development Cor	PEYUF	20.82	133.1	2,770	24.00	0.14	0.89
Range Resources	RRC CB	54.36	159.0	8,640	70.00	0.17	0.81
Birchcliff Energy Ltd.	BIREF CB	12.35	131.0	1,620	16.00	0.16	0.81
Berry Petroleum Company	BRY	45.23	54.7	2,470	70.00	0.27	0.74
Denbury Resources Inc.	DNR	17.63	403.0	7,100	28.00	0.18	0.70
Whiting Petroleum Corporation	WLL CB	50.31	119.0	5,990	88.00	0.13	0.63
Cimarex Energy Company	XEC CB	60.80	86.2	5,240	110.00	0.07	0.59
<i>Total or Median</i>				34,570		0.16	0.78
<b>Top Line Cash Payers</b>							
Cross Timbers Royalty Trust	CRT	47.33	6.0	280	44.00	-	1.08
Permian Basin RT	PBT	19.75	46.6	920	20.00	-	0.99
Sabine Royalty Trust	SBR	62.91	14.6	920	65.00	-	0.97
Freehold Royalties Ltd.	FRHLF	19.18	58.8	1,130	21.00	0.05	0.92
Dorchester Minerals, L.P.	DMLP CB	22.50	30.7	690	27.00	-	0.83
<i>Total or Median</i>				3,940			0.97
<b>Bottom Line Cash Payers</b>							
Linn Energy, LLC	LINE	35.95	176.0	6,330	30.00	0.36	1.13
Vanguard Natural Resources, LLC	VNR	27.77	48.8	1,360	25.00	0.37	1.07
San Juan Basin Royalty Trust	SJT CB	20.94	46.6	980	21.00	-	1.00
Legacy Reserves L.P.	LGCY	28.93	43.6	1,260	30.00	0.28	0.97
Enduro Royalty Trust (40%)	NDRO	20.38	13.2	270	21.00	-	0.97
Hugoton Royalty Trust	HGT	15.75	40.0	630	17.00	-	0.93
Mesa Royalty Trust	MTR	39.75	1.9	74	48.00	-	0.83
Enerplus Corporation	ERF CB	24.22	180.6	4,370	35.00	0.17	0.74
<i>Total or Median</i>				15,270			0.97
B=Buy; 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 \$100 a barrel for oil and \$6 a million btu for natural gas.							





# Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

January 13, 2012

Table ISC-3								
McDep Income and Small Cap Energy Portfolio								
Value Multiples - Rank by EV/Ebitda								
			Price (\$/sh)	Revenue	Dist/ Equity	Adjstd Resrvs/ Prod	PV/ Ebitda	EV/ Ebitda
	Symbol/ Rating		12-Jan 2012	Royalty (%)	Ebitda	NTM	NTM	NTM
<b>Small Cap Independent Producers</b>								
Range Resources	RRC	CB	54.36		-	14.0	17.6	14.3
Birchcliff Energy Ltd.	BIREF	CB	12.35		-	19.3	15.2	12.3
Peyto Exploration and Development Corp	PEYUF		20.82		0.37	12.9	12.4	11.0
PDC Energy	PETD		31.29		-	8.1	8.6	7.9
Berry Petroleum Company	BRY		45.23		-	11.4	8.2	6.1
Denbury Resources Inc.	DNR		17.63		-	12.6	8.6	6.0
Cimarex Energy Company	XEC	CB	60.80		-	6.9	8.2	4.8
Whiting Petroleum Corporation	WLL	CB	50.31		-	8.5	7.1	4.4
	<i>Median</i>					12.0	8.6	7.0
<b>Top Line Cash Payers</b>								
Cross Timbers Royalty Trust	CRT		47.33	80	0.96	14.1	16.5	17.7
Sabine Royalty Trust	SBR		62.91	100	1.00	7.3	16.2	15.7
Permian Basin RT	PBT		19.75	32	0.98	17.2	13.1	12.9
Dorchester Minerals, L.P.	DMLP	CB	22.50	77	0.84	6.1	12.9	10.7
Freehold Royalties Ltd.	FRHLF		19.18	71	0.84	6.7	10.7	9.8
	<i>Median</i>					7.3	13.1	12.9
<b>Bottom Line Cash Payers</b>								
San Juan Basin Royalty Trust	SJT	CB	20.94		0.75	8.5	15.5	15.5
Hugoton Royalty Trust	HGT		15.75		0.87	14.0	16.3	15.1
Linn Energy, LLC	LINE		35.95		1.09	16.2	11.8	13.3
Mesa Royalty Trust	MTR		39.75		0.88	13.9	13.3	11.0
Vanguard Natural Resources, LLC	VNR		27.77		0.88	8.7	9.6	10.2
Legacy Reserves L.P.	LGCY		28.93		0.64	9.9	8.8	8.6
Enduro Royalty Trust (40%)	NDRO		20.38		0.70	6.6	8.9	8.6
Enerplus Corporation	ERF	CB	24.22		0.61	8.4	10.0	7.4
	<i>Median</i>					9.3	10.9	10.6
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 December 31, 2012; 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).								





# Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

January 13, 2012

Table ISC-4								
Oil and Gas Income and Small Cap Stocks								
Rank by Enterprise Value to 200 Day Average								
			Price (\$/sh)	Enterprise Value/				
	Symbol/ Rating		12-Jan 2012	52Wk High	52Wk Low	50 Day Avg.	200 Day Avg.	McDep Ratio
<b>Small Cap Independent Producers</b>								
	Denbury Resources Inc.	DNR	17.63	0.74	1.45	1.07	1.00	0.70
	PDC Energy	PETD	31.29	0.74	1.42	0.96	0.99	0.92
	Berry Petroleum Company	BRY	45.23	0.82	1.26	1.07	0.98	0.74
	Whiting Petroleum Corporation	WLL CB	50.31	0.71	1.51	1.05	0.96	0.63
	Peyto Exploration and Development C	PEYUF	20.82	0.83	1.15	0.91	0.96	0.89
	Birchcliff Energy Ltd.	BIREF CB	12.35	0.83	1.23	0.92	0.95	0.81
	Range Resources	RRC CB	54.36	0.75	1.16	0.86	0.92	0.81
	Cimarex Energy Company	XEC CB	60.80	0.55	1.17	0.96	0.80	0.59
	<i>Median</i>			<i>0.75</i>	<i>1.24</i>	<i>0.96</i>	<i>0.96</i>	<i>0.78</i>
<b>Top Line Cash Payers</b>								
	Cross Timbers Royalty Trust	CRT	47.33	0.93	1.25	0.98	1.05	1.08
	Sabine Royalty Trust	SBR	62.91	0.89	1.33	0.97	0.98	0.97
	Freehold Royalties Ltd.	FRHLF	19.18	0.80	1.37	1.03	0.97	0.92
	Permian Basin RT	PBT	19.75	0.84	1.10	0.98	0.94	0.99
	Dorchester Minerals, L.P.	DMLP CB	22.50	0.75	1.08	0.97	0.88	0.83
	<i>Median</i>			<i>0.84</i>	<i>1.25</i>	<i>0.98</i>	<i>0.97</i>	<i>0.97</i>
<b>Bottom Line Cash Payers</b>								
	Legacy Reserves L.P.	LGCY	28.93	0.89	1.21	1.03	1.01	0.97
	Vanguard Natural Resources, LLC	VNR	27.77	0.88	1.16	1.01	0.99	1.07
	Linn Energy, LLC	LINE	35.95	0.91	1.10	0.98	0.97	1.13
	Mesa RoyaltyTrust	MTR	39.75	0.79	1.02	0.93	0.89	0.83
	Enerplus Corporation	ERF CB	24.22	0.78	1.09	0.95	0.88	0.74
	San Juan Basin Royalty Trust	SJT CB	20.94	0.75	1.03	0.89	0.87	1.00
	Hugoton RoyaltyTrust	HGT	15.75	0.64	1.00	0.77	0.72	0.93
	<i>Median</i>			<i>0.79</i>	<i>1.09</i>	<i>0.95</i>	<i>0.89</i>	<i>0.97</i>

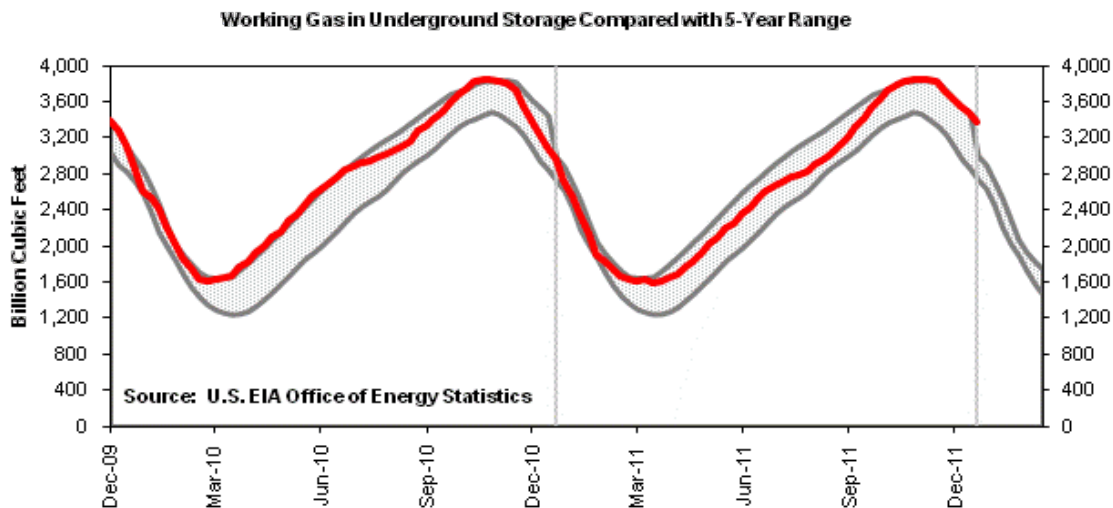
CB=Contrarian Buy, Stock Price apparently in downtrend compared to 200-day average.



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