



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

March 16, 2012

Bullish for U.S. Economic Growth

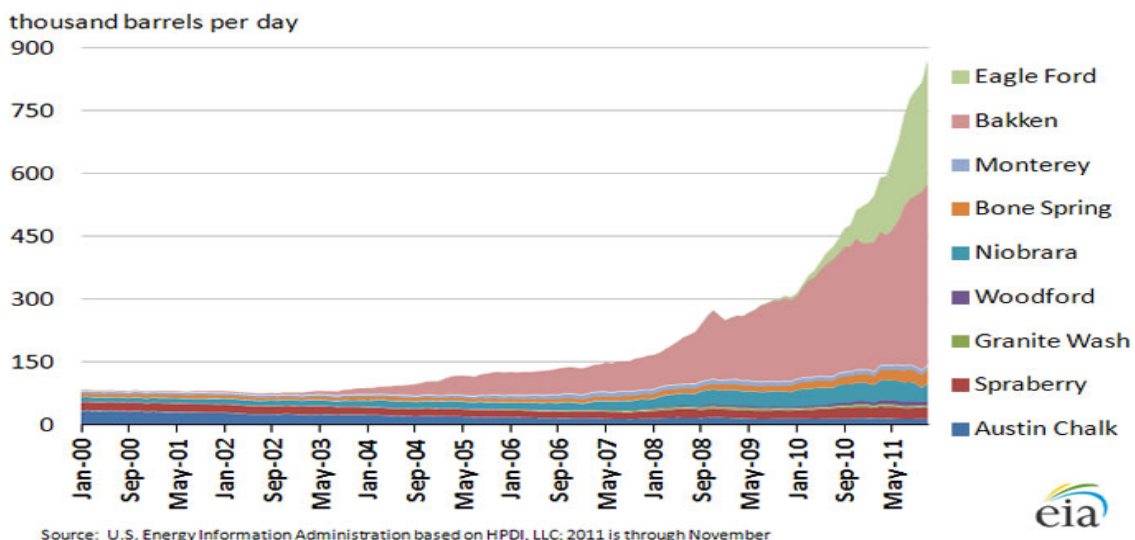
Summary and Recommendation

The new growth outlook for U.S. oil and gas production may be the best energy news for the U.S. economy in 50 years. There is now some credibility in visions of technology solving energy supply and dreams of energy independence. Even much-maligned government energy policy has helped, though by entirely unintended consequences. Good energy news for the U.S. economy also supports a better outlook for the U.S. stock market generally, as well as for oil and gas producers. Stocks of oil producers are performing better now while stocks of natural gas producers have longer term appeal.

Tight Oil Approaching a Million Barrels Daily

Technology that was supposed to create cheap alternative energy has instead created cheap oil and even cheaper natural gas. Following success in expanding natural gas production from shale, horizontal drilling with multi-stage hydraulic fracturing is expanding oil production from shale and similarly low-permeability rock. In a few short years, tight oil has boosted U.S. oil production by nearly a million barrels daily (see chart [Tight Oil Production for Selected Plays](#) below). It may be another decade before the U.S and Canada can offset all North American imports, but that has become a believable target rather than the empty promise of multiple U.S. presidents.

Figure 2. Tight oil production for selected plays

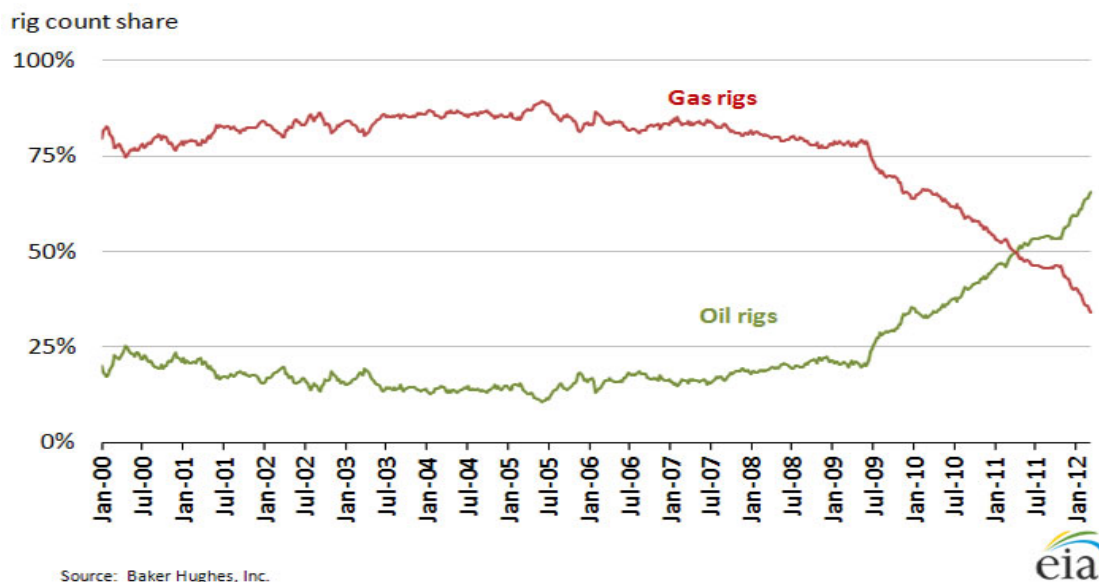


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Gas Rigs Turn to Oil Targets

Natural gas drilling has had so much success that new supply has gotten ahead of demand and driven down price. Responding to those market signals, drillers have redirected their targets toward oil (see chart [Share of Rigs by Orientation](#) below). Yet, oil wells also produce natural gas as a byproduct, thereby adding further to the short-term surplus.

Figure 3. Share of weekly active rig counts by orientation



Cheap Natural Gas Sparks Growth

The last time Americans saw such a low price of natural gas relative to oil was in the 1950s and 1960s. Consequently demand grew by some 7% a year for the two decades until shortages developed at the low government-controlled price (see chart [Natural Gas Consumption](#) on page 3). Markets today have similar capacity for growth after a period of adjustment. Until shortages occurred in the 1970s, incremental costs of producing more conventional natural gas were low. Now, except for incremental supply as a byproduct of oil drilling, incremental supply of natural gas may require an early price increase to support more drilling.

Government Policy Drives Up Oil Price That Spurs Drilling

Not surprisingly, the current president claims credit for increasing domestic oil and natural gas supply. Most of the justification often cited is patently false, in our opinion. Yet, on the most important factor, oil price, government policy has succeeded, after a fashion. As an example, the

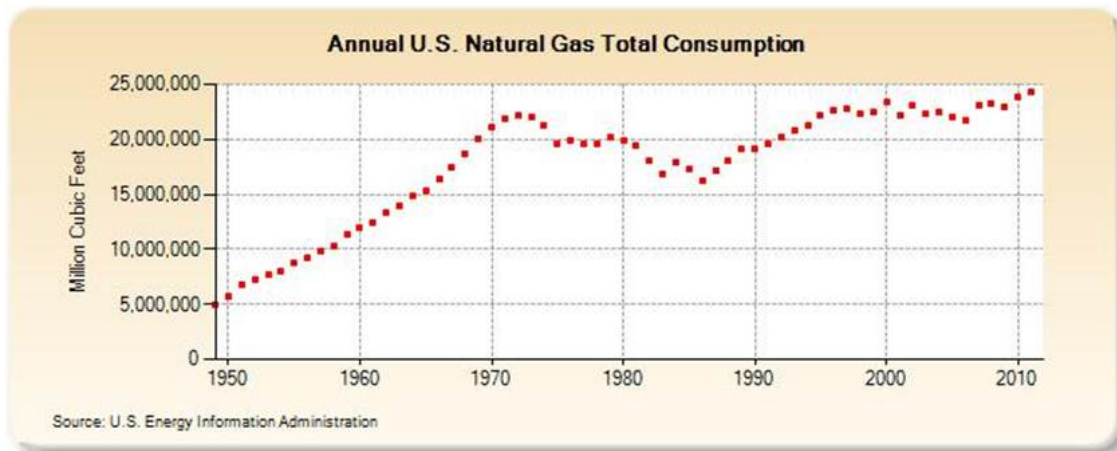


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president's refusal to approve the Keystone Pipeline has caused oil supply to be jammed at the wellhead in North Dakota and Canada. Due to that restriction and other factors, global oil price is some \$20 a barrel (more than \$0.40 a gallon) above Oklahoma oil price and some \$30 a barrel (\$0.70 a gallon) above North Dakota and Canada. Yet the global oil price has been driven up enough that the discounted \$90 a barrel price is attractive to drillers. Shale oil drilling is expensive and requires oil price upwards of \$70 a barrel now, perhaps climbing over time. Meanwhile, gasoline and heating oil are priced in relation to global oil to the benefit of inland refiners who can access the cheaper supply-restricted crude oil. The consumer pays more as a result of government policy which is probably not intended from a reelection point of view, but may be preferred to help justify uneconomic alternative energy pet projects.



Oil Stocks Lead, Natural Gas Stocks Lag

McDep Ratios appear mostly independent of whether a stock is concentrated more on natural gas or oil (see [Table ISC-1](#) and [Table ISC-2](#)). Natural gas stocks have higher unlevered cash flow multiples (EV/Ebitda) as investors look past low current cash flow from production at low price (see [Table ISC-3](#)). Measured by Enterprise Value compared to 200-day average, oil stocks have the most positive trends in stock price (see [Table ISC-4](#)).

Kurt H. Wulff, CFA



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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	15-Mar	Market	Value	Nat		Ebitda	NTM	Yield	McDep
CB (see below)		2012	Cap	(\$mm)	Gas	Oil	NTM	(\$/un)	(%)	Ratio
Small Cap Independent Producers										
PDC Energy	PETD	39.25	1.40	1,300	55	45	7.4	-	-	0.98
Range Resources	RRC CB	60.59	1.26	12,190	64	36	14.3	0.16	0.3	0.89
Berry Petroleum Company	BRY	50.81	1.54	4,290	12	88	5.8	0.32	0.6	0.80
Peyto Exploration and Development	PEYUF	17.41	1.21	2,810	76	24	8.8	0.72	4.2	0.76
Cimarex Energy Company	XEC B	80.21	1.13	7,820	43	57	5.9	0.36	0.4	0.75
Denbury Resources Inc.	DNR	19.17	1.37	10,300	4	96	5.8	-	-	0.75
Whiting Petroleum Corporation	WLL B	57.53	1.27	8,710	9	91	4.8	-	-	0.71
Birchcliff Energy Ltd.	BIREF CB	9.46	1.39	1,740	58	42	10.6	-	-	0.67
<i>Total or Median</i>				49,200			6.7			0.76
Top Line Cash Payers										
Permian Basin RT	PBT	22.70	1.00	1,060	37	63		1.50	6.6	1.13
Cross Timbers Royalty Trust	CRT	45.39	1.00	270	70	30		2.55	5.6	1.03
Freehold Royalties Ltd.	FRHLF	20.71	1.06	1,280	14	86		1.69	8.2	0.99
Sabine Royalty Trust	SBR	61.85	1.00	900	55	45		4.06	6.6	0.95
Dorchester Minerals, L.P.	DMLP CB	24.07	1.00	740	57	43		2.12	8.8	0.89
<i>Total or Median</i>				4,300					6.6	0.99
Bottom Line Cash Payers										
Linn Energy, LLC	LINE	38.21	1.76	11,760	40	60	10.1	2.76	7.2	1.14
Vanguard Natural Resources, LLC	VNR	28.28	1.38	2,630	21	79	12.2	2.31	8.2	1.09
Enduro Royalty Trust (40%)	NDRO	21.65	1.00	290	45	55	7.4	1.78	8.2	1.03
Legacy Reserves L.P.	LGCY	28.96	1.35	1,860	18	82	8.3	2.20	7.6	0.97
San Juan Basin Royalty Trust	SJT CB	19.02	1.00	890	100	-	14.8	0.94	5.0	0.91
Mesa Royalty Trust	MTR	42.28	1.00	79	75	25	12.9	2.86	6.8	0.88
Hugoton Royalty Trust	HGT	14.96	1.00	600	87	13	16.6	0.76	5.1	0.88
Enerplus Corporation	ERF CB	23.50	1.31	6,100	23	77	6.6	2.18	9.3	0.75
<i>Total or Median</i>				24,200			11.1		7.4	0.94
Composite										
<i>Enterprise Value Weighting</i>				77,600	35	65				0.84
<i>Equal Weighting</i>					46	54				0.90
<i>Equal Weighted Buys</i>					41	59				0.79

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 March 31, 2013. Enterprise Value = Market Cap and Debt.



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Table ISC-2								
McDep Income and Small Cap Energy Portfolio								
Net Present Value and McDep Ratio								
			Price (\$/sh)	Shares	Market Cap (\$mm)	Net Present Value (\$/un)	Debt/ Present Value	McDep Ratio
	Symbol/ Rating		15-Mar 2012	(mm)				
Small Cap Independent Producers								
PDC Energy	PETD		39.25	23.8	930	40.00	0.28	0.98
Range Resources	RRC	CB	60.59	160.0	9,690	70.00	0.18	0.89
Berry Petroleum Company	BRY		50.81	55.0	2,790	70.00	0.28	0.80
Peyto Exploration and Development Cor	PEYUF		17.41	133.9	2,330	24.00	0.13	0.76
Cimarex Energy Company	XEC	B	80.21	86.2	6,910	110.00	0.09	0.75
Denbury Resources Inc.	DNR		19.17	393.0	7,530	28.00	0.20	0.75
Whiting Petroleum Corporation	WLL	B	57.53	119.0	6,850	88.00	0.15	0.71
Birchcliff Energy Ltd.	BIREF	CB	9.46	132.0	1,250	16.00	0.19	0.67
<i>Total or Median</i>					38,280		0.18	0.76
Top Line Cash Payers								
Permian Basin RT	PBT		22.70	46.6	1,060	20.00	-	1.13
Cross Timbers Royalty Trust	CRT		45.39	6.0	270	44.00	-	1.03
Freehold Royalties Ltd.	FRHLF		20.71	58.4	1,210	21.00	0.05	0.99
Sabine Royalty Trust	SBR		61.85	14.6	900	65.00	-	0.95
Dorchester Minerals, L.P.	DMLP	CB	24.07	30.7	740	27.00	-	0.89
<i>Total or Median</i>					4,180			0.99
Bottom Line Cash Payers								
Linn Energy, LLC	LINE		38.21	175.0	6,690	30.00	0.49	1.14
Vanguard Natural Resources, LLC	VNR		28.28	67.2	1,900	25.00	0.30	1.09
Enduro Royalty Trust (40%)	NDRO		21.65	13.2	290	21.00	-	1.03
Legacy Reserves L.P.	LGCY		28.96	47.5	1,380	30.00	0.25	0.97
San Juan Basin Royalty Trust	SJT	CB	19.02	46.6	890	21.00	-	0.91
Mesa Royalty Trust	MTR		42.28	1.9	79	48.00	-	0.88
Hugoton Royalty Trust	HGT		14.96	40.0	600	17.00	-	0.88
Enerplus Corporation	ERF	CB	23.50	196.0	4,610	34.00	0.18	0.75
<i>Total or Median</i>					16,440			0.94
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.								



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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		15-Mar 2012	Royalty (%)	Ebitda	NTM	NTM	NTM
Small Cap Independent Producers								
Range Resources	RRC	CB	60.59		-	15.8	16.0	14.3
Birchcliff Energy Ltd.	BIREF	CB	9.46		-	23.7	15.8	10.6
Peyto Exploration and Development Corp	PEYUF		17.41		0.35	14.9	11.5	8.8
PDC Energy	PETD		39.25		-	8.2	7.6	7.4
Cimarex Energy Company	XEC	B	80.21		-	8.2	7.9	5.9
Berry Petroleum Company	BRY		50.81		-	11.8	7.3	5.8
Denbury Resources Inc.	DNR		19.17		-	14.1	7.8	5.8
Whiting Petroleum Corporation	WLL	B	57.53		-	9.8	6.7	4.8
	<i>Median</i>					13.0	7.8	6.7
Top Line Cash Payers								
Cross Timbers Royalty Trust	CRT		45.39	80	0.96	14.6	16.6	17.1
Sabine Royalty Trust	SBR		61.85	100	1.00	7.2	16.0	15.3
Permian Basin RT	PBT		22.70	32	0.91	9.7	12.1	13.8
Dorchester Minerals, L.P.	DMLP	CB	24.07	77	1.00	6.1	12.7	11.3
Freehold Royalties Ltd.	FRHLF		20.71	71	0.80	6.7	10.0	9.8
	<i>Median</i>					7.2	12.7	13.8
Bottom Line Cash Payers								
Hugoton Royalty Trust	HGT		14.96		0.84	14.4	18.9	16.6
San Juan Basin Royalty Trust	SJT	CB	19.02		0.73	8.7	16.3	14.8
Mesa Royalty Trust	MTR		42.28		0.87	14.1	14.6	12.9
Vanguard Natural Resources, LLC	VNR		28.28		1.03	8.7	11.1	12.2
Linn Energy, LLC	LINE		38.21		0.82	14.7	8.9	10.1
Legacy Reserves L.P.	LGCY		28.96		0.63	11.7	8.6	8.3
Enduro Royalty Trust (40%)	NDRO		21.65		0.61	5.7	7.2	7.4
Enerplus Corporation	ERF	CB	23.50		0.57	8.2	8.9	6.6
	<i>Median</i>					10.2	10.0	11.1
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 March 31, 2013; 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).								



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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	15-Mar 2012	52Wk High	52Wk Low	50 Day Avg.	200 Day Avg.	McDep Ratio	
Small Cap Independent Producers								
	PETD		39.25	0.84	1.78	1.11	1.19	0.98
	XEC	B	80.21	0.71	1.48	1.13	1.12	0.75
	WLL	B	57.53	0.80	1.64	1.06	1.11	0.71
	DNR		19.17	0.79	1.52	1.01	1.09	0.75
	BRY		50.81	0.88	1.35	1.02	1.06	0.80
	RRC	CB	60.59	0.82	1.20	1.00	0.98	0.89
	PEYUF		17.41	0.71	1.03	0.91	0.84	0.76
	BIREF	CB	9.46	0.69	1.00	0.82	0.78	0.67
	<i>Median</i>			<i>0.80</i>	<i>1.41</i>	<i>1.02</i>	<i>1.07</i>	<i>0.76</i>
Top Line Cash Payers								
	PBT		22.70	0.97	1.26	1.08	1.08	1.13
	FRHLF		20.71	0.86	1.48	1.02	1.07	0.99
	CRT		45.39	0.89	1.20	0.97	0.99	1.03
	DMLP	CB	24.07	0.80	1.16	1.04	0.99	0.89
	SBR		61.85	0.88	1.30	0.98	0.97	0.95
	<i>Median</i>			<i>0.88</i>	<i>1.26</i>	<i>1.02</i>	<i>0.99</i>	<i>0.99</i>
Bottom Line Cash Payers								
	LGCY		28.96	0.89	1.22	1.00	1.02	0.97
	VNR		28.28	0.88	1.20	1.01	1.02	1.09
	LINE		38.21	0.96	1.12	1.01	1.01	1.14
	MTR		42.28	0.85	1.16	1.02	0.98	0.88
	ERF	CB	23.50	0.77	1.06	0.98	0.90	0.75
	SJT	CB	19.02	0.68	1.09	0.98	0.84	0.91
	HGT		14.96	0.61	1.08	0.97	0.74	0.88
	<i>Median</i>			<i>0.85</i>	<i>1.12</i>	<i>1.00</i>	<i>0.98</i>	<i>0.91</i>

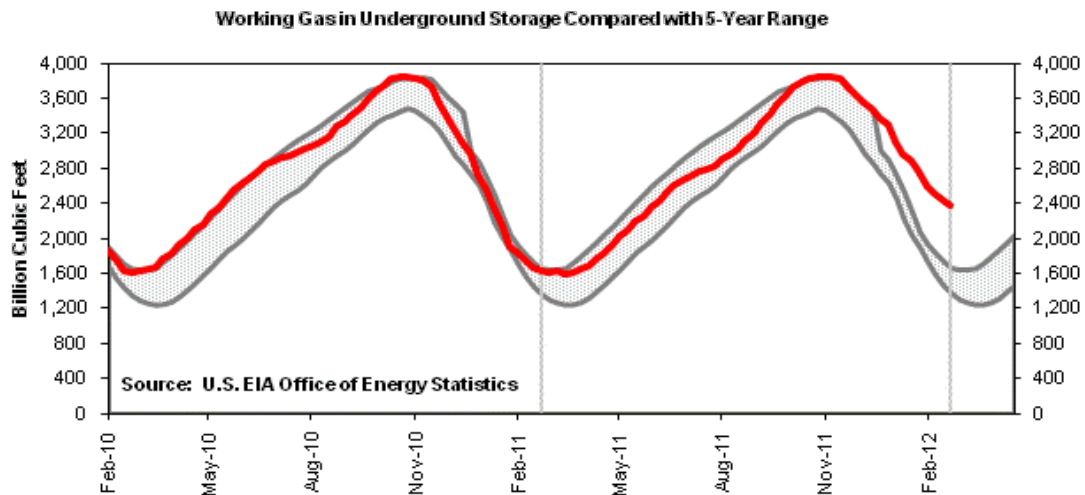
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