



Income and Small Cap Weekly

Analysis of Oil & Gas Stocks

July 17, 2009

Stocks Undervalued on \$6.60 Six-Year Natural Gas

Summary and Recommendation

Our long-term investment conclusion is upbeat despite our seemingly downbeat reduction in assumed long-term price of natural gas to \$8.00 a million btu from \$10.00 previously. That change triggers a reduction of 20% in our estimate of Present Value of North American Natural Gas (NANG) (see *Meter Reader*, July 14, 2009). Accordingly, McDep Ratios move up to a median of about 0.74. Meanwhile, the closest market indication of long-term natural gas price is the average of futures quoted monthly for the next six years (see chart on last page). Though that price has averaged \$8.00 for the past three years, it has declined to \$6.60 on the July 16 settlement. Yet, a median McDep Ratio of 1.0, where stocks would be fairly valued at current prices, implies a long-term price expectation of about \$6.00 (8.00 times 0.74). By setting our present value calculations to \$8.00, we are saying that \$6.00 is too low, \$6.60 is too low and that stocks are a bargain. For immediate action we have three natural gas buy recommendations, **Cimarex Energy (XEC)**, **Dorchester Minerals, L.P. (DMLP)** and **Hugoton Royalty Trust (HGT)**. An additional five stocks with greater than 60% concentration on the underappreciated clean fuel resource also have low McDep Ratios and long-term appeal (see Table 1).

Global Trading Indicators Support Oil and Gas Investment

Starting at the most general level we see the U.S. dollar in a downtrend with the DXY index at about 0.79 compared to the 200-day average of about 0.84. Next, we see inflation expectations in an uptrend as measured by the difference between nominal rates and real rates. Nominal interest rates appear to be in an uptrend with interest on the U.S. Ten-Year Note at about 3.5% compared to the 200-day average of about 3.1%. The difference relative to the real yield on the Ten Year U.S. Treasury Inflation Protected Security appears to be widening. Global stock markets are in an uptrend with most major indices trading above the 200-day average. Emerging markets are leading.

A declining dollar, rising inflation and a positive stock market backdrop are good for oil price with six-year futures trading at \$76 a barrel compared to the 40-week average of \$71. Reasonable demand expectations combined with a tight supply outlook are also supportive of rising oil price. Natural gas verges on a rising trend.

Combining the global influences, investors see leading performance occurring in non-U.S. and oil oriented stocks and catch up potential in U.S. and natural gas oriented stocks. Given the broadening positive stock price indicators it seems just a matter of time before natural gas stocks join the uptrend.

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Table 1										
McDep Income and Small Cap Energy Portfolio										
Debt, Business Segments and Income Yield										
						Present Value by Segment (%)				
	Symbol/Rating	Price (US\$/sh)	EV/ Market	Enterprise Value (\$mm)	NAmer. Natural Gas	Oil Prod'n	Dist. NTM (\$/un)	Dist. Yield (%)	McDep Ratio	
	B = Buy H = Hold	16-Jul 2009	Cap							
Canadian Income Trusts (US\$)										
Peyto Energy Trust	PEYUF	8.14	1.46	1,260	69	31	1.24	15.2	0.71	
Pengrowth Energy Trust	PGH	7.73	1.88	3,700	34	66	1.03	13.4	0.70	
Penn West Energy Trust	PWE H	12.64	1.74	9,000	27	73	1.55	12.2	0.68	
Enerplus Resources Fund	ERF	21.11	1.24	4,300	43	57	1.86	8.8	0.64	
Canadian Oil Sands Trust	COSWF B	23.37	1.11	12,500		100	2.00	8.5	0.58	
<i>Total or Median</i>				30,800					0.68	
Small Cap Independent Producers										
Encore Acquisition Company	EAC B	31.79	1.97	3,330	22	78	-	-	0.84	
Cimarex Energy Company	XEC B	30.99	1.34	3,400	62	38	0.24	0.8	0.73	
Berry Petroleum Company	BRY H	19.11	2.14	1,820	33	67	0.30	1.6	0.72	
Birchcliff Energy Ltd. (US\$)	BIREF	5.28	1.36	870	70	30	-	-	0.66	
<i>Total or Median</i>				9,420					0.73	
Top Line Cash Payers										
Cross Timbers Royalty Trust	CRT	24.88	1.00	150	64	36	1.51	6.1	0.89	
Dorchester Minerals, L.P.	DMLP B	22.70	1.00	680	63	38	1.35	5.9	0.84	
Freehold Royalty Trust (US\$)	FRHLF	13.11	1.21	790	26	63	1.03	7.9	0.80	
Sabine Royalty Trust	SBR	40.31	1.00	590	38	63	2.63	6.5	0.73	
Permian Basin RT	PBT	9.88	1.00	460	27	73	0.80	8.1	0.55	
<i>Total or Median</i>				2,670					0.80	
Bottom Line Cash Payers										
Linn Energy, LLC	LINE	20.20	1.61	3,710	48	52	2.52	12.5	1.39	
Encore Energy Partners, L.P. (52%)	ENP	14.59	1.34	460	24	76	2.15	14.7	0.89	
San Juan Basin Royalty Trust	SJT H	12.46	1.00	580	100	-	0.80	6.4	0.59	
Hugoton Royalty Trust	HGT B	12.26	1.00	490	89	11	0.78	6.4	0.53	
Mesa Royalty Trust	MTR	23.90	1.00	50	75	25	2.28	9.5	0.43	
<i>Total or Median</i>				5,290					0.59	
Composite (excl COSWF)										
<i>Enterprise Value Weighting</i>				35,600	41	59			0.74	
<i>Equal Weighting</i>					51	49			0.74	
<i>Equal Weighted Buys</i>					47	53			0.74	
* Percentages in Symbol column refer to current market Enterprise Value weightings; Rating column, equal weightings.										
* Percentages in Price column refer to equal weighted buys.										



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Table 2								
Oil and Gas Income and Small Cap Stocks								
Net Present Value and McDep Ratio								
			Price (\$/sh)	Shares	Market Cap (\$mm)	Net Present Value (\$/un)	Debt/ Present Value	McDep Ratio
	Symbol/ Rating		16-Jul 2009	(mm)				
Canadian Income Trusts (US\$)								
Peyto Energy Trust	PEYUF		8.14	105.9	860	13.00	0.22	0.71
Pengrowth Energy Trust	PGH		7.73	257.0	1,990	14.00	0.33	0.70
Penn West Energy Trust	PWE	H	12.64	410.0	5,180	23.00	0.29	0.68
Enerplus Resources Fund	ERF		21.11	165.7	3,500	36.00	0.12	0.64
Canadian Oil Sands Trust	COSWF	B	23.37	482.2	11,270	42.00	0.06	0.58
<i>Total or Median</i>					22,800		0.22	0.68
Small Cap Independent Producers								
Encore Acquisition Company	EAC	B	31.79	53.3	1,690	44.00	0.41	0.84
Cimarex Energy Company	XEC	B	30.99	81.7	2,530	46.00	0.19	0.73
Berry Petroleum Company	BRY	H	19.11	44.6	850	35.00	0.38	0.72
Birchcliff Energy Ltd. (US\$)	BIREF		5.28	122.0	640	9.00	0.18	0.66
<i>Total or Median</i>					5,710		0.29	0.73
Top Line Cash Payers								
Cross Timbers Royalty Trust	CRT		24.88	6.0	150	28.00	-	0.89
Dorchester Minerals, L.P.	DMLP	B	22.70	29.8	680	27.00	-	0.84
Freehold Royalty Trust (US\$)	FRHLF		13.11	49.5	650	17.00	0.14	0.80
Sabine Royalty Trust	SBR		40.31	14.6	590	55.00	-	0.73
Permian Basin RT	PBT		9.88	46.6	460	18.00	-	0.55
<i>Total or Median</i>					2,530			0.80
Bottom Line Cash Payers								
Linn Energy, LLC	LINE		20.20	114.0	2,300	11.00	0.53	1.39
Encore Energy Partners, L.P. (52%)	ENP		14.59	23.4	340	17.00	0.23	0.89
San Juan Basin Royalty Trust	SJT	H	12.46	46.6	580	21.00	-	0.59
Hugoton Royalty Trust	HGT	B	12.26	40.0	490	23.00	-	0.53
Mesa Royalty Trust	MTR		23.90	1.9	50	56.00	-	0.43
<i>Total or Median</i>					3,760			0.59
B = Buy, H = Hold								
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.								



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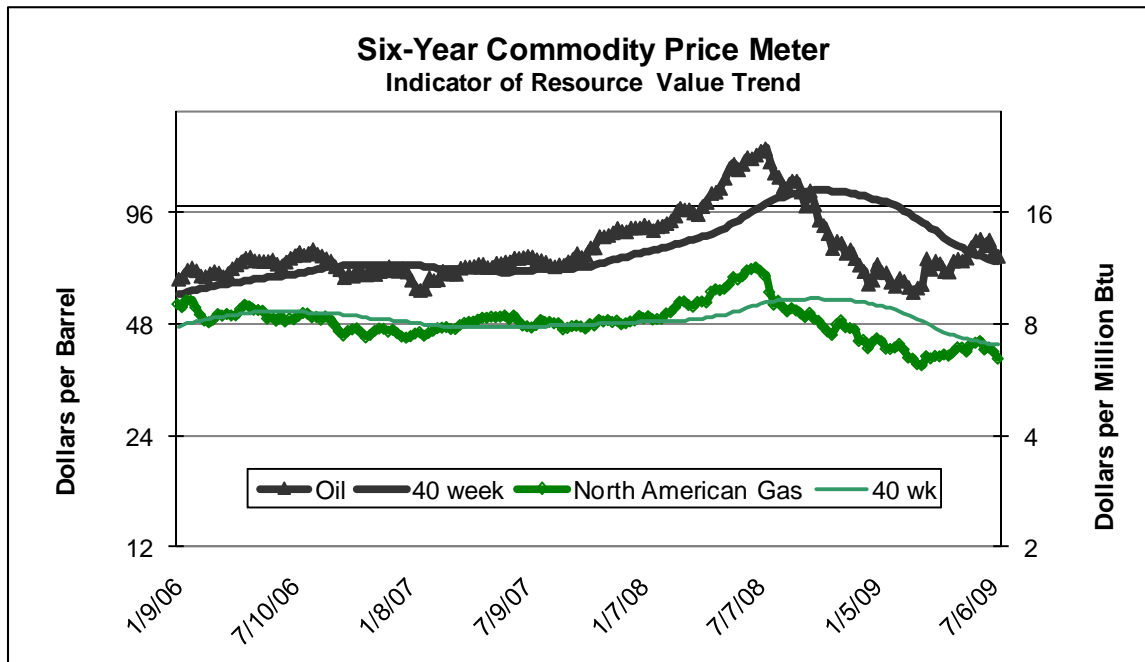
Table 3									
Oil and Gas Income and Small Cap Stocks									
Value Multiples - Rank by EV/Ebitda									
			Price (\$/sh)	Revenue	Dist/ Equity	Adjstd Resrvs/ Prod	PV/ Ebitda	EV/ Ebitda	
	Symbol/ Rating		16-Jul 2009	Royalty (%)	Ebitda	NTM	NTM	NTM	
Canadian Income Trusts (US\$)									
	Canadian Oil Sands Trust	COSWF	B	23.37		0.76	21.5	15.9	9.3
	Peyto Energy Trust	PEYUF		8.14		1.17	17.1	12.3	8.7
	Enerplus Resources Fund	ERF		21.11		0.63	9.3	12.2	7.7
	Pengrowth Energy Trust	PGH		7.73		0.80	8.1	10.9	7.6
	Penn West Energy Trust	PWE	H	12.64		0.75	8.3	11.2	7.6
	<i>Median</i>						9.3	12.2	7.7
Small Cap Independent Producers									
	Birchcliff Energy Ltd. (US\$)	BIREF		5.28		-	9.9	25.8	16.9
	Berry Petroleum Company	BRY	H	19.11		-	11.7	13.5	9.7
	Encore Acquisition Company	EAC	B	31.79		-	11.4	11.4	9.5
	Cimarex Energy Company	XEC	B	30.99		-	7.2	7.9	5.8
	<i>Median</i>						10.7	12.4	9.6
Top Line Cash Payers									
	Dorchester Minerals, L.P.	DMLP	B	22.70	64	0.93	8.1	18.7	15.7
	Sabine Royalty Trust	SBR		40.31	100	1.00	10.0	20.9	15.3
	Cross Timbers Royalty Trust	CRT		24.88	84	0.92	13.0	16.9	15.0
	Permian Basin RT	PBT		9.88	32	0.85	10.9	19.1	10.5
	Freehold Royalty Trust (US\$)	FRHLF		13.11	71	0.67	6.3	11.0	8.8
	<i>Median</i>						10.0	18.7	15.0
Bottom Line Cash Payers									
	Linn Energy, LLC	LINE		20.20		5.38	18.3	23.5	32.7
	Encore Energy Partners, L.P.	ENP		14.59		1.56	12.9	12.4	11.0
	San Juan Basin Royalty Trust	SJT	H	12.46		0.67	9.2	17.6	10.4
	Hugoton RoyaltyTrust	HGT	B	12.26		0.65	13.0	19.2	10.2
	Mesa RoyaltyTrust	MTR		23.90		0.90	14.4	22.2	9.6
	<i>Median</i>						13.0	19.2	10.4
EV = Enterprise Value = Market Cap and Debt; Ebitda = Earnings before interest, tax, depreciation and amortization; NTM = Next Twelve Months Ended June 30, 2010; P/E = Stock Price to Earnings; PV = Present Value of oil and gas and other businesses									



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