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A special report by

Oil and Gas Investor

Opportunities in Oil and Gas Exploration and Production

September 2002

Skilled and seasoned stockbuyers—the ones who manage billions of dollars for individual investors through special funds—have taken notice of the recent difference in oil and natural gas exploration and production (E&P) companies' stock prices and their earnings potential.

At press time, some private fund managers had millions of dollars their investors want placed in E&P companies and had yet to place it all yet. Dozens of new E&P companies are being formed by veteran executives who sold their firms last year and in 2000 at historic-high oil and gas prices. Much of this new private money is going to firms like these. A great deal more is moving into the public E&P sector in general.

Among these beneficiaries are large-cap E&P companies. These are oil companies strictly in the business of finding and producing oil and gas. Unlike the major oils, like Shell and BP, these companies are not in the business of operating pipelines, refineries, service stations or chemical plants. Their gains and losses depend a great deal on the price of oil and gas but increasingly depend on their savvy in buying out other oil companies at good prices, finding oil and gas where even the major oils thought improbable and using risk management to guarantee good prices for their oil and gas a year or more out.

This special report discusses why buysiders like oil and gas stocks and some they're especially excited about.

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The financial community is hearing—and liking—the new mantra from large-cap oil and gas producers at energy conferences this year: financial discipline and not just growth, but profitable growth.

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A Recipe for Investing

Buysiders have taken notice of price-appreciation potential in oil and gas exploration and production stocks. Here's why.

Article by Leslie Haines

It is time to take a fresh look at the oil and gas sector, specifically the large-cap exploration and production (E&P) companies. These independent producers drill more than three-fourths of the oil and gas wells in this country every year, while also pursuing high-growth targets abroad in increasing numbers.

If shell-shocked investors are fleeing to companies that produce and manage hard assets, nothing is more real than oil and gas in the ground or in the pipeline.

The E&Ps look intriguing—they make respectable returns, they will show strong growth in 2003 and 2004 from projects already under way (without further exploration risk), and they are generally undervalued based on historical multiples.

The macroeconomics underlying them are positive. For the foreseeable future, the U.S. will be powered by oil and gas, and while the economy may endure its ups and downs, there is no getting around one constant—during the last 20 years, U.S. demand for oil and gas has climbed steadily.

In 1970 oil consumption was about 15 million barrels a day. In 2001, it had risen to 20 million a day. That will continue as the population grows, the number of vehicles on the road increases and natural-gas-fired power plants are built to offset air pollution from coal.

There is a message in this to the optimists, the skeptics and the cautious: the scales have tipped in favor of the oil and gas stocks. Astute investors are building their positions in these large-cap E&P companies now, as they anticipate a robust 2003 and 2004.

There are several reasons why:

- Macro fundamentals look good. Natural gas demand keeps growing while domestic supply deliverability has been flat, indicating gas prices will rise.
- The E&Ps are growing production thanks to new technologies that boost their chances of drilling success and ultimate oil and gas recovery from ever-more elusive formations.
- Drilling costs are lower than they were two years ago.
- The U.S. economy depends on these commodities.
- The E&Ps are undervalued based on cash flow projections.

No wonder many analysts now believe the upside of the E&Ps outweighs any remaining downside. Some go so far as to predict the E&Ps will outperform the broader market during the next 12 to 18 months. Up to and through the broad market meltdown of July and August 2002, most E&Ps already were outperforming the S&P 500.

RETURNS: AN OIL AND GAS SAMPLER

	Total Return*	Ave. Annual Return
Anadarko Petroleum (APC)	136%	13
Apache Corp. (APA)	144%	14
Burlington Resources (BR)	13%	2
Devon Energy (DVN)	132%	13
Newfield Exploration (NFX)	162%	15
Noble Energy (NBL)	46%	6
XTO Energy (XTO)	594%	32

** July 1, 1995 to June 30, 2002.*

Source: Bloomberg

Undervalued

In many cases, the E&Ps appear undervalued. In the group followed by Lehman Brothers, the average large-cap producer trades at 5.8 times forward debt-adjusted cash flow, which is at the low end of the range since1994 of five to seven times.

The group covered by Salomon Smith Barney current trades at an average 5.3 times the 2003 projection for debt-adjusted price to discretionary cash flow. That is less than the average multiple of six at which the group has traded during the past five years. In July the company upgraded ratings on several E&P names based on the longer-term outlook, especially for natural gas prices.

"The longer-term risk-reward profile for E&P shares is quite attractive at this time, [even if] the prospect for commodity prices near-term remains a concern," said Bob Morris, E&P analyst for Salomon Smith Barney in New York.

"We continue to believe investors should be positioning to be overweight this sector heading into winter, given our view that the longer-term fundamentals of natural gas prices remain quite solid."

Morris says the upside to the E&P group he covers is about 35% while the downside is no more than 15%—and this is based on oil and gas prices during the next 12 to 18 months, assuming $20-per-barrel oil and $3.50-per-million-Btu (MMBtu) gas. Both are far lower than the current or12-month strip prices on Nymex.

Most of the E&P stocks this year have been

TOTAL RETURNS MADE BY LARGE-CAP E&P COMPANIES*

Company	Total Return
Anadarko Petroleum	136%
Apache Corp.	144%
Burlington Resources	13%
Devon Energy	132%
Newfield Exploration	162%
Noble Energy	46%
XTO Energy	594%
EOG Resources	89%
Forest Oil	75%
Ocean Energy	33%
Pogo Producing	48%
Vintage Petroleum	33%

** July 1, 1995 to June 30, 2002. Total return = stock appreciation plus dividends.*

Source: Bloomberg

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discounting oil prices of about $22 or $23 per barrel and natural gas prices of $3, even though the current strip on Nymex is far rosier.

At long last, gas

Long-term natural gas fundamentals are strong. The U.S. economy is recovering, if slowly, and so too will gas demand. That's good news for the E&Ps, which typically derive much more than 50% of their production from natural gas rather than oil.

Several of the large gas-fired power-generation plants that were announced during the plant construction boom two years ago, have finally come onstream this year, further increasing the call for gas. "Natural gas use for power generation rose an estimated 4.1%in 2001, entirely because of increased use by non-utility generators [of power]," says the U.S. Energy Information Administration.

At the same time, the number of rigs drilling for gas has declined by about a third during the past year as gas prices fell off unsustainable highs. (At $3 to $3.50 per MMBtu now, they appear sustainable and most companies can make money.)

Despite a lot of drilling two years ago, the production-decline rate for existing fields has been accelerating (see chart). That's why U.S. gas production is predicted to decline by as much as 6% this year and 3% or 4% next year, absent a meaningful upturn in gas drilling. Experts thus expect gas prices to remain healthy in the next two years—between $3 and $4 per MMBtu.

"We can't always accurately predict short-term moves in gas prices, but we believe over time they will normalize at $3.25 per MMBtu, which is at parity with $20 oil," says Jason Gammel of Prudential Securities.

Companies must increase their drilling programs. That in turn, coupled with rising natural gas prices, should increase cash flows in 2003 and 2004.

What's Different Now?

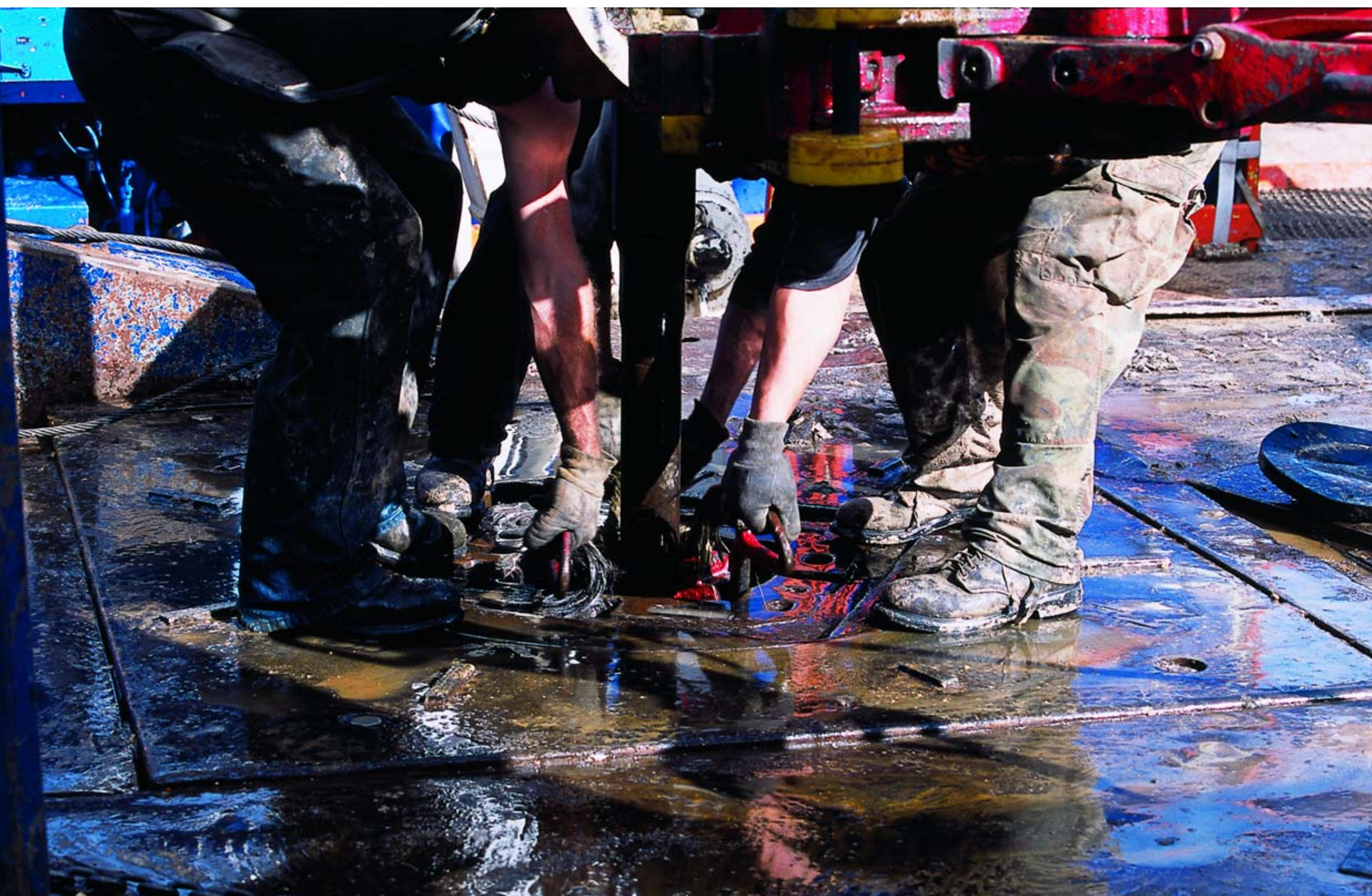
If you haven't checked out the large-cap exploration and productions stocks in a while, here's what's different these days. These companies:

Are focused on returns on capital employed as much as they are on growth of oil and gas production per share. They have fine-tuned their decision-making processes and beefed up computer modeling software to zero in on higher-return projects.

Have access to oil and gas opportunities in every country in the world. Drilling expenditures–and production—in the U.S. now make up only about half of their totals, as they continue to make more significant discoveries abroad. Large-caps now routinely drill in Canada, Ecuador, the North Sea, Azerbaijan, Algeria, China, Indonesia, Gabon, South Africa, and offshore Brazil, Israel, Egypt and China, and in many other foreign locations.

Have access to the same high-tech wonders—and all of the computing power—once reserved for the major oils. One result: Since 1997-98, more large-caps hold leases in the deepwater Gulf of Mexico and contribute oil and gas production from sediments found below water as deep as 5,000 feet. A second result: The ratio of wells drilled to wells successfully producing rose steadily during the past decade to about 80%, as technology improved the science behind drilling, and reduced finding and production costs.

Roughnecks pull out the slips while pipe comes out of the hole during drilling for natural gas in west Texas



Growth is the story

Many major U.S. industries are in a slow-growth, no-growth or contraction mode, but the large-cap E&Ps display strong underlying base production coupled with good growth projects. In some cases, the potential is enormous.

Anadarko Petroleum Corp. (NYSE: APC), Houston, one of the largest independent producers, consistently keeps more rigs working in the U.S. than any other large-cap company. It has big projects under way in this hemisphere and longer-term potential abroad, as in Algeria, where it is now one of the largest producers.

Burlington Resources (NYSE: BR), Houston, is the largest U.S. holder of North American gas reserves and the third-largest producer among the E&Ps. Through recent acquisitions and divestments, and a two-year restructuring drawing to a close, its drilling portfolio is refocused on the gas strategy, from south Texas to northern Canada. Growth is coming from Canada, China and Algeria. Growth of 3% to 8% annually is expected during the next three or four years.

Noble Energy (NYSE: NBL), Houston, is active from Israel to Equatorial Guinea to Ecuador, in addition to its U.S. interests. The Houston firm will deliver as much as 14% production growth in 2003, analysts say.

Pioneer Natural Resources (NYSE: PXD), Irving, Texas, offers the greatest percentage production increase among its peers during the next two or three years—between 40% and 60%—thanks to astute investments in the Gulf of Mexico, Alaska and South Africa that will begin producing oil and gas in 2003 and 2004.

These are completed projects whose large production facilities are being installed and hooked up today. Pioneer Natural Resources outperformed its peers during the last two years, but Lehman Brothers thinks more is to come.

Prudential Financial thinks Devon Energy (NYSE: DVN), Oklahoma City, offers upside potential of 27%. The company's cash flow multiple suffered when it made two multibillion-dollar acquisitions recently, but the company has paid off nearly $1.2 billion of debt and will start growing again. Its cash flow multiple is expected to revert to the historical premium it has enjoyed versus its peers.

Fast-growing XTO Energy (NYSE: XTO), Fort Worth, dominates the Midcontinent gas-producing region. The company is known for its ability to increase production on whatever assets it buys. During the last three years through acquisitions, it has built up a huge portfolio of properties to exploit.

From 1997-2001, XTO's total returns were an impressive 254% versus 221% for Microsoft and 164% for GE. It also outperformed the raging Dow during the period—the latter rose 69%, less than a third as much as XTO. So much for the boring old economy of oil and gas being left in the dust by the high-tech stock darlings.

Ocean Energy Inc. (NYSE: OEI), Houston, is another growth example. From 1999-2001, it averaged 10% production growth while reducing debt from 70% of the balance sheet to 47% and reducing finding and development costs by more than half. It is expected to deliver double-digit compounded annual growth in oil and gas production through 2004. The company expects 15% to 27% growth in 2003 alone.

"[With Ocean], we believe investors remain exposed to major oil company-style potential, with company-changing upside in current and future projects," says an analyst with Stifel, Nicolaus & Co., Denver.

The same could be said of several of the large-cap E&Ps, something professional investors have already noticed. ❋

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Why Large-Cap E&P Stocks?

Four prominent energy analysts explain why investors should be buying the shares of large oil and gas exploration and production companies.

Interviews by Brian A. Toal
Photography by Lowell Georgia

The financial community is hearing—and liking—the new mantra from large-cap oil and gas producers at energy conferences this year: financial discipline and not just growth, but profitable growth.

Buyside and sellside analysts believe that strong North American natural gas fundamentals and pricing over the long term are going to translate into highly visible growth of reserves in the ground, production, cash flow and shareholder returns for large-cap exploration and production (E&P) companies. Their every move is tied to bottom-line improvement.

They also believe the stocks of these producers represent a good hedge against the rest of the market. Fadel Gheit, senior energy analyst for Fahnestock & Co. in New York, asserts: "If you buy a basket of E&P stocks, you'll be ahead of the S&P 500 by double digits."

To find out more about Wall Street's positive stance on the bigger names among North American E&P companies, Oil and Gas Investor *recently talked with four leading buyside and sellside analysts.*

The participants were Nikolaos (Nikos) Monoyios, vice president and portfolio manager for OppenheimerFunds Inc. in New York; Christopher W. (Kit) Smith, senior vice president and portfolio manager for G.E. Asset Management in Stamford, Connecticut; Shannon L. Nome, managing director, large- and small-cap E&P equity research, for JPMorgan Securities Inc. in Houston; and Wayne W. Andrews, vice president, equity research, and E&P analyst for Raymond James & Associates Inc. in Houston. (Note: The analysts may hold positions in the equities they discuss, or their firms—in the case of the sellside analysts—may derive investment banking revenues from the companies mentioned.)

Investor: *Nikos, what's your investment thesis for owning large-cap E&P companies?*
Monoyios: We're in an environment where commodity prices are likely to stay high relative to historical levels. In fact, during the next 10 years, oil prices on average will likely be higher than they were during the past 10 years—economies are growing and non-OPEC oil production is likely to peak in the next five to 10 years. This would give OPEC more pricing power.

Meanwhile, there seems to be a new, higher $3 to $5 price plateau for natural gas—despite the recent negatives of a record warm winter, a mild recession, and a lot of gas drilling during the past couple of years. We expect that trend to continue. Hopefully, gas prices won't rise higher than $5, because that would only tend to kill demand. In short, look for future gas prices to be much better than they've been in the past.

Investor: *The rationale for this thesis?*
Monoyios: One, gas is getting a lot harder to find, and two, new gas wells generally have much steeper decline curves than wells did in the past. So you have to run faster just to stay in place. Meanwhile, on the demand side, there's a 2% to 3% annual growth in U.S. gas consumption..

Investor: *What else do you like about large-cap E&P companies?*
Monoyios: Today's remaining large E&P companies are much more financially disciplined, more business-like, more shareholder friendly. They're not just pursuing growth for growth's sake. Instead, they're very focused on return on capital employed, per-share growth in both reserves and production, and creating shareholder value. Also, from a balance-sheet perspective, they're financially much stronger than ever before.

Investor: *Does one invest in this sector as a hedge against other market trends or for good stock-price appreciation?*
Monoyios: One would invest in this sector for both reasons. We should see good performance from this group relative to the rest of the market, but we'll also see absolute price appreciation in E&P stocks during the next few years.

Investor: *Which large-cap E&P stocks are particularly compelling?*
Monoyios: We still like some of the Canadian upstream companies. The two largest remaining in our portfolios after last year's mergers are Talisman Energy and Canadian Natural Resources. These stocks are good plays on the North American natural gas theme, are relatively cheap to their underlying assets, and have managements that are very conscious about their rates of return and growing earnings, cash flow and reserves per share.

Investor: *What about your U.S. large-cap E&P holdings?*
Monoyios: Our largest holding is Murphy Oil. It has double-digit production-growth potential from already discovered fields under development in the deepwater Gulf of Mexico and Ecuador and from high-impact exploration plays in the deepwater Gulf, Canada and Malaysia. In addition, the Murphy family owns about 45% of the stock and is very conscious of shareholder value and dilution.

Investor: *What's the current mood of the buyside as it relates to the oil and gas sector?*

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"Today's remaining large E&P companies are much more financially disciplined, more business-like, more shareholder friendly…."

Nikolaos (Nikos) Monoyios, **OppenheimerFunds Inc.**

Monoyios: We're seeing a lot of investors with relatively little experience in the oil and gas business interested in learning more about it. They realize this is a sector that has real companies with real assets, earnings and cash flow on a per-share basis.

Investor: *Kit, what about your investment thesis on the industry in general and on large-cap producers in particular?*

Smith: What I find intriguing is the fact that while domestic drilling, mostly for natural gas, peaked in the summer of 2001, there was at best only a 1% production response. This means that during the next few years, it's going to be tough for the industry to meet the greater demand for gas as more gas-fired power-generation plants come online and as the national economy grows stronger.

As for the recent gas-inventory glut, this has occurred not because the industry overproduced, but because gas demand, dampened by the price spike during the winter of 2000-01, has been less than anyone expected. In the long term, stocks with a strong exposure to natural gas are a good place to be invested.

This includes large-cap E&P companies like Burlington Resources, Apache Corp., Anadarko Petroleum, Devon Energy, EOG Resources and EnCana Corp. These companies possess the qualities we look for in an investment candidate. Their managements have the ability to take a longer-term perspective. They have balance-sheet strength and hence, the ability to find and develop good, longer-term legacy assets.

Investor: *The current mood of the buyside with respect to the oil and gas sector?*

Smith: We've recently seen a pause and a pullback from this sector by investors. People are concerned that maybe the U.S. economy isn't going to accelerate as fast as hoped, and demand and pricing for gas is going to be weaker than thought.

In the long term, however, we see natural gas prices moving in a range of $2.50 to $4.50 per thousand cubic feet. At $2.50, that would put a halt to enough exploration and development projects that we'd be facing the prospect of a real gas shortage. And at $4.50, you've got LNG (liquefied natural gas) competition and the prospect of fuel switching by some industrial end-users.

Investor: *Do the E&P stocks you've mentioned represent a hedge against trends in other market sectors, or should they be bought for their inherent price-appreciation potential?*

Smith: One should be buying these stocks when they're selling at attractive valuations versus their net asset values. That should be the principal driver for investment in this group.

Investor: *As you listen to oil and gas presentations, are you hearing anything new this year?*

Smith: A lot of E&P companies are now showing more of a willingness to hedge their production, to lock in favorable economics and returns on projects. They're getting big enough that they need to plan ahead, so they're not faced with turning their capital spending on and off as commodity prices go up and down.

Investor: *Shannon, what's your large-cap investment thesis?*

Nome: First, E&P companies are fortified with significant hard assets. In a highly speculative world, which seems to be manifested daily with the announcement of some corporate scandal or accounting problem, investors will continue to seek out companies that offer hard assets as a hedge against some of that market uncertainty.

During first-half 2002, E&P stocks were up 8.5% while the S&P 500 dropped 14%. Our expectation is that these stocks will continue to outperform the market.

Second, increased political risk in the Middle East has heightened the focus on secure domestic energy sources. Recently, the U.S. government held an eastern Gulf of Mexico lease sale. This created a new set of undrilled opportunities for E&P companies—especially financially strong large-cap producers—to increase their reserves, production, earnings and cash flow.

Third, at a time when it's getting harder, not easier, to find large deposits of oil and gas, new technology is helping E&P companies drill deeper and better image complex, subsurface hydrocarbon structures—thereby improving success rates.

Nikolaos (Nikos) Monoyios

Investor: *What about the outlook for commodity prices?*

Nome: That's another plus. We see natural gas prices averaging $3 to $4 during the next couple of years. The fact is, we've picked a lot of the low-hanging fruit from the domestic natural gas tree, and are now having to drill in more difficult areas. So, with the availability of supply no longer that great, gas prices are being pushed up. And for companies that are able to control the cost of finding reserves in this environment—and that have a low-cost drilling inventory to exploit—there's great opportunity for margin expansion.

As for oil prices, they should average $25.35 this year and $25.40 during 2003 because OPEC will likely maintain discipline throughout this period, and because demand will grow enough to offset any non-OPEC increments in production.

Investor: *Based on this investment thesis, which large-cap E&P stocks are poised for growth?*

Nome: Ocean Energy has a multiyear inventory of exploratory prospects that should generate 10%-plus annual growth in production—it doesn't have to make acquisitions to achieve that growth. Currently, the company is exposed—through its prospects in the Gulf of Mexico, offshore West Africa and offshore Brazil—to

Shannon L. Nome

unrisked reserve potential of as much as 8 billion barrels of oil equivalent.

XTO Energy also has a multiyear drilling inventory which should generate10%-plus production growth during the next several years—in this case from low-risk development drilling, mainly for gas, in East Texas, as well as the Arkoma and San Juan basins in Arkansas/ Oklahoma and New Mexico, respectively.

In recent years, Pioneer Natural Resources has driven debt/total capitalization down from 70% to about 50% and has put together a strong exploration team that has generated a premier inventory of deepwater drilling projects in the deepwater Gulf of Mexico and offshore South Africa. With the development of these gas-leveraged projects, the company's average daily production will jump 47% in 2003.

Investor: *Wayne, why is this a good time to buy large-cap E&P stocks?*

Andrews: U.S. natural gas production is in a very steep decline, simply because there aren't enough rigs drilling for gas at current prices. Recently, there were about 700-plus rigs drilling for gas, but it's going to take something north of 1,000 rigs drilling before we see any meaningful increase in gas supply. The price required for producers to invest in new gas projects is probably in the $3 to $3.50 range—and fortunately we're now beginning to see in the futures market some sustainability in gas prices in that range.

Investor: *How fairly valued are E&P stocks currently?*

> *"During first-half 2002, E&P stocks were up 8.5% while the S&P 500 dropped 14%. Our expectation is that these stocks will continue to outperform the market."*
>
> Shannon L. Nome, **JPMorgan Securities Inc.**

Andrews: These stocks as a whole have typically traded at discounted valuation multiples compared with the multiples of stocks in other industries because of the volatility and uncertainty of natural gas prices. But now that we're seeing some sustainability in higher gas prices—which we believe will continue—the market at some point may be willing to pay an expanded valuation multiple for these stocks.

Investor: *Do they represent a hedge against other sectors of the market?*

Andrews: Yes. Unlike dot-com companies, E&P companies have measurable assets in the ground, which tend to hold their value, so an investor can easily size up the net asset value of a producer and limit his downside risk. Also, these stocks have plenty of room for share-price appreciation.

Investor: *Within the large-cap E&P group, what are your top picks?*

Andrews: We tend to focus on companies that are growing their reserves and production per share—without any significant change in their capital structure. Like Shannon, we like Pioneer Natural Resources. It's our E&P stock pick of the year. We believe that during the next 12 to 18 months it will show the highest growth in reserves and production per share of any producer within our coverage group. Also, the stock can be bought at a cheaper valuation than the average for its peer group. So, in Pioneer, an investor is getting both growth and value.

We also like XTO Energy. The company has wisely hedged its natural gas production, such that it can maintain a robust capital-spending program in East Texas, where it has a large acreage position and a successful development drilling program. Based on that capital-spending program, we believe it is capable of maintaining its 15%-plus annual growth in production.

Another large-cap producer we like is Apache Corp. It has typically managed its balance sheet wisely to take advantage of cycles in the industry. The company, which trades at a discount to its peers, has made sound acquisitions—buying the right properties at the right price—and has grown its reserves and production per share. We expect this trend to continue in the future.

Investor: *What will drive Apache's growth this year and next?*

Andrews: Its natural gas assets in Canada, on which it spent about $1.8 billion during the past 18 months, and its international exploration operations, particularly in Egypt. ❋

TOP E&P STOCK PICKS

	Recent price*	12-month target **
Anardarko Petroleum (NYSE: APC)	$38.00	Outperform
Apache Corp. (NYSE: APA)	$46.34	Outperform/$63.00
Burlington Resources (NYSE: BR)	$33.06	Outperform
Canadian Natural Resources (TSE: CNQ)	C$45.05	Outperform
Devon Energy (Amex: DVN)	$35.54	Outperform
EnCana Corp. (NYSE: ECA)	$24.08	Outperform
EOG Resources (NYSE: EOG)	$30.93	Outperform
Murphy Oil (NSYE: MUR)	$64.95	Outperform
Ocean Energy (NYSE: OEI)	$16.68	$28.00
Pioneer Natural Resources (NYSE: PXD)	$20.55	$32.00-$35.00
Talisman Energy (NYSE: TAL)	$36.07	Outperform
XTO Energy (NYSE: XTO)	$16.05	$24.00-$27.00

** Closing price July 23, 2002, in US$, except for Canadian Natural. ** Buysiders use Market Outperform ratings rather than stock price targets.*