

Exclusive Outlook

WEST COAST ASSET MANAGEMENT, INC.

JULY 31, 2004

Revenue/Co-Worker Turns Snapshots Into Works of Art

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Have you ever watched a professional photographer sort transparencies on a light table or review image thumbnails on a computer screen? While the layman studies the first two or three photos, a professional can scan 200 images and separate out three or four worthy of further effort. Through training and experience, the photographer learns to see key elements that separate the great images from the snapshots.

For example, a friend of ours reviews his images first for composition, using “the rule of thirds,” a technique for evaluating how subjects fill space in the frame. Professional investors also learn to quickly see important features that help us weed out weak companies from the thousands available. One of our favorite metrics for forming a first impression is revenue per co-worker (R/CW).

A MEASURE OF EFFICIENT PRODUCTIVITY

Revenue per co-worker is as simple as it sounds. If you know a company’s sales, and you know its number of co-workers, you simply divide the number of co-workers into the sales figure. The numbers are easy to obtain, and this simple calcu-

lation reveals much about a company. It also evokes many questions of value to investors.

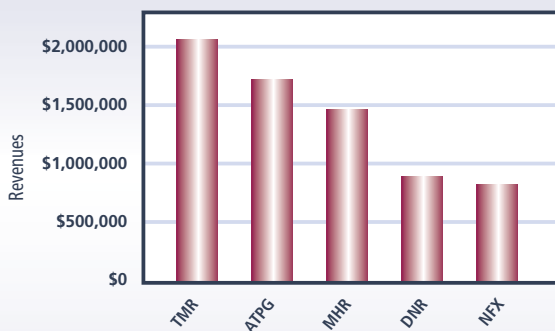
Primarily, revenue per co-worker tells us the relative productivity of companies within the same industry. For example, business service companies average around \$150,000 in annual revenue per co-worker. Automatic Data Processing (ADP) boasts almost \$175,000 per co-worker, well above the average, while Paychex (PAYX) manages only \$125,000 per co-worker, suggesting that ADP runs a far more efficient operation (see chart).

As a measure of productivity, R/CW tells us a great deal about management. In nearly every business, labor is the single largest controllable cost. Allocation of resources is a primary function of management. It was not merely politically correct semantics to rename the “personnel” department “human resources.” Getting the job done with the fewest possible people requires the right people in the right places doing the right things. That’s good resource allocation, and that’s good management.

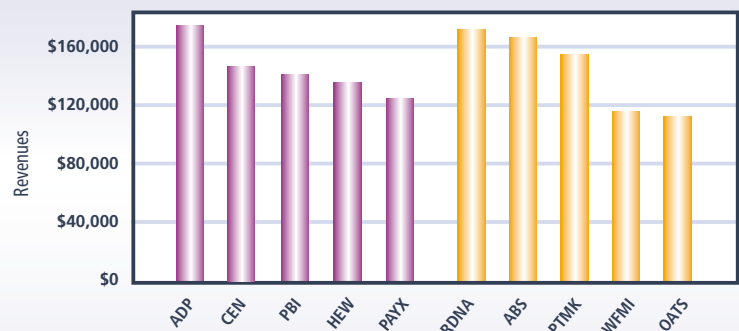
FROM THE TOP DOWN

Companies with high R/CW generally have high operating

2003 REVENUE/CO-WORKER



TMR Meridian Resources
ATPG ATP Oil & Gas
MHR Magnum Hunter Resources
DNR Denbury Resources
NFX Newfield Exploration



ADP Automatic Data Processing
CEN Ceridian
PBI Pitney Bowes
HEW Hewitt Associates
PAYX Paychex
ARDNA Arden Group
ABS Albertson's
PTMK Pathmark Stores
WFMI Whole Foods Market
OATS Wild Oats Markets

Comparing revenue per co-worker is an excellent way to measure productivity among companies in the same industry.



margins. As shown in the chart on page 1, oil and natural gas producers generate around \$1.5 million in annual revenues per co-worker, far above most industries. Consider Magnum Hunter Resources (MHR), profiled May 31, 2002. The company's net cash margin per thousand cubic feet of natural gas produced is approximately \$4 based on current \$6 prices (67% margin), a lucrative business in our opinion.

On the opposite end of the spectrum are service companies with low margins and high volume. One of our favorite morning stops, Starbucks (SBUX) generates only \$55,000 in annual revenue per co-worker. However, many of the company's co-workers are part-time and operating margins of 11% enable the company to generate a healthy profit.

"BEAUTY IS ONLY SKIN DEEP, BUT UGLY GOES RIGHT TO THE BONE"

One might assume that high revenues per co-worker indicate a strong company and a low ratio marks a weak company, but the former is true less often than the latter. Many factors, including an unusual spike in sales or recent layoffs, can inflate R/CW, but a low R/CW usually means one or two things: either sales are too low or labor is not being managed well.

Of course, one must define "high" and "low." Microsoft presents a R/CW ratio roughly three times the average in its industry, but Microsoft's other strengths (like massive stockpiles of cash) make the statistic unimportant. We think anyone above the industry average rates "high," while a company with R/CW less than half the average is clearly "low."

In the example above, ADP appears to be a much more productive company than Paychex, but Paychex's stock trades at a price to earnings multiple 50% higher than ADP's. Likewise, Arden Group boasts significantly higher revenues per co-worker compared to Wild Oats Markets and Whole Foods Market, yet the latter companies trade at multiples more than 200% higher than Arden Group. This is surprising to us, considering that Arden Group has more than \$20 per share in net cash on their balance sheet and gross margins exceeding all peers.

A GOOD FIRST IMPRESSION

When reviewing a table full of annual reports, revenue per co-worker gives us a quick way to flag possible problems and possible stars. We still need to find out about sales and employ-

SEEING IS BELIEVING

What has drawn us to invest in oil and natural gas companies (exploration and production) over the last few years is very simple – **Supply & Demand**. North America has been heavily drilled over the past century, and most companies can no longer find reserves at historical prices. Meanwhile, demand has been increasing and political stability worldwide has been decreasing.

Major oil and gas companies have largely abandoned their operations in the U.S. in search of larger reserves overseas. This industry shift has created a niche for smaller and more nimble companies to explore for and apply new technologies to reserves that have been passed over. In spite of these new efforts by smaller "independents", domestic supply of natural gas is likely to decrease each year in the foreseeable future.

The answer to the shortfall in natural gas supply lies in Liquefied Natural Gas (LNG), which will have to be shipped to the U.S. from foreign countries. LNG receiving terminals need to be approved and constructed before LNG makes an impact on U.S. supply. Environmental regulations and community resistance will likely push this out towards the end of this decade and beyond. Natural gas from Alaska is also likely to show up in the U.S. markets, but not for a number of years due to lack of a pipeline.

ment trends at the individual companies and their industries over time. Ultimately, this metric narrows the number of companies that undergo our rigorous research regimen, where we study financials, customers, markets, management, demographic, social and political trends, and company culture.

Just as a photographer must also review exposure, contrast, depth of field, and other factors essential to a great photograph, investors must look far beyond revenue per co-worker before they commit capital to a company. But revenue per co-worker is an excellent measure for forming first impressions.

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Magnum Hunter 2 Years Later...

It is with pleasure that we update you on Magnum Hunter Resources (MHR), profiled in our May 31, 2002 Exclusive Outlook. Since we last wrote about MHR, oil prices have risen from \$25 per barrel to \$40 per barrel, natural gas prices have risen from around \$3.25 per thousand cubic feet to \$6.5 per thousand cubic feet, and MHR's stock price has risen from \$7.32 to \$10.85 (48%). When we last went to press, MHR had just completed the acquisition of Prize Energy, which more than doubled their reserve base at a purchase price of \$.83 per thousand cubic feet equivalent (Mcf). Today, U.S. reserves commonly sell for close to \$2 per Mcfe.

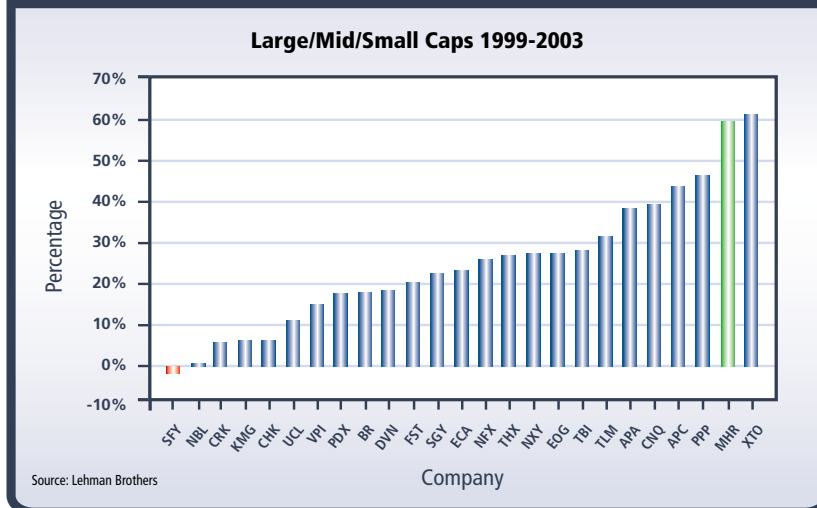
On June 21, 2004, MHR announced that it had executed a purchase and sale agreement to acquire \$243 million of oil and gas properties located in the state of New Mexico. New Mexico is one of MHR's core areas of operation, where they have achieved a drilling success rate of 97% in the last three years. Reserves associated with the acquisition are 76% natural gas and were acquired from Tom Brown, Inc., a subsidiary of EnCana Corporation (ECA). The company believes this new acreage holds reserves of close to 150 billion cubic feet equivalent (Bcfe). Along with this asset purchase, MHR sold approximately 17.25 million common shares, netting \$170 million. MHR's debt to total capitalization ratio now stands at approximately 51%, down significantly from 71% at year-end 2001.

MHR's pro forma reserves will be approximately one trillion cubic feet equivalent (Tcfe). Natural gas currently accounts for nearly 70% of production and 60% of reserves. The company has an excellent hedge position with little more than half of 2004 production hedged at favorable prices. This will dramatically boost cash flows, as previous years were constrained by unfavorable hedges.

MHR boasts a drilling inventory of more than 2,000 prospective locations and a land position approaching 9 million acres under lease or option. This includes a massive coal bed methane pilot program with industry leader CDX Gas, LLC in the San Juan Basin of New Mexico. The company also has significant midstream assets (gathering, transmission, and marketing), which it plans to spin-off late this summer and use the proceeds to pay down debt (approximately \$50 million). Below is a list of MHR's achievements during the past few years:

- 5 year average drilling success rate of 93%.
- 5 year average cash flow per share growth (debt adjusted) of 60.3% (second only to XTO Energy, Inc. (XTO) among peers - see chart).
- 5 year average debt adjusted growth rate of 17.5% (average of reserves/share, production/share and cash flow/share growth rates).

Cash Flow Per Share (Debt Adjusted) Five Year Annual Growth Rate



- 3 year average finding and development costs of \$1.22 per Mcfe (keep in mind reserves now sell for close to \$2 per Mcfe).
- 3 year reserve replacement ratio of 436% (amount of production replaced by new reserves).
- Since the end of 2002, interest expense per Mcfe produced has gone from \$.74 to less than \$.50, and net cash margin per Mcfe produced has gone from \$1.50 to \$4, based on \$6 gas (67% margin).
- Oil & Gas Journal recently ranked Magnum Hunter as the number one fastest-growing company based on growth in stockholders equity.

Chairman, President, and CEO Gary Evans owns approximately 3 million shares, and the company has a history of repurchasing stock at opportune times (rare for oil and gas companies). Evans was recently named a winner by professional services firm Ernst & Young LLP for the Ernst & Young Entrepreneur Of The Year 2004 Awards in the Southwest Area in the Energy category.

We have met with management on numerous occasions, and have visited one of MHR's oil fields in North Central Texas. They have done an excellent job of creating value on a per share basis, and we are very pleased with their opportunistic style and execution. MHR shareholders have enjoyed an annual compounded return of more than 30% since the company went public on December 31, 1990.

MHR has a market capitalization of approximately \$950 million, with net debt of around \$650 million, leaving an enterprise value of \$1.6 billion. The company should produce cash flow upwards of \$250 million in 2004, and we expect production and reserves to increase for the foreseeable future. At current prices, we continue to believe Magnum Hunter represents an excellent opportunity. We also believe it would be an accretive acquisition for many prospect poor companies with discretionary cash flow. ▲

