Oil and Gas Investor

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U.S. BUYSIDE

Nationwide, buysiders are guarded in their macro-energy outlook for 2007 but are long-term bullish on industry fundamentals and company-specific investments.

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Starting last fall, it became clear even to casual industry observers that large oil and gas inventory overhangs weren't going to bode well for commodity prices and energy-stock valuations going into 2007.

Then came the second consecutive milder-than-normal January and their expectations were fulfilled. The heady $78-plus oil markets of last August yielded to crude prices in the low $50s while gas-futures, in double digits last summer, dipped to below $6. Meanwhile, energy-stock values plunged 10% to 15% and even more.

Does this signal the end of the bull market in energy? Buysider consensus about this is best summed up in Bette Davis' oft-quoted line from *All about Eve*: "Hold on to your seats, fellas; it's going to be a bumpy ride."

In Ventura, California, West Coast Asset Management's Atticus Lowe focuses on smaller-cap E&P stocks with a high margin of safety that trade at a large discount to his assessment of their intrinsic value.

Translation: the early part of 2007 is going to be marked by high volatility and softness in the commodity markets, with oil prices trading in a broad range of $48 to $65 and gas prices moving in a band of $5.50 to $7.

Ultimately, however, as more momentum players exit the energy-stock playing field and more traditional oil and gas investors again become dominant, the energy-ticker tide on the corner of Wall and Broad streets will gradually begin to rise.

Says one energy buysider, "The world is looking at very tight supply/demand fundamentals beyond 2007, with [oil] demand outstripping supply during the next five years." Observes another, "Despite the price of crude doubling since 2003, energy consumption worldwide has nonetheless increased, with 51% going into transportation today versus 39% in 1979. Meanwhile, since 1995, the average first-year production from U.S. gas wells has dropped more than 50%."

To seasoned energy investors, the handwriting is on the wall: meaningfully higher commodity prices are on the horizon during the rest of this decade simply because the demand for oil and gas is inelastic and supply isn't going to be able to keep pace.

This, of course, doesn't mean a rising tide will lift all boats. On the contrary, bottom-up buysiders point out that investors need to separate the wheat from the chaff. Focus, they say, on those undervalued energy companies that have either a meaningful inventory of prospects for sustained growth, in the case of E&P companies, or that can control costs and hence, improve earnings visibility, in the case of service companies.

Eyeing undervalueds

A money-management firm with assets under management of $425 million and an overall 35% weighting to oil and gas investments, Ventura, California-based West Coast Asset Management is long-term bullish on energy today.

The firm, co-founded at the end of 2000 by Paul Orfalea—the founder of Kinko's—also manages a $50-million hedge fund, West Coast Opportunity Fund LLC, primarily focused on energy investments, including private placements in the form of convertible preferred stocks and bonds, structured notes, microcap stocks, leveraged buy-outs and private equity.

"We take a top-down view of the macro-fundamentals of the energy sector, looking this year for at least $6 natural gas and $50 oil, with meaningfully higher prices longer term since we believe the demand for oil and gas is inelastic and supply won't be able to keep pace," says Atticus Lowe, partner and chief investment officer for West Coast Asset Management.

"However, we're ultimately a bottom-up investor focused on a small number of stocks that we believe have a high margin of safety and trade at a large discount to our assessment of intrinsic value."

Since inception, the firm has invested in Prize Energy which was acquired by Magnum Hunter Resources in 2001, Howell Petroleum

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which was bought by Anadarko Petroleum in 2002, and Magnum Hunter which was purchased by Cimarex Energy in 2005. In each case, the acquisitions were made at significant premiums to where the target companies were then trading.

In its current portfolio, the most likely takeout candidate is Houston's Carrizo Oil & Gas. "We believe the assets of this $700-million-market-cap producer, which has 85,000-plus acres in the coveted core of the Barnett Shale in the Fort Worth Basin, are worth at least $1.2 billion in a sale today," says Lowe.

Carrizo also has other valuable assets in East Texas, the Rockies, the North Sea and the Gulf Coast where it just drilled a 1-trillion-cubic-foot (Tcf) gas target on its Mega Mata prospect. "If this test is successful, it could add another $500 million to the company's NAV (net asset value)."

The buysider also likes Canadian Superior Energy, a debt-free, $250-million-market-cap Calgary-based operator with western Canadian assets worth at least $150 million, 2.6 million acres offshore Nova Scotia and two large acreage blocks offshore eastern Trinidad.

In Trinidad, the company's Block 5-C offsets the multi-Tcf Dolphin gas field operated by British Gas. There, it has identified, with seismic, three prospects that collectively have unrisked gas reserves of about 6.5 Tcf.

"We believe each prospect has a 40% chance of success," says Lowe. "If we assume the government ultimately backs in for 50% and that each Mcf (thousand cubic feet) is worth $2 in the ground, this means that, on an unrisked basis, Block 5-C is worth $4.9 billion net to Canadian Superior, or $32.50 per share, and on a 40% risked basis, $2 billion or $13 per share."

Among other undervalued E&P stocks, Lowe is focused on ATP Oil & Gas, a Houston-based operator pursuing development drilling in the Gulf of Mexico and the North Sea. "The stock trades around $37, but it is worth at least $90 today based only on the present value of its proven and probable reserves."

He also cites Contango Oil & Gas, a small Houston-based operator that has a 10% interest in the Freeport LNG terminal under construction in southeastern Texas, 30,000 net acres in the Fayetteville shale play that could have a net present value of more than $500 million, and 66 prospective Gulf blocks.