# GOLD & ENERGY ADVISOR

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# "Seven Energy Stocks Poised to Soar in the Private Equity Buyout Boom (Part I)!"

**"Two years ago I issued a special report on the oil stocks most likely to shoot upwards as a result of buyouts. (You might remember that our picks did great!) This month, I'm updating that report. We'll see which companies still have good potential. Next month, I'll add two new candidates!"**

*James DiGeorgia, Editor*

- **The current private equity M&A (Mergers and Acquisitions) mania**
- **Why I expect takeovers in the energy market**
- **Five stocks poised for success**

Were you in the stock market back in the 1980s?

If so, you probably remember the LBO (leveraged buyout) mania that went on then.

Larger companies swallowed up smaller ones. Sometimes, smaller companies devoured larger ones. Billions of dollars in market share changed hands.

In many cases, after the sales closed, the acquisition targets were dissolved, or carved up into pieces and sold.

Hollywood even made movies (like *Wall Street* and *Other People's Mone*y) about how greedy all those dealmakers supposedly were. As usual, though, the media had it all wrong.

If a company is grossly undervalued, it means it has serious problems that need to be corrected. The overall economy suffers if these problems are allowed to fester. (Danny DeVito's speech in *Other People's Money* about buggy-whip manufacturers was right on target!)

The corporate raiders not only cleaned up the companies they took over, but they scared lazy executives at other companies into cleaning up their businesses before they got eaten too. But I digress.

Anyway, why am I bringing up market conditions from 20 years ago?

Because we're actually in a bigger M&A (merger and acquisition) boom now then we were back then. And this could have huge (and profitable!) repercussions for us in the energy markets.

I'll talk more about that later. First, I'll discuss what's going on today, and why it's happening. Next, we'll see how it applies to the energy markets (some of it does, and some of it doesn't).

Lastly, we'll conclude with a discussion of five specific stocks that are great takeover candidates, and thus are positioned well for huge leaps in their prices.

So let's get started, with a discussion about...


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## The Biggest M&A Boom in History

*Fortune* magazine recently listed the ten biggest private-equity buyouts in history. Nine of the ten have happened in the last 30 months:

1. $38.9 billion—Equity Office Prop. Trust (2007)
2. $32.7 billion—Hospital Corp. of America (2006)
3. $31.1 billion—RJR Nabisco (1989)
4. $27.4 billion—Harrah's Entertainment (2006) (sold at 35 % premium over closing stock price)
5. $25.7 billion—Clear Channel Comm. (2006)
6. $21.6 billion—Kinder Morgan (2006)
7. $17.6 billion—Freescale Semiconductor (2006)
8. $17.4 billion—Albertson's (2006)
9. $15.0 billion—Hertz (2005)
10. $13.9 billion—TDC (2005)

According to Dealogic, through May 21st there have been $2.33 trillion of announced deals. That's an annual pace of $4.7 trillion, which would be about 20 percent higher than the record set in 2000 (an inflation-adjusted $3.9 trillion).

The pace has been torrid, and there's no sign of anybody slowing down. Instead, Kohlberg Travis Roberts has announced its plans to pay $26 billion for credit card processor First Data, including selling a record $8 billion in high-yield bonds. KKR plans to buy TXU for $32 billion. And other deals have been announced as well.

## Why is this Boom Happening?

A private equity company raises money from large institutions and wealthy investors. Thanks to sagging returns in the stock and bond markets, large investors are seeking out "alternative" forms of investment. Since private equity companies have averaged a return of 14.2 percent in the last 20 years, versus only 9.8 percent for the S&P, there's a lot of eager money pouring into these companies.

These firms don't invest in a diversity of stocks as funds would do. Instead, they seek to buy entire companies.

Once they've taken over a particular business, they usually renovate it. They eliminate unprofitable divisions, layoff redundant employees, and cut costs overall. After a few years, when they've turned the company around, they bring it public again. This results in a big payday for the investors.

So far, this sounds like the LBO boom in the 1980s, but there are some differences. Today, some of the major players are looking beyond troubled companies, and going after healthy ones too.

For example, Michael Capellas is the former head of Compaq and MCI, and is now with private-equity firm Silver Lake Partners. As he recently told an editor at *Fortune*, "The scale of this business has gotten such that Silver Lake and others can look at world-class companies. Now instead of turnarounds we are looking more at companies that maybe need funding to drive growth, like accelerating R&D."

Also, today's private-equity firms are brimming with cash. They don't need as much leverage as the dealmakers did before.

Having said that, though, there's plenty of money available for them to borrow. In the last 12 months, defaults on leveraged loans were only 0.29 percent. Thus, banks are lining up to lend out money for these buyouts. Because of this, I expect to see the current boom last for a while longer. I also expect to see debt playing a larger role in future deals.

## Big Targets and Big Names

It's easier to grasp the scale of the mania when you see the companies and names involved.

There are some big firms getting taken over, such as Albertson's, Harrah's Entertainment (the casino giant), and Hertz rental cars. Buyout rumors are swirling around some other surprising companies, including Texas Instruments and Dell.

The roster of players is also very impressive. Some of the biggest names in the country are involved. For example, the $44.3 billion private-equity giant Carlyle Group can call on the political clout of former US President George H.W. Bush, and is led by Lou Gerstner, the former head of IBM.

Other major players include former Treasury Secretary Paul O'Neill, former SEC head Arthur Leavitt, former GE CEO Jack Welch, and many others.

Some private-equity players are even famous in their own right, like Kirk Kerkorian. Until recently, he owned 10 percent of General Motors. He's also owned all or part of MGM three times, and recently tried to buy Chrysler from Daimler.

Summary: this is no short-lived fad…

**There are major players involved, with major-league money at stake.**

Of course, with this much money to be made, there are the inevitable excesses.

Some private-equity companies are little more than out-of-control parasites, killing their hosts. For example, Fremont Partners bought out Nellson Nutraceutical Inc. for $300 million. Sixteen months later, Nellson was forced to pay Fremont a $55 million dividend, to give Fremont "an early return of capital." It had to borrow the money to do so, and wound up in Chapter 11 bankruptcy a few months later as a result.

Perhaps a more egregious example is the ongoing Thomas H. Lee Partners deal to buy 80 percent of Hawkeye Holdings. Three weeks after the deal was announced, before it had even closed, the Partners filed for an IPO (initial public offering). The Partners took a $20 million advisory fee for negotiating the buyout deal with itself (!), and another $1 million "management fee," which is interesting because they didn't yet own the company they were supposedly managing. Plus, they're planning to take an additional $6 million to cover their taxes.

All together, this adds up to $27 million that the Partners will extract from the company—an especially juicy deal, considering that the target company only earned $1.5 million in the first half of the year.

Nevertheless, despite the excesses, the overall trend looks strong. The M&A boom should last for a while.

Of course, you can make a killing if you own one of the target stocks. When a private-equity firm goes after a company, the target's share price shoots way up.

And that's why this boom is interesting to us. The private equity mania hasn't really reached the energy markets yet!

## Why Energy Stocks are Different

Energy stocks have, for the most part, been largely unaffected by private-equity activity.

Why is this so? There are several reasons.

First of all, your typical private-equity investor has a lot of experience in the business and

**Latest prices as GEA goes to press—June 21, 2007**

Comex spot contract: silver $13.15, gold $654
Nymex spot platinum: $1,296, palladium $378
Nymex Light Sweet Crude Oil $69.54

| Silver coins | | Dealer will buy at this price | Dealer will sell at this price |
|---|---|---|---|
| 100 1 oz. silver American Eagles | | $1,400 | $1,450 |
| 100 1 oz. common rounds | | $1,315 | $1,400 |
| $1,000 face value US pre-1965 coin bag (circulated) | | $9,200 | $9,800 |
| $1,000 face value US circulated silver dollar bag (VG or better) | | $12,300 | $13,200 |
| US Morgan silver dollars | PCGS MS64 | $44 | $48 |
| | PCGS MS65 | $117 | $124 |
| | PCGS MS66 | $270 | $340 |

**Platinum coins**

| | | | |
|---|---|---|---|
| U.S. Platinum Eagle: | 1 oz. | $1,300 | $1,340 |
| | 1/2 oz. | $650 | $670 |
| | 1/4 oz. | $328 | $344 |
| | 1/10 oz. | $140 | $150 |

**Gold coins**

| | | | | |
|---|---|---|---|---|
| Australian Kangaroo | | | $660 | $690 |
| British sovereign (Kings) | | | $150 | $170 |
| (Elizabeths) | | | $150 | $170 |
| Canadian Maple Leaf | | | $650 | $685 |
| Credit Suisse 1 oz. gold bar | | | $655 | $690 |
| Mexican 50 peso Centenario | | | $790 | $820 |
| South African Krugerrand | | | $650 | $670 |
| US Gold Eagle: | | 1 oz. | $662 | $692 |
| | | 1/2 oz. | $331 | $360 |
| | | 1/4 oz. | $165 | $180 |
| | | 1/10 oz. | $66 | $76 |
| US $20 double eagle: | | | | |
| Liberty | Raw | MS60 | $657 | $687 |
| | NGC | MS63 | $875 | $925 |
| | NGC | MS64 | $1,315 | $1,450 |
| | NGC | MS65 | $3,580 | $3,900 |
| Saint Gaudens | Raw | MS60 | $665 | $705 |
| | NGC | MS63 | $720 | $780 |
| | NGC | MS64 | $845 | $895 |
| | NGC | MS65 | $1,250 | $1,350 |



financial world. Few of them have any experience in the rough-and-tumble oil and gas world. There's a huge culture gap between double-breasted suits on Wall Street and oil-soaked uniforms worn by roughnecks on oil rigs.

Not only that, the fundamental business models are different. Dealmakers were comfortable buying Albertson's and Hertz: these businesses have commercial real estate, advertising budgets, P&L statements, and other things that an executive with an MBA is comfortable discussing.

On the other hand, an Occidental Petroleum, with major operations in Libya, or a Berry Petroleum, with most of its reserves in the form of heavy crude (which is different than light crude in some important ways), are scary to a private equity investor. How can he evaluate the political risk of operating in Libya? What does he know about the heavy crude market? What if oil prices overall go down? What if some new energy alternative is discovered, and all the oil company stocks get whacked in the markets? And so on.

This is why private equity investors have, for the most part, steered clear of the energy companies. And I think they'll continue to do so.

Why then have I dedicated this issue to the M&A mania? It's because I believe in the spillover effect.

There are several energy stocks that are great candidates for a takeover. I think these stocks are significantly underpriced.

I don't think the private-equity firms will recognize this necessarily (although they might). But I do expect the current M&A activity to spill over into the energy markets.

Although the private equity firms don't know the energy industry, the energy majors (Exxon Mobil, British Petroleum, ConocoPhillips, etc.) certainly do. And as the broader boom continues, it will become easier and easier for the energy majors to get financing and other necessary elements lined up, to go devour their smaller undervalued siblings.

## Why This Takeover Boom will be Different

A few years back, we saw a major M&A trend sweep through the energy industry. Exxon merged with Mobil. British Petroleum merged with Amoco, and then bought Arco. Chevron and Texaco merged. Conoco and Phillips consolidated. The French companies Total, Fina, and Elf also joined forces.

But that trend is over. It was driven by unique circumstances; the plummeting oil prices of the late 1990s had taken a huge toll on energy companies.

Plus, the big companies needed the scale and size necessary for their massive projects in Asia and Africa. Now that they have it, there's little incentive for more mergers. Frankly, even if they did merge, we wouldn't care anyway. The stocks are too big now, and there's little profit to be made from future M&A activity.

No, the interesting action is now in the small companies. When one of the giants devours one of the small fry, there are big profits to be made. And that's where we want to be!

## Why I Expect Another Energy Takeover Boom

There are some strong forces driving another wave of energy takeovers.

First of all, thanks to high oil prices, the majors are drowning in cash. Exxon Mobil is making $4.7 million in profit *every hour*. ConocoPhillips can now buy back 10 percent of its own stock every year. Other companies are gushing cash too, and their debt levels are low.

Second, energy stocks are underpriced. The stock market overall has an average valuation of 19.4 times earnings. But as an example, EOG (one of the stocks on our list) is selling for only 16.4 times earnings.

Third, some of these companies are juicy targets just for their technological advances alone. For example, EOG has developed a new method for horizontal drilling. And Apache has discovered a new way to analyze three-dimensional seismic data. (The company used it to discover Qasr, their natural gas field in Egypt that contains 2.3 trillion cubic feet of gas.)

Fourth, the majors are desperate to replace their depleting reserves.

I'm sure few people would agree with me, but I actually feel sorry for the oil executives today. If you were in charge of Exxon Mobil, for example, your stockholders expect you to increase the value of their investment every year. That value is largely determined by the oil and gas reserves you own.

But you're pumping oil and gas out of the ground every day, and draining your reserves

## Portfolio Update

In Update #343, we gave instructions for subscribers who wrote options on Anadarko Petroleum (APC), ConocoPhillips (COP), Devon Energy (DVN), and Talisman Energy (TLM).

For APC, we let the stock get called away on our May $45 call on APC. We still have 100 shares, with a return so far of 5.6%.

For COP, we rolled up our May $65 calls (COPEM) to June $55 calls (COPFM). This maintained our hedge and reduced our cost basis in the stock.

For DVN, we rolled up our May $70 calls (DVNEN) to June $70 calls (DVNFN). This maintained our hedge and reduced our cost basis in the stock.

For TLM, we rolled up our May $15 calls (TLMEC) into July $15 calls (TLMGC). This was a wash to maintain our hedge.

In Update #351, we issued instructions to subscribers who own Suncor Energy options: SUFL and SUFO.

We bought back June $70 calls (SUFO) and sold the June $60 calls (SUFL) to close out the positions. Our net was a return of 151%.

In Update #353, we issued instructions for subscribers who wrote options on COP and DVN.

For COP, we rolled up our June $65 calls (COPFM) to July $55 calls (COPGM). This maintained our hedge and reduced our cost basis in the stock.

For DVN, we rolled up our June $70 calls (DVNFN) to July $70 calls (DVNGN). This maintained our hedge and reduced our cost basis in the stock.

In Update #354, we issued instructions for subscribers who wrote options on Bill Barrett Corp. (BBG), Cimarex Energy (XEC), and Encore Acquisition (EAC).

For BBG, we let the stock get called away. This resulted in a 21.45% profit.

For XEC, we rolled up our June $35 calls (XECFM) to the July $35 calls (XECGM). This maintained our hedge and reduced our cost basis in the stock.

For EAC, we rolled up our June $25 calls (EACFE) to the July $25 calls (EACGE). This maintained our hedge and reduced our cost basis in the stock.

by 1.6 *billion* barrels every year. You need to replace that much every year just to keep what you started with—never mind actually *increasing* your reserves, which is what your shareholders are expecting you to do.

The problem is that it takes lots of money and lots of time to find even small amounts of oil now. For example, offshore drilling can cost a half-million dollars per day, per well. And a major find can require hundreds of wells.

But even that isn't the worst problem. Thanks to high oil prices, the majors have plenty of money, but they don't have the necessary time. For example, some of the projects starting up in West Africa won't come on line until 10 years from now.

Unfortunately, oil stockholders aren't willing to wait 10 years for reserves to be replaced. (Not to mention that the reserves will be depleted even further during that time.) Executives need to replace that oil *now*.

### Have They Been Reading *GEA*?

Some recent articles in the mainstream media have left me shaking my head.

For example, *Barron's* talked to Judson Jacobs, the director of upstream technology at Cambridge Research Energy Associates. The article said "there are probably no giant oil fields remaining to be discovered – 'elephant' discoveries will be few and far between."

The same article described the new "race to replace rapidly depleting oil and gas reserves." It quoted Geoff Kieburtz, managing director and oilfield service analyst at Citigroup, who said, "The easy oil is gone; the next barrel is always going to require more technology to extract."

Then there was this quote: "Clearly non-OPEC oil has peaked."

Non-OPEC oil has peaked? Energy reserves are "rapidly depleting"? There are no giant oil fields left to be discovered? These sound like past issues of *Gold & Energy Advisor*!

Are the mainstream media finally waking up to the reality of our straining oil supply? Well, it's going to happen sooner or later. Maybe it will happen now, maybe it won't.

The real question is this—once the media finally acknowledge the truth about oil, will they also apologize for misleading the American public about it for so long? Now *that* would be a surprise!

As a final nail in the coffin, there's little new oil left in the West. Almost all new discoveries today are in places you'd be afraid to visit.

Barrel for barrel, an oil well in Texas is far more valuable than a well in Kazakhstan or Nigeria. For example, that big oil field in the Caspian Sea caused celebrations when it was discovered, but it's a lot less attractive today, now that war and chaos have enveloped the Caucasus region. (The Caspian oil flows through unguarded Caucasus pipelines, in regions infested with Muslim terrorists.)

Summary: the easiest way to get more oil isn't to look for it. The fastest and cheapest way is to buy it from the companies who already have some. Or, even better, just buy the companies themselves.

## Qualities of a Good Takeover Candidate

So if you were an oil executive, looking to buy a smaller company, what would you look for? Here's my list. The company must:

- Have significant reserves.
- Have seasoned, experienced management. Conversely, if the company is poorly managed, you want to see significant assets or operations that you could manage better and turn around.
- Be a good complement to the existing portfolio of reserves and assets.
- Be an entry into new, important areas of exploration and production.
- Be available at a good price.

These are the exact same criteria I used to identify seven good takeover candidates in my original 2005 report. Of those seven, two were eventually bought out: Unocal by Chevron, and Kerr-McGee by Anadarko. (The Unocal buyout was announced as I was issuing my report!)

Out of the hundreds of oil stocks available, we picked seven as candidates, and two of them were actually bought. The other five have done very well too. I think this is impressive evidence for the validity of this approach.

So let's apply this approach to the market today, and see what the good candidates are now.

## The First Five Takeover Candidates

As I mentioned earlier, I'm going to issue seven recommendations, in two stages. This month, we'll talk about the first five. I'll cover the remaining two next month.

It turns out that the first five were in the 2005 report as well. They were excellent candidates then, and they remain excellent candidates now. The five stocks are:

- Occidental Petroleum (OXY)
- Devon Energy (DVN)
- Murphy Oil (MUR)
- EOG Resources (EOG)
- Berry Petroleum (BRY)

Company fundamentals are below, in two entries each. The first is from my original 2005 report, the second has the numbers for today.

**Occidental Petroleum (OXY).** OXY over the years has acquired a high potential portfolio of exploration and development projects, including re-entry into Libya. Their chemical business could be integrated into one of the mega global oil giants.

The company is currently selling at valuations below its peers. OXY would make a good acquisition candidate by one of the mega global oil giants.

**EOG Resources (EOG).** EOG has one of the best US portfolios of independent exploration and development oil companies. Its Barnett acquisitions would be especially attractive to potential buyers. Its reserves are mostly natural gas. Any energy portfolio should include some natural gas, so this would be a good addition to the natural gas portion of a major's portfolio.

| Company and Symbol | Reserves (BOE) | Value ($Billions) | Market Cap ($Billions) + Debt | Location of Reserves |
|---|---|---|---|---|
| Occidental (OXY) | 1.97 B | $78.80 | $30.95 | US, Latin America, Middle East, Pakistan, Russia, Libya |
| Occidental (OXY) **2007** | 2.87 B | $113.80 | $49.95 | US, Qatar, Yemen, Columbia, Ecuador, Other |
| Devon (DVN) | 2.1 B | $84.00 | $31.30 | US, Canada, Azerbaijan, Brazil, China, Egypt, W. Africa |
| Devon (DVN) **2007** | 2.36 B* | $84.00 | $38.19 | 60% US, 25% Canada, Azerbaijan, Brazil, China, Egypt, W. Africa |
| Murphy Oil (MUR) | 213.8 M | $8.55 | $9.72 | US, Canada, W. Africa, Malaysia, Ecuador, UK |
| Murphy Oil (MUR) **2007** | 388 M | $13.58 | $12.00 | Same |
| EOG Resources (EOG) | 100 M | $4.00 | $12.95 | US, Canada, Trinidad, North Sea |
| EOG Resources (EOG) **2007** | 1.1 B | $30.10 | $18.10 | Same |
| Berry Petroleum (BRY) | 110 M | $3.30 | $1.14 | California, Rocky Mountains |
| Berry Petroleum (BRY) **2007** | 150 M | $4.50 | $2.09 | Same |

**Company Fundamentals from 2005 to 2007**. *Reserves are in "BOE": barrels of oil equivalent. "B" means billion, "M" means million. Value is calculated at $40 per barrel of oil, as in the original 2005 report. *Devon's reserves might double or triple from its recent successes in the Gulf of Mexico.*

**Berry Petroleum (BRY).** BRY is a smaller independent exploration and production company based in California. The majority of the company's reserves and operations are in California, but it has been expanding its operations in Colorado.

The company's reserves are mostly heavy crude, which sells at a lower price than sweet crude. However, as light, sweet crude becomes scarce and thus more expensive, energy users will be forced to consider heavier crudes. So the pricing should get better.

The company could be a good acquisition for a company like Occidental Petroleum that has major operations in California. It could also be a good acquisition for one of the integrated companies that have refining operations—these could maximize the price of heavy crude, as it is a less expensive product.

**Devon Energy (DVN).** Devon is often mentioned as a potential takeover candidate in the financial media. Devon has been increasing its reserves with natural gas. However, the recent discoveries in the Gulf of Mexico could boost their crude oil reserves by 200-300 percent, according to their 2006 annual report. Devon remains one of our favorites.

**Murphy Oil (MUR).** Most investors still think of MUR as a refiner and marketer of oil. Nevertheless, it has substantial resources that were discovered in deepwater Malaysia and West Africa. These could potentially change the fortunes of the company. As a refiner, Murphy also has excellent position. The US is desperately short of refining capacity—that's why gas prices remain high, even when oil prices fluctuate.

Oil companies are learning that even "safe" places aren't actually safe after all.

I've written before about Shell's woes in Russia, where the company lost majority ownership in the gargantuan Sakhalin II energy project. British Petroleum also has major operations in Russia, but BP hasn't violated its budget agreements with the Russian government like Shell did. So BP executives thought the company was safe from persecution.

But it turns out that fulfilling your contractual obligations provides no protection in Russia. The government might decide to cancel your agreements anyway, and take all your property as a result.

About one-quarter of BP's oil production comes from Russia. Unfortunately, as this issue goes to press, the Russian government is deciding whether or not to confiscate a big field from BP.

Why? Because it can.

Barrel for barrel, drop for drop, oil in the West is much more valuable than oil in Africa or Asia. Since there's little new oil left in the West to find, it's more attractive to buy the companies that already own it.

## They're Still Great Candidates!

Even though I recommended these five stocks back in 2005, I think they're still great buys today.

In the table on the previous page, did you notice that all of these companies have increased their reserves substantially in the last two years? This makes them all the more attractive as takeover targets.

## My Recommended Entry Points

We've made a lot of money in the ongoing oil bull, but lately it's been frustrating in one respect.

We want to buy on weakness, and hedge on strength. This means you have to wait for a weakness in the stock before you buy.

Unfortunately, these have been rare lately. And it's all too easy to get impatient, and charge into a stock prematurely.

Nevertheless, this discipline is important. Pullbacks will occur, even in a strong bull. A little patience now will result in improved profits later.

So, keeping that in mind, here are my recommended buy-in prices for these stocks.

| Company Symbol | Current Price | Initial Buy | Add to Position |
|---|---|---|---|
| OXY | $56.91 | $54.00 | $52.00 |
| DVN | $78.41 | $72.50 | $71.00 |
| MUR | $59.00 | $56.00 | $53.75 |
| EOG | $75.23 | $73.00 | $71.58 |
| BRY | $38.04 | $33.00 | $31.75 |

This concludes Part I of my special report on energy takeover candidates. Next month, I'll give you two more recommendations, and I'll show you why I think they too are great candidates for buyout targets!