GOLD & ENERGY ADVISOR

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"How to Buy Oil for $5.54 per Barrel!"

"Oil has leaped up over $70 again. But Wall Street has been distracted by the sideshow over in the Dow Jones Industrial Average, as the index has hit new highs. Therefore, the Street hasn't noticed (yet) that certain energy companies are now drastically undervalued.

"In this issue, I'll reveal seven energy companies that I believe are grossly underpriced at the moment. Their reserves are being valued for as little as $5.54 per barrel!

"Here's what's going on, and how you can take advantage of it!"

James DiGeorgia, Editor

- **In-depth evaluations of the best energy companies**
- **An update to our "buy-out candidate" report**
- **Energy watchdog agency confirms: oil prices will remain high!**

Last month I began an update of our 2005 special report on oil stocks that were poised to be bought out, or otherwise soar in price.

I explained why I believe the current M&A boom on Wall Street will spread to the energy industry.

As I mentioned, our original report listed seven stocks. Two of them were actually acquired by other companies, and the other five are up by an average 52.4 percent. This confirms the validity of our approach.

Last month, I restated my belief in the remaining five stocks. I said they're still strong buyout candidates.

I also promised that this month, I'd recommend two more, to bring our list back up to seven.

Well, I'm going to fulfill that promise this month, but with a slight twist.

I've now completed an exhaustive study of energy stocks, and I've found not two, but *four* more strong takeover candidates.

I'm going to add all four to our list. However, to keep our list at seven, I'm going to remove two of the previous five.

This isn't to say that these two aren't good stocks—on the contrary, we've owned them in the *GEA* portfolio in the past, and would like to do so again if the prices are right. But I want to keep our buyout list manageable, and seven is a good number for this.

I'll discuss all seven stocks in a moment. First, I want to talk about the criteria used to rank these stocks.

If You Were an Oil Executive…

…how would you decide if a company was a good candidate for a buyout? Here are the criteria we've used here in *GEA*. The candidate company must:

- Have significant reserves.
- Have seasoned, experienced management. Conversely, if the company is poorly managed, there must be significant assets or operations that could be managed better and turned around.
- Be a good complement to the buyer's 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 good criteria, and they've served us well. However, there are lots of companies that meet them. And we want to refine the overall list of candidates—for our top seven stocks, we want only the best of the best. So let's dig deeper.

Here are the factors we can use to rank energy companies.

Proved Reserves. Proved reserves are the company's energy assets that are reasonably certain to exist and be recoverable, using current technology, under current economic conditions. The higher the proved reserves are, the more attractive the company becomes as a takeover candidate.

Oil Reserves. Don't be confused by this one—it's related to Proved Reserves, but (usually) it won't be the same number. Proved Reserves includes both oil and natural gas (NG), but Oil Reserves refers to oil exclusively. Oil is getting scarce today, and is more useful overall than NG. Therefore, the higher this number is, the more likely the company will be pursued as a takeover target.

Percent of Oil to BOE. This number is simply Oil Reserves divided into Proved Reserves. It tells us what percentage of the company's energy assets are oil, as opposed to NG. Again, the higher this number is, the better. If there are two companies, each with a billion BOE ("barrels of oil equivalent"), the company with more of its energy as oil will be

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"BOE" is how the industry combines oil and gas into one measurement. Obviously, barrels are a poor measuring device for gas, so "equivalent" barrels are used instead.

One barrel of crude oil contains the same amount of energy as 5,700 cubic feet of NG. Therefore, one barrel of "equivalent" oil might be a barrel of oil, or 5,700 feet of NG, or some combination of the two.

A company's BOE number tells you how much energy the company has, not specifically how much oil it has. Generally, the higher the percentage of oil a company has in its total BOE, the more likely it is to be pursued as a takeover candidate.

more attractive. Natural gas is still valuable, of course. It's just that oil is even more valuable.

Market Value per Barrel. Every publicly-traded company is "worth" its total market capitalization. In theory, you could buy the entire company for this amount. When we divide this number by the amount of BOE the company has, this tells us how many dollars per barrel the company is worth. The lower this number is, the better. (In fact, I think you'll be shocked at just how cheaply you can buy some energy stocks at the moment. More on this later.)

F & D (Finding and Development) Costs. How much does a company spend to find and develop its energy assets? That's what this number tells us (expressed in dollars per BOE). Note that this number is historical—it tells us what the company has spent in the past. It can't predict future costs or expenses. (In fact, costs have been rising across the industry, as oil has become more difficult to find.) But we can use this number to rank energy companies against each other. The lowest-cost companies are those which explore in less-expensive regions of the world, or have other factors in their favor (proprietary technology, an expert team of engineers, and so on). Obviously, the lower the F&D number is, the more attractive the company becomes.

Reserve Lifespan. How long will a company be able to produce energy? To find out, we divide the reserves by current production. This tells us how many years it will be until the company runs out of oil and gas. Obviously, this number assumes that production remains constant, which usually isn't true. (All the companies on our list are trying to increase their production.) But it's a useful number for comparing companies to each other. You might think that a higher lifespan is always better, but that's not necessarily true either. In fact, if this number is too high, it might make the company *un*attractive as a takeover target. We'll see a specific example of this later.

Replacement. Energy stocks are, by their very nature, depreciating assets. Every barrel of oil that comes out the ground reduces that company's reserves, and therefore its value. Well-managed companies seek to replace this depletion—indeed, the top companies are finding (or acquiring) even more reserves than they produce. Therefore, the companies become more valuable over time. Obviously, these companies are much more attractive for buyouts.

Portfolio Update

In Update #358, we issued a recommendation to go long EOG Resources (EOG). We did so by selling the August $70 put (EOGTN) for $2.55.

In Update #369, we issued instructions for subscribers who wrote options against ConocoPhillips (COP), Encore Acquisition (EAC), and Talisman Energy (TLM).

For ConocoPhillips, we rolled up our COP options to the next month and strike price. We bought (to close) the COP July $65 calls (COPGM), and sold (to open) the COP August $70 calls (COPHN).

For Encore Acquisition, we rolled up our EAC options to September. We bought (to close) the July $25 calls (EACGE), and sold (to open) the September $25 calls (EACIE).

For Talisman Energy, we rolled up our options to October. We bought (to close) the July $15 calls (TLMGC), and sold (to open) the October $15 calls (TLMJC). These instructions were for two contracts.

In Update #370, we issued instructions for subscribers who wrote options against Devon Energy (DVN) and Cimarex Energy Co. (XEC).

For Devon Energy, we rolled up our options to the next month. We bought (to close) the July $70 calls (DVNGN), and sold (to open) the August $70 calls (DVNHN).

For Cimarex Energy, we rolled up our options to the next month. We bought (to close) the July $35 calls (XECGG), and sold (to open) the August $35 calls (XECHG).

Introducing the Candidates

There are literally hundreds of energy companies available. I've winnowed the list down to just 19 excellent stocks. From these, we'll pick the strongest takeover candidates.

I want to emphasize that these are all great companies. We already own eight of them in the *GEA* portfolio, and another five of them have been in the portfolio in the past. We'd like to own them all, if the prices were right.

So don't assume that the stocks which don't make the list aren't good companies. Again, we aren't weeding out losers; we're picking out the best from the best.

Latest prices as GEA goes to press—July 20, 2007

Comex spot contract: silver $13.33, gold $684
Nymex spot platinum: $1,332, palladium $378
Nymex Light Sweet Crude Oil $76.00

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.	$1,350	$1,390
		1/2 oz.	$675	$690
		1/4 oz.	$337	$345
		1/10 oz.	$145	$155
Gold coins				
US Gold Eagle:		1 oz.	$684	$704
		1/2 oz.	$342	$352
		1/4 oz.	$171	$176
		1/10 oz.	$70	$90
US $20 double eagle:				
Liberty	Raw	MS60	$685	$720
	NGC	MS63	$865	$900
	NGC	MS64	$1,240	$1,300
	NGC	MS65	$3,300	$3,425
Saint Gaudens	Raw	MS60	$695	$725
	NGC	MS63	$765	$800
	NGC	MS64	$830	$870
	NGC	MS65	$1,275	$1,340

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Here then are the 19 companies we'll be examining closely:

- Anadarko Petroleum (APC)
- Apache Corp. (APA)
- Berry Petroleum (BRY)
- Bill Barrett (BBG)
- Chesapeake Energy (CHK)
- Cimarex Energy (XEC)
- Devon Energy (DVN)
- Encore Acquisition (EAC)
- EOG Resources (EOG)
- Murphy Oil (MUR)
- Newfield Exploration (NFX)
- Nexen Inc. (NXY)
- Occidental Petroleum (OXY)
- Pioneer Natural Resources (PXD)
- Plains Exploration (PXP)
- Suncor Energy (SU)
- Talisman Energy (TLM)
- Whiting Petroleum (WLL)
- XTO Energy (XTO)

Reserve Lifespan

The first thing we'll examine is the lifespan of each company's reserves.

Symbol	Company	Reserve Life (years)
BBG	Bill Barrett	8.21
XEC	Cimarex Energy	8.86
NFX	Newfield Exploration	9.38
TLM	Talisman Energy	9.49
DVN	Devon Energy	11.03
EOG	EOG Resources	11.90
APC	Anadarko Petroleum	12.30
APA	Apache Corp	12.60
OXY	Occidental Petroleum	13.64
BRY	Berry Petroleum	15.30
XTO	XTO Energy	15.33

CHK	Chesapeake Energy	15.49
MUR	Murphy Oil	15.50
PXP	Plains Exploration	16.30
WLL	Whiting Petroleum	16.32
EAC	Encore Acquisition	18.19
PXD	Pioneer Natural Resources	25.21
SU	Suncor Energy	139.78

We see that all of these companies—except Suncor—will exhaust their current reserves in 8 to 25 years.

Note that Suncor really stands out here. It will take almost a century and a half to produce all of Suncor's reserves. This might sound like a positive, but it's actually a negative. If you were an oil executive looking to buy an energy company, you'd be doing so because your own company was depleting its reserves. To buoy up your company's stock price, you would need to replace these reserves immediately.

So it's not very exciting to buy oil that won't come out of the ground for over a century.

Much of Suncor's energy is in the Canadian oil sands, which are expensive and difficult to work. To ramp up production significantly, Suncor would require an enormous capital investment.

Also, Suncor is less attractive as an acquisition because it's a purely Canadian company. Presumably, an acquisition attempt by an overseas company would be rejected for political reasons. We saw this when China's state-owned oil company tried to acquire Unocal (the American energy firm) recently. The outcry this attempt generated was enough to shut down the deal, and Chevron bought the company instead for a lower amount.

All of these factors combined remove Suncor from our consideration. It's still a great company, and has by far the largest reserves of the 19 on our list. (Its 15 billion barrels are almost as much as all the rest of our companies combined.) But it's not ideally positioned as a takeover target.

Percentage of Oil in BOE

Now we'll look at the composition of each company's reserves.

Symbol	Company	Percent of Oil in BOE
PXP	Plains Exploration	94.60%
NXY	Nexen Inc.	86.05%
WLL	Whiting Petroleum	78.63%
OXY	Occidental Petroleum	78.00%
BRY	Berry Petroleum	75.00%
EAC	Encore Acquisition	74.79%
MUR	Murphy Oil	66.14%
TLM	Talisman Energy	48.65%
PXD	Pioneer Natural Resources	46.08%
APA	Apache Corp	46.00%
APC	Anadarko Petroleum	41.96%
DVN	Devon Energy	41.37%
NFX	Newfield Exploration	30.08%
XEC	Cimarex Energy	24.79%
XTO	XTO Energy	18.75%
BBG	Bill Barrett	11.27%
EOG	EOG Resources	10.40%
CHK	Chesapeake Energy	7.10%

Almost every energy company has both oil and NG. As I said before, oil is more valuable than NG, and we'd prefer stocks that are weighted toward crude. But a mixture is still acceptable.

However, below 30 percent BOE or so, the stock becomes a NG stock with a little oil mixed in. As such, we'll eliminate the five stocks in red from our list. They're still good companies—in fact, we currently own two of them in the *GEA* portfolio. They're just not ideal as buyout candidates.

Finding and Developing Cost

Obviously, the cheaper a company can find and develop energy assets, the better. Here are the remaining stocks, ranked by F&D cost.

Symbol	Company	F&D Per Brl 2006
OXY	Occidental Petroleum	14.51
EAC	Encore Acquisition	15.87
APA	Apache Corp	16.50
WLL	Whiting Petroleum	16.56
DVN	Devon Energy	17.95
PXD	Pioneer Natural Resources	18.36
TLM	Talisman Energy	20.00
BRY	Berry Petroleum	21.57
NFX	Newfield Exploration	21.68
NXY	Nexen Inc.	24.96
MUR	Murphy Oil	26.74
APC	Anadarko Petroleum	31.09
PXP	Plains Exploration	40.19

Anadarko has recently made some substantial acquisitions, and now owns or controls 2.4 billion BOE. This is the fourth-highest of all the companies on our list, and it's an excellent buyout target. Because Anadarko is still 'digesting' its acquisitions, much of the oil it acquired is still listed as 'probable' reserves rather than 'proved'. This in turn has caused its stock to lag behind its peers.

Once the true extent of proved reserves is known, I expect APC's price to re-assert itself. Therefore, I'm keeping it on our list.

(APC is also in the *GEA* portfolio, for this exact reason.)

With oil selling at $70 today, anything below $50 is acceptable. So all these companies are fine. But we're pruning our list, so we'll remove the ones with F&D above $25—except for Anadarko (APC), which I want to keep on the list for other reasons (as explained in the sidebar below the table).

Replacement Rate

Now we'll examine how quickly each company is replacing its reserves as they're depleted.

Symbol	Company	Replacement Percentage
APA	Apache Corp	330
BRY	Berry Petroleum	260
NFX	Newfield Exploration	250
OXY	Occidental Petroleum	245
PXD	Pioneer Natural Resources	200
APC	Anadarko Petroleum	196
DVN	Devon Energy	180
EAC	Encore Acquisition	179
NXY	Nexen Inc.	124
TLM	Talisman Energy	116
WLL	Whiting Petroleum	94

Except for Whiting Petroleum, all the companies on the list are increasing their reserves each year. Since WLL isn't doing this, we'll prune it from the list. We'll also remove Talisman, as the next lowest.

Market Value

We're down to our last 9 companies. We'll make our final decision according to their market value per barrel.

Symbol	Company	Market Value Per Barrel
EAC	Encore Acquisition	$5.54
PXD	Pioneer Natural Resources	$8.44
APA	Apache Corp	$11.48
BRY	Berry Petroleum	$11.93
APC	Anadarko Petroleum	$13.36
DVN	Devon Energy	$14.24
OXY	Occidental Petroleum	$17.43
NFX	Newfield Exploration	$17.81
NXY	Nexen Inc.	$30.38

As you can see, they're all very undervalued. Even Nexen, at $30.38 per barrel, is priced at less than half the market value of its oil.

But why pay half-price, when you get it for just one-quarter? At $70 oil, any energy company priced below $17.50 is selling for *less than one-quarter of its reserves' value*. So we'll prune away the stocks priced above $17.50 per barrel, and retain our final seven.

Seven Oil Stocks Poised to Soar!

Here's our final list:

- Anadarko Petroleum (APC)
- Apache (APA)
- Berry Petroleum (BRY)
- Devon Energy (DVN)
- Encore Acquisition (EAC)
- Occidental Petroleum (OXY)
- Pioneer Natural Resources (PXD)

As I said earlier, I believe that all 19 stocks on our initial list are good companies. These seven, though, are grossly undervalued in my opinion. For example, when you buy stock in EAC, you're buying oil at *$5.54 per barrel*.

I anticipate that over time, as the oil bull progresses, these companies will become more fairly valued. I'm looking for a valuation of $40 per barrel (which would still be really cheap at today's oil prices). This would double to quadruple the prices of the companies on this list.

Why are these companies so undervalued?

By now, you might be thinking that this is all too good to be true. Oil for $5.54 per barrel? How could these companies be so undervalued?

There are lots of good reasons why this is happening. Wall Street is, for the most part, very uncomfortable forecasting energy prices. Therefore, the Street usually uses traditional methods of valuating energy companies, which don't give the full picture. Wall Street is missing the true value of these companies—their energy assets.

A typical stock analyst has been trained to look at traditional business indicators: cash flow, earnings growth, profitability, and so on. These numbers work great for "normal" businesses. For example, analysts can predict Wal-Mart's earnings with reasonably good confidence. The company's recent performance, combined with other factors like the number of new store openings, can be analyzed fairly easily. Therefore, Wall Street's predictions won't always be right, but they'll usually be close.

However, these analytical techniques don't work at all with energy companies. How do you price the value of a wildcatter drilling for oil? (Today, he's broke. Tomorrow, he might be worth billions.)

How can you assess the worth of an international oil concession? (Two years ago, oil rights in Libya were almost worthless. Today, they're extremely valuable. Meanwhile, the exact opposite has occurred in Venezuela.)

How can you recommend the stock of a company that's sitting on a huge reserve of oil that's *worthless* at current prices? (A few years ago, the oil sands in Canada were little more than geological curiosities—they cost more to mine than the oil was worth. Today, they're worth hundreds of billions.)

Because of all this uncertainty, Wall Street analysts perceive the whole industry to be very risky. They're very uncomfortable assessing companies whose primary assets (oil and gas) are seemingly subject to such wild swings.

As a *GEA* reader, you see the error in this reasoning. In this newsletter, I've extensively documented the forces that will keep oil prices high for the foreseeable future.

Of course, there will be short-term volatility. Long-term, though, the price isn't going to come down significantly. In fact, I expect it to be substantially higher, as you know.

Wall Street hasn't figured this out yet, and that's why we have such a great opportunity. The analysts are going to wake up eventually. The outrageous cash flows experienced by the larger companies (Exxon Mobil, ConocoPhillips, etc.) have already gotten the Street's attention. That's why I no longer recommend the mega-cap energy stocks, for the most part.

However, the other energy stocks are still being ignored. That's why we can buy oil for $5.54 per barrel!

Recommended Entry Points

Obviously, I think these seven stocks have great potential. But we can improve that potential even more by not diving in impulsively. As always, I recommend buying on weakness only. If there's one thing you can count on, it's this: whether the market is in a bull or a bear, prices will always move up and down.

So it's always better to buy on a downswing. Here are my recommended entry points:

Company Symbol	Current Price	Initial Buy	Add to Position
OXY	$60.64	$55.00	$52.95
DVN	$78.13	$76.00	$73.36
APA	$84.14	$80.00	$76.97
EAC	$27.70	$26.10	$25.00
BRY	$39.12	$37.00	$34.48
PXD	$48.90	$48.00	$45.68
APC	$52.40	$51.00	$47.11

(Note: these are guidelines for experienced investors. Novice investors should wait for specific instructions in my regular email Updates.)

So there they are: seven oil stocks poised to soar in the coming oil takeover boom!

As I write this, oil has jumped back up above $70 per barrel. I still expect to see $100 oil—sustainably within the next few years, probably with short-term temporary spikes before then.

When that finally occurs, I think we'll see these companies trade at multiples of today's prices!

This report is based on information from company annual reports, Yahoo Finance, S&P, Argus, Lehman Brothers. and Goldman Sachs' research reports.

Even the IEA is Gloomy about Oil Prices

The International Energy Agency (IEA) in Paris is a highly respected monitor of world energy markets. A recent IEA report confirms our long-term outlook here in *GEA*: unless the world economy goes into a deep recession, oil prices have nowhere to go but up.

Historically, the IEA is very conservative. For example, they didn't predict the massive surge in Chinese demand that started three years ago. But even they admit that oil prices will remain under severe upwards pressure for the foreseeable future.

Actually, that's putting it mildly. The IEA report made some predictions, but didn't explore the full implications. For example, growth in non-OPEC oil and biofuel production is expected to sag starting in 2009. Three years after that, OPEC is expected to be producing at full capacity, with little ability to expand further.

Well, if non-OPEC production stops growing, and OPEC oil production stops growing, then "peak oil" is truly upon us. That's what peak oil is, after all: a peak (and then gradual decline) in oil production.

Meanwhile, demand will remain voracious. The IEA projects that demand will continue to grow at 2.2 percent per year, every year, even as supply growth is choked and strangled. (Plus, the IEA has a record of underestimating demand, so 2.2 percent is probably a conservative figure.)

Flat or declining production, combined with increasing demand, means oil prices will soar!

Of course, the IEA report was careful to avoid drawing any conclusions from its data. But it's not very difficult to see what's coming.