GOLD & ENERGY INVESTOR

Newsletter #126 **March 2014**

A Gusher of Opportunity

Editor's Note: Our last monthly we looked at the concept of shale oil and gas and how it came to be. This issue we are going to move into deciding who the big winners are going to be over the next year.

Clearly, 2014 is going to be about one thing: consolidation of assets. Those assets are shale oil and gas. Many companies own those assets, so deals are going to get done.

In other words, we're looking at a tremendous gusher of investments available -- and becoming newly available -- in the energy space, so get ready!

With the two months of the year complete, stocks in the energy patch are as cheap as they were at the end of 2013 because earnings have been decent and prices are little-changed.

This provides us with a great opportunity. That is part of the reason this issue is coming to you a bit later than normal.

Now on to this issue, as I think you will find this information -- and the energy investment opportunity we've uncovered for you -- of great interest. — *James DiGeorgia*

James Di Georgia, Editor

In the 1980s, I knew a manager who used to play a game called "**Banko**." He would put money in the banks all over the country before they went public.

Back then, these banks would give depositors shares of the IPO if they wanted in. It was a great game while it lasted. Put money in a bank and get stock in a few years. Such a deal!

We are going to be able to play a version of this game and I am going to call it "**Gusher**."

When a well hits, you will often get a gusher. In our version of Banko, we are going to buy a variety of mid- and small-cap energy names this year and look to be rewarded with a Gusher as their stock prices gush on a takeover (or takeover rumor).

But first we need to understand how a takeover works. There is no better place to look than in the space we talked about last -- shale oil and gas.

XOM's Gusher in the Making

Amazingly enough, the major integrated oil companies were late to the party of understanding the full implications of shale oil and gas. But now they are playing catch-up.

In fact, they are not just betting on oil, but natural gas as well.

The first big deal in the shale oil and gas space was **ExxonMobil's (XOM)** purchase of **XTO Energy** announced in 2009 and completed in 2010.

This was the biggest deal Exxon had done since it purchased Mobil in 1999. That price was $88 billion. By comparison, ExxonMobil paid $35 billion for XTO Energy.

However …

The deal has yet to pay off for XOM because the price of natural gas has stayed low since its acquisition … although that is beginning to change in 2014 thanks to the Polar Vortex.

Exxon rose 41.18% from Jan. 1, 2010, through Feb. 28, 2014.

In the same time period, the S&P 500 jumped 66.75%.

XTO has seen its proven shale gas reserves rise over 100% as we entered 2013, thanks to the company developing its acreage and making acquisitions.

This is a 25- to 30-year bet for ExxonMobil, and the company has staying power like none other. That's because it is a financial giant when compared to almost any other company in the world.

This is the type of bet Warren Buffett makes, and it's why he owns 40.1 million shares and recently added 8.8 million shares.

XOM CEO Rex Tillerson

ExxonMobil CEO Rex Tillerson is only 61 years old, so he has plenty of time to see this 25- to 30-year bet play out. In fact, **"The Outlook for Energy: A View to 2040"** is a nice playbook of what lies ahead, produced by Exxon late last year.

Here are some of the highlights.

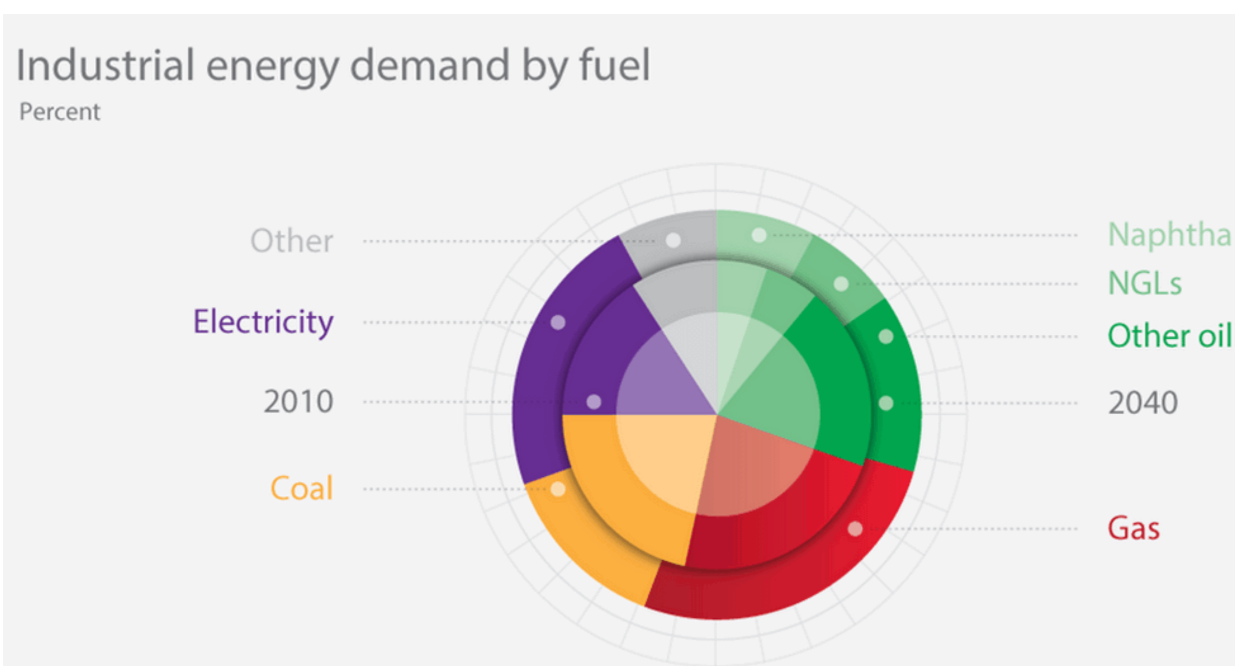
First, global fundamentals predict the **population of the world** is going to grow from 7 billion to 9 billion and the global economy will double. As a result, global energy demand is going to grow by 35% at a minimum.

Population growth will be more rapid in urban areas. A rise in living standards worldwide will also drive energy demand.

Throw in a geopolitical crisis with supply cuts, and demand will rise even more.

Exxon produced several charts of interest related to 2040. First, **the biggest increases for energy are going to come from natural gas and electricity**.

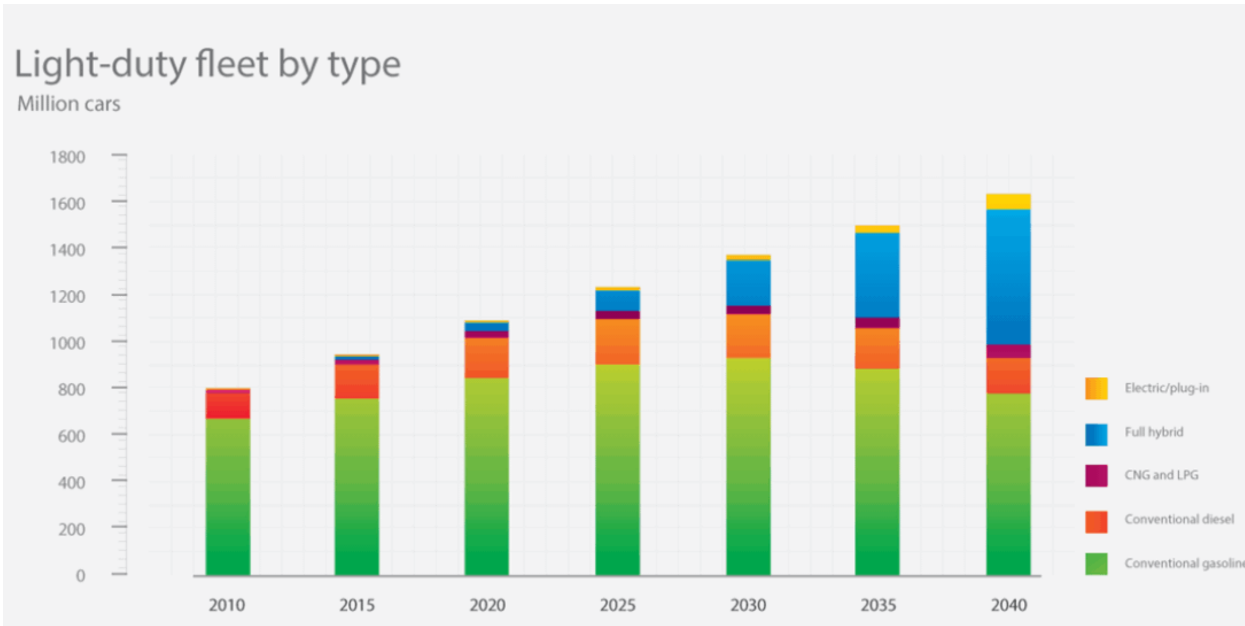
What is interesting about this chart is that utilities are moving to natural gas from coal**,** so this is **a double win for natural gas**.



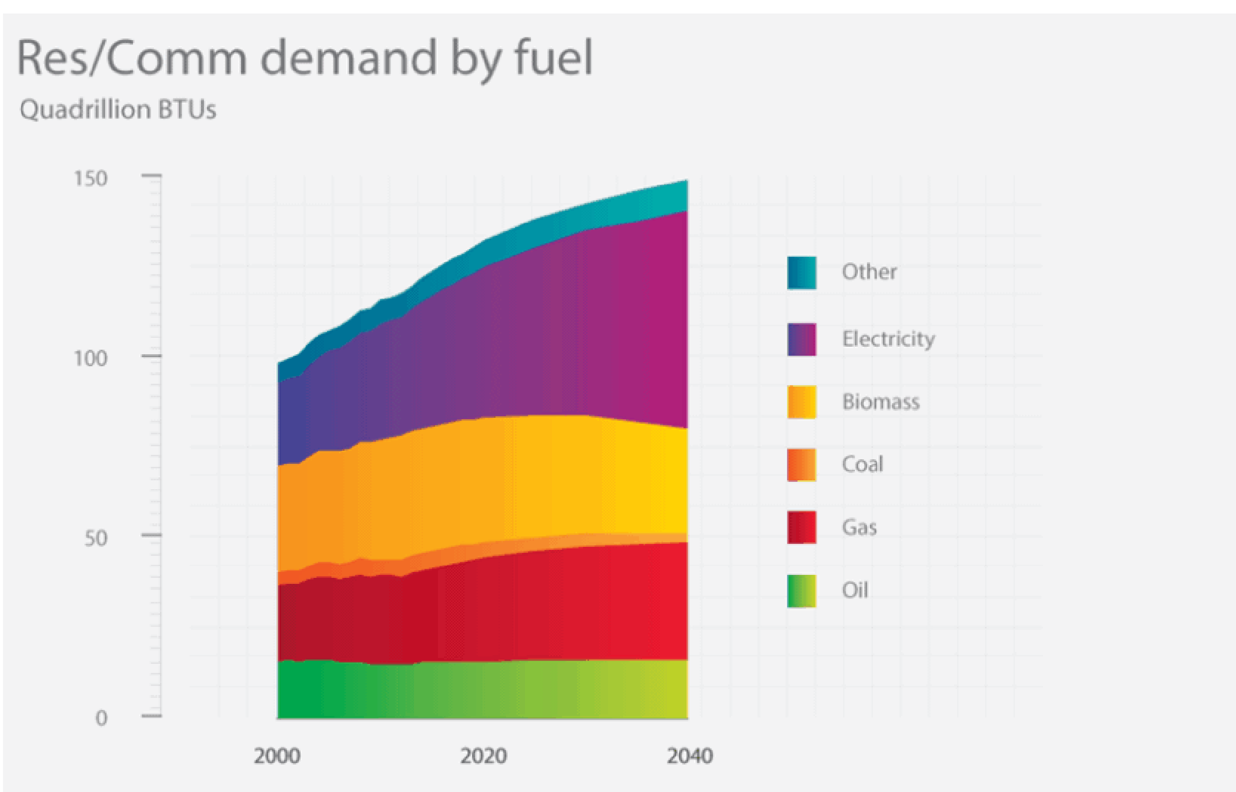
The next chart that caught our eye was the change in the **light-duty fleet** by type of energy used.

The big change between now and 2040 is the growth of the full hybrid as well as electric and Compressed Natural Gas (CNG)/Liquefied Petroleum Gas (LPG).

Conventional gasoline and diesel will remain constant.



The last chart of interest is **residential/commercial demand** by fuel.
What is most interesting about this chart is that the use of electricity is going to grow the most.
As noted two paragraphs ago, a **great deal of electricity is going to be produced through natural gas**.



Oil demand will rise by 25% through 2040 thanks in large part to increased commercial transportation. This demand, according to Exxon, will get met by deepwater drilling, oil sands and tight (shale) oil.

Natural gas will see the largest increase in supply. Natural gas by 2040 will contribute over 25% of our energy needs, and its demand will grow 65% from 2010.

Meanwhile, ***coal*** -- which is the top fuel used for power generation and, currently, the second energy supply in demand -- will decline from 25% to under 20%.

Nuclear will see some growth, as will ***renewable energy***, which will grow from 1% of demand to 4%.

To meet this demand, the **International Energy Agency (IEA) predicts that infrastructure costs will be about $1.6 trillion per year from 2035**.

That is not billion dollars a year but a ***trillion dollars***.

So what have we learned so far from Exxon's plan to 2040?

Exxon was smart to buy XTO because the growth in energy demand is going to be met by natural gas.

Second, the biggest user of natural gas is going to be electrical utilities. Next, a great deal of money is going to be spent to build out the infrastructure to support the growth.

Who is Set to Make That Money? It Could be You

So now that we understand what Exxon is thinking, we now need to explain what the concepts of upstream, midstream and downstream mean in energy-speak.

- An **upstream company** is one that is known as an Exploration & Production (E&P) company. These are the companies that look for new areas to drill and then operate the wells to produce crude oil or natural gas.
- A **midstream company** then delivering crude to a refinery. Natural gas is also sent to a purification plant.
- The refinery, or a processor of natural gas, is the **downstream company**. It delivers the product to a consumer, as in gasoline, or to industry, like a chemicals company.

So now that we understand how the world is changing and how product is going to be delivered, it is time to look at who the players are in each of the above universes.

Obviously, we have spent some time already talking about ExxonMobil. XOM is such a big company that it is more powerful in terms of its economic production than most countries in the world.

The next biggest players in terms of market caps are **Chevron (CVX)**, **PetroChina (PTR)**, **BP PLC (BP)**, **Total SA (TOT)** and **Royal Dutch Shell (RDSA)**.

Chinese energy companies like **PetroChina (PTR)**, **China Petroleum & Chemical Corp. (SNP)** and **CNOOC LTD (CEO)** are going to have a hard time buying U.S. assets, especially due to the tough political climate as China plays its hand in the disputed islets called Senkaku in Japan and Diaoyu in China.

Also, thanks the February crisis in the Ukraine, there is little chance that a Russian company could be a buyer.

Total SA will have a better chance of buying U.S. assets given that the company is based in France. But the best foreign company that's well-integrated into the U.S. is BP, which really seems to think its name stands for Beyond Petroleum.

Despite Deepwater Horizon, BP has bent over backward to rectify its wrongs. Chevron, BP and Royal Dutch Shell all need to continue buying U.S. assets if they are going to compete with ExxonMobil.

Chevron held its analyst meeting this week and it will be interesting to hear analyst comments by week's end. The company plans to increase production to 3.1 billion barrels a day in 2017 (up from 2.6 billion) and sell $10 billion in assets (mostly upstream, according to the company) over the next three years.

Chevron CEO said that's a bigger increase than ExxonMobil.

For the year ended 2012, Exxon did $482 billion in revenues. Chevron did $230 billion while BP did $375 billion and Shell did $467 billion. **So the big competitor to Exxon worldwide is really Shell.**

Shell's big problem is that it gets a ton of their crude from the North Sea, which is much more expensive than crude found in shale or the Southwestern United States.

In other words …

The Next Big Acquisition in the Shale Oil/Gas Space Could be Done by Shell

For valuation purposes, we are going to stick with our ***Alpha Intelligence Stock Scorecard*** to see how these companies are valued.

ExxonMobil has a price target of $111.13, with Chevron at $146.56 and BP at $51.95. Shell has a price target of $76.75.

Based on closing prices of 2/28/14, here are their discounts to the price targets.

Ticker	Price	Price Target	Discount	% Discount
XOM	96.27	111.13	14.86	15.44%
CVX	115.33	146.53	31.2	27.05%
BP	50.61	51.95	1.34	2.65%
RDS-A	72.87	76.75	3.88	5.32%

Clearly, the stocks with the most upside are Chevron and ExxonMobil.

Shell and BP are close to being fairly valued with their recent moves.

The point to be made here is not that these are names we really want to buy but, rather, that they are not so expensive they cannot use their paper, i.e. stock, to make acquisitions.

They may offer cash but clearly the lack of expensive paper helps the acquisition market.

Since Exxon paid $35 billion in 2010 for XTO Energy, it makes sense to look at other players with a similar market cap that could be acquired by Shell, BP or Chevron.

"Comeback" author Charles R. Morris did a nice job of breaking out the biggest players in the shale space. These companies are ranked by market cap and revenues.

(As we've discussed in this space, "Comeback" focuses on what Morris calls the "Energy Nexus" and how it will positively affect the economy.)

Clearly, however, there is a wide range to sales and net income among these energy names.

From a revenue standpoint, there is **EOG Resources (EOG)**, **Devon Energy (DVN)** and **Chesapeake (CHK)** and then there are the secondary players.

Of these, EOG is clearly the leader in net income.

For 2013 EOG made $2.197 billion in net income. Chesapeake has come back nicely with net income of $474 million after a loss of $940 million.

We have added to the names Morris discussed in "Comeback" for our review of the biggest players in the shale space. Names added include **Anadarko (APC)**, **Apache (APA)**, **Pioneer Natural Resources (PXD)** and **Continental Resources (CLR)**.

Company	Symbol	Sales (in $ billions)	Net Income (in $ millions)	Market Cap (in $ billions)	Total Debt (in $ billions)
EOG Resources*	EOG	14,487	2,197	51.87	5.91
Anadarko Petroleum	APC	$14,581	801	42.97	13.56
Apache	APA	16,402	2,188	31.6	9.72
Pioneer	PXD	3,489	-838	28.01	2.66
Devon Energy*	DVN	10,397	-20	26.53	12.02
Continental Resources	CLR	3,455	764	21.88	4.72
Encana*	ECA	5,858	236	17.87	7.73
Chesapeake Energy*	CHK	17,506	474	16.82	13.02
EQT Corp*	EQT	1,862	390	15.19	2.5
Range Resources*	RRC	1,367	13	13.63	3.14

Note that, of the names Morris looked at, Devon and **Range Resources (RRC)** seriously lag the others in terms of net income for the year.

With Devon being the second-largest market cap, clearly there is something more at play here than earnings and cash flows.

What is it? The answer is simple, reserves.

The Metrics Many Energy Investors Miss

There are two metrics to track for reserves: proven reserves and proven/probable/possible reserves. The spread between the two is worth tracking as well.

To use Devon as an example, the company increased its **proved oil reserves** to 837 million barrels. This number represents **an increase** of 112 million barrels through successful drilling.

Next we look at the **replacement rate** of oil for 2013, and this figure worked out to 180% of the oil produced.

Devon's **total proved reserves of oil, natural gas and natural gas liquids** totaled 3 billion boe (barrels oil equivalent). **Reserves rose** by 335 million boe. Proved reserves fell by 103 million boe in 2013 due to sales and revisions. **Total reserve life** remains at 12 years. Of this number, **proved undeveloped reserves** were 24% of proved reserves.

These statistics -- proved oil reserves, increased proved oil reserves, replacement rate, total proved reserves, increased total proved reserves, total reserve life and provided undeveloped reserves -- are key metrics, in addition to traditional fundamental metrics.

These numbers can typically be found in either the earnings release for the fourth quarter of each year as well as in the Annual Report, especially the Letter to Shareholders.

As we discussed earlier, ExxonMobil has been able to double reserves of XTO since it acquired the company. Exxon's competitors are going to try to improve their reserves with purchases of U.S. shale oil and gas plays.

Given that these companies are so large, they are not going to focus on smaller players in the U.S. Rather they have to think big.

In addition, the above mid-sized players need to increase their reserve if the big boys are going to be interested in them. **So we have two types of potential acquisitions in 2014, multi-national integrated oil companies buying mid-sized players for nice premiums and mid-sized players swallowing up smaller companies.**

In this issue, we are going to focus on our favorite mid-sized player. First, we need to look at which names have been recognized by the market for executing well. Strong names include **EOG Resources (EOG)**, **Continental Resources (CLR)**, **EQT Corp. (EQT)** and **Range Resources (RRC)**.

Given that there may not be as much upside appreciation to these names, we are going to focus on the rest of the universe.

In particular …

New Recommendation: Encana Corp. (ECA) -- 'Profitability Over Production Volumes'

In our opinion, the best-looking chart is that of Encana (ECA). The stock has been range-bound between $17 and $19.50 for the past 14 months. Finally, it has broken out of that range and can now begin the move to its 2008 high of $99.36.

Shares ended the day Wednesday at $19.91. The first stop is a breakout above $22.50 and then $30.

A move to $30 from here would give the stock basically a 50% move.

The company has been rapidly shifting away from natural gas to liquids. Encana is based in Calgary but has been expanding in the U.S. with exposure in the Piceance Basin (Colorado), Jonah gas field (Wyoming), and Haynesville Shale (Louisiana and Texas).

Emerging plays for the company can be found in the San Juan Basin (New Mexico) and Denver-Julesburg/Niobrara Basin (Colorado) along with the Tuscaloosa Marine Shale (Louisiana and Mississippi).

The ***Alpha Intelligence Stock Scorecard*** price target is $20.30, with the upper bound at $26.39.

Clearly, the stock is no longer cheap, but it is not fully valued … and that is what we are focused on here.

Encana's earnings estimate for December 2014 is $0.95, and $1.20 for December 2015. Therefore, the current-year price/earnings ratio (P/E) is 21.12 and 16.73 for next year.

These figures are in sync with the overall market.

In the latest quarter, **Encana beat estimates by $0.12 as it reported $0.31 vs. estimates of $0.19.** The company noted on the call that margins will continue to rise as it shifts to liquids.

The theme of 2014 is profitability over production volumes.

Revenues are estimated to come in at $6.17 billion for 2014 and $6.31 for 2015. Growth of revenues is not that high and we will look at this figure more in our analysis. The price/sales ratio is 2.52.

Total debt is $7.73 billion. The stock has been held back by the large amount of debt relative to its overall revenues and earnings. **The company has indicated that it will IPO its Clearwater Royalty business, which should help it to further reduce debt.**

What is really interesting is that analysts have been very quiet on this name, with no changes since November when Deutsche Bank took the stock to "Hold" from "Sell" and Merrill Lynch took the name from "Underperform" to "Neutral."

Currently there is one "Strong Buy," with 7 "Buys" and 15 "Holds" along with 2 "Underperforms."

The bottom line is that there is a great deal of room for analysts to upgrade this name. The company will present at the FirstEnergy Capital Annual East Coast Energy Conference on Thursday.

A month ago, rumors surfaced that **Blackstone (BX)** was in discussions to potentially purchase Encana's Deep Panuke natural gas field, located in Nova Scotia. Again this would help to reduce debt levels.

In terms of **production numbers**, the company averaged 66,000 barrels of oil equivalent per day (boe/d) an 82% increase year-over-year for the fourth quarter.

The forecast for 2014 is a 30% increase in boe/d.

Average natural gas production for 2013 was 2,777 million cubic feet per day (MMcf/d), meeting 2013 goals.

In 2014, natural gas production will decline slightly as it continues to shift to liquids. Key for 2014 will be news on its emerging plays.

Getting in on Encana during this "quiet time" makes a great deal of sense. That's why I recommend that you …

Buy 100 shares of Encana Corp., symbol ECA, at the market.

Be sure to make this move in this potential profit gusher right away, and come back for my take on the broader markets below.

Technical Review

The Dow Jones Industrial Average had yet to recover to its September high. It has now, however, but it has not moved above its January high.

Meanwhile, the S&P 500 has moved above its January high.

Remember, the Dow Jones includes only 30 stocks and is price-weighted. That means the higher-priced stocks have greatest influence on the index.

We only see three Dow stocks that are attractive technically: **American Express (AXP)**, **Merck & Co (MRK)** and **Walt Disney (DIS).**

Moving on to the major gold and energy ETFs, the **SPDR Gold Shares ETF (GLD)** has a positive slope on its 50-day moving average.

Many traders focus on whether a stock is above or below its moving average. We have found that the slope of the 50-day moving average is more important.

An upward slope is bullish.

The **iShares Silver Trust (SLV)** had a positive 50-day moving average slope since mid-August to late October, and recently it has returned to positive after struggling to keep pace with gold.

We track energy stocks using the **Energy Select SPDR ETF (XLE).** It remains with a positive 50-day moving average slope after a negative period that recently ended.

This ETF includes **ExxonMobil (XOM)**, **Chevron (CVX)**, **Schlumberger (SLB)** and **Anadarko Petroleum (APA)**, to name a few.

We track oilfield equipment and drilling stocks with another ETF, the **Oil &Gas Equipment & Services SPDR (XES)**, which has moved up to almost $45.

This ETF includes **Schlumberger (SLB)**, **Halliburton (HAL)**, **Baker Hughes (BHI)** and **Diamond Offshore (DO)**, to name a few.

XES had a brief negative period but it has returned to strength.

As for oil, prices have pulled back recently. But if you look at the **U.S. Oil Fund (USO)**, the 50-day moving average slope remains positive.

Meanwhile, natural gas via the **U.S. Natural Gas Fund (UNG)** is in good shape. Its 50-day moving average slope is positive since our last update, though it did have a brief period in the red in November.

We remind you of our friend Phil Erlanger's, of Good Morning Wall Street, comments made in our last update. He tracked the retracement on the S&P 500 from the 2007 high to the 2009 low and came to a very interesting conclusion. First, the S&P 500 has now cleared its 2007 high. Since that has happened, when you draw that retracement from the 2007 high to the 2009 low, the natural extension would be a move 61.80% higher from the 2007 high or 2138.

Currently, the S&P 500 is making a move on 1,900.

You can be sure I'll be tracking it all the way there. So, stay tuned to your e-mail for updates on your current positions, and new ways to take advantage of developing opportunities in gold, silver, oil, gas and other commodities.

Always watching your chickens,

James DiGeorgia

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