

## *ENERGY STOCKS A GOOD BET FOR 2004 AND BEYOND*

There are two reasons to consider adding energy stocks to your portfolio this year and keeping them for the long-term. The global increase in demand, combined with the inevitable depletion of supply, will likely continue to drive up energy stock prices. Some of the most successful, best run energy companies also pay sizable dividends. With interest rates and bond yields so low, an energy stock with a 3% yield can also be a good income investment.

### OUTLOOK FOR SUPPLY AND DEMAND

The prices of gasoline and crude oil have reached new highs, and the prices of most energy stocks are approaching their 52-week highs. Normally this would be a bad time to buy these companies, but there are plenty of reasons to think energy prices will go higher. Consider the following supply and demand data compiled in Barron's 3/15/04 issue:

#### Supply

- Oil (and natural gas) inventories are at historically low levels.
- World oil discoveries peaked in 1964.
- The average oil field's output declines by 4.8% a year.<sup>1</sup>
- U.S. oil production, excluding Alaska, has declined to 4.8 million barrels a day.
- OPEC produces more than a third of the world's oil; OPEC maintains quotas.
- OPEC holds more than half of the world's proved oil reserves: geopolitical risk.
- Newer technology depletes the oil more quickly.
- There is disagreement about whether or not oil production has peaked. More than one [non-government] industry expert believes we are already at or within five years of peak oil production. The U.S. Geological Survey and the U.S. Energy Information Administration believe oil production can continue to increase for 30 or more years.

#### Demand

- Demand rises at about 1.5% annually, while output declines three times as fast.<sup>1</sup>
- U.S. oil imports have increased to nine million barrels a day.
- Demand from emerging countries has increased. China's has more than doubled in the last 12 years.

### DESPITE RECENT PRICE INCREASES, NOT ALL ENERGY STOCKS ARE OVERVALUED

Energy stocks as a group were up more than 5% in the first two months of this year. Still, proposed cuts by OPEC—they meet March 31 to decide—and growing demand out of China and other emerging market countries should keep driving prices, particularly since this group is not overvalued on a price to earnings basis. Compare the industry averages for the energy subsectors to the S&P 500 Index P/E of about 22.5.

### P/Es for the energy group<sup>2</sup>:

- **under 13:** industry average P/E for the huge integrated oil companies, averaging about \$100 billion in market cap
- **less than 16:** industry average P/E for the oil and gas operations companies (exploration and production) that are over \$5 billion in market cap
- **almost 50:** industry average P/E for oil well services companies (the “drillers”)
- **under 16:** industry average P/E for natural gas companies over \$5 billion in market cap

P/E isn't the only means for judging valuation; nor is it necessarily the best. I find the price to sales (P/S) ratio a better indicator of value, as earnings per share is more easily manipulated to distort the actual earnings, and it becomes problematical with negative earnings. Sales per share is more straightforward, allowing companies' businesses to be easily compared. Using the P/S ratio, the energy group appears less undervalued, but some stocks still qualify as reasonably priced. The S&P 500 Index P/S is currently about 1.5, a reasonable valuation to use as a guideline.

### P/S averages<sup>2</sup> are:

- **0.97:** Integrated Oils
- **2.44:** Oil & Gas Operations
- **2.76:** Oil Well Services
- **1.72:** Natural Gas

## THE BEST OPPORTUNITIES IN THE ENERGY SECTOR

The energy subsectors have many differences in pricing cycles and valuation criteria, but they have in common this basic premise: If demand continues to increase and supply is finite and being depleted, their products and services will become more valuable. I don't think there is any doubt that this is the current situation for the supply/demand scenario.

Where is the best opportunity for investing in energy? I have considered stocks from these four energy sectors, some obviously more income plays than growth plays:

**Integrated Oils** – These behemoths do it all: exploration, development, production, transport, marketing, and more. They typically pay the *biggest dividends*, but, because their size limits the amount they can grow, they are awarded the smallest P/Es of the group.

**Oil and Gas Operations (E & P)** – These second- and third-tier firms focus more on the exploration and production of oil and gas, are typically mid-caps with some room to grow, and pay *smaller dividends*.

**Oil Well Services & Equipment** – These drillers function on a different chronological cycle (typically January through May is when their stock prices peak), called into service when reserves are being depleted. These stocks' prices have been on a tear recently, with shortages and political fears adding to their rise from the usual post-winter depletion cycle. Their P/Es are currently very high, but their earnings are expected to increase much more in the next year than the other oil stocks. They usually pay *little or no dividends*.

**Natural Gas** – These utility companies typically transport, store, and distribute natural gas through their own pipelines. Once a customer is hooked up to their pipelines, they are unlikely

to switch. Natural gas also has the advantage of being the clean-burning fuel. These companies' *dividend payouts vary*.

## ENERGY STOCKS AS INCOME INVESTMENTS

Before discussing the individual companies that I recommend from each subsector, a sampling of current yields from the more traditional income investment options follows. You can compare the dividend yields of my energy stock picks to what is otherwise available:

<b>Current<sup>3</sup> Yield</b>	<b>Description</b>
	<u>Corporate Bonds</u>
2.388	3-year A+-rated
	<u>High Yield Bonds</u>
3.215	3-year BBB+-rated
	<u>Municipal Bonds (tax-exempt income)</u>
1.348	3-year AAA California
	<u>Treasuries</u>
1.865	3-year Zero Coupons/Strips
2.80	5-year bond
1.57	2-year bond
	<u>CDs</u>
1.55	1-year CD
2.05	2-year CD

It should be noted here that the above yields are dependent on holding the bond, treasury, or CD until it matures. At maturity you are paid the par or full value of the security you purchased; the yield is determined by the difference between what you paid for it and par. If sold before maturity, your sale price will probably be less than par, thereby reducing the yield. With CDs there is also often a fee for selling early.

The dividend yield of a stock is the result of a formula dividing the dividend per share the stock pays by its price per share. If the stock price goes up, and the dividend remains the same, the dividend yield diminishes, but you can sell the stock for more. The dollar amount of the dividend continues to be the same rate per share times the number of shares you own. Dividends are usually paid quarterly.

## MY ENERGY STOCK PICKS

Based on the depleting supply and increased demand, I believe energy stocks should continue to do well this year and beyond. I have researched many stocks in each energy subsector to come up with the following recommendations, chosen because they meet my GARP (growth at a reasonable price) criteria and/or offer income that competes with the fixed income market as quoted in the previous section.

While some of these stocks are more growth-oriented, and others more income-oriented, I believe they should all steadily appreciate in value over the next few years.

## Integrated Oils

**BP plc** (BP \$50.08<sup>4</sup>) – BP pays \$1.80 annual dividend, a yield of 3.67%<sup>5</sup>. Its P/E is 14. Their revenues have increased every year for the last five years. Their debt to equity and price to sales are appealingly low (.2 and .8). On a total return basis the company has performed in line with the S&P 500 over the past 15 years. Standard & Poor's expects earnings to increase about 13% in 2004, free cash flow to remain solid, and the company to buy back \$5 billion of its stock this year. Their 12-month target price is \$53, and they have a Hold rating on the stock.

**ChevronTexaco** (CVX \$88.20) – Chevron pays \$2.92 annual dividend, a yield of 3.32%. Its P/E is 12. They have raised their dividend 16 years in a row. The company is reorganizing to raise returns and they are selling non-core assets. Their debt to equity is a reasonable 30%, as is the P/S at .8. Last year the company outperformed its peers, in line with the S&P 500 Index. S&P has a 12-month target price of \$84, and they rate the stock a "Hold".

## Oil & Gas Operations/Exploration & Production Companies

**Anadarko Petroleum** (APC \$52.61) – Anadarko's annual dividend is \$0.56, a yield of 1.1%. Its P/E is quite low at 10, suggesting the stock price has room to move up. Exploration and production accounted for 95% of 2002 sales. The company believes 4% to 10% production growth is likely in 2004. S&P has a 12-month target price of \$52 and rates the stock a "Hold".

**Pioneer Natural Resources** (PXD \$33.17) – Pioneer pays an annual \$0.40 dividend, a 1.21% yield. They also have a low 10 P/E, but their 5-year growth outlook is 14%, higher than Anadarko's. This company expects production growth of 15% - 25% for 2004, and about 10% for 2004 – 2008. They plan to use excess cash to pay down debt and to buy back up to \$2 million in shares. S&P has a 12-month target price of \$38 and rates the stock "Accumulate".

## Oil Well Services/Drilling

**Nabors** (NBR \$45.30) – The world's largest oil and gas land drilling contractor pays no dividend. They have a rather high P/E at 35, but their 5-year growth rate is estimated at a robust 21%. 2005's earnings per share are estimated to increase by 29%. S&P expects total U.S. land drilling activity to strengthen, and Nabors to benefit offshore as well due to three new platforms being deployed in 2004. Their 12-month target price is \$53, and they rate the stock a "Buy". (This company has been on my Growth Stock Recommendation List since December 2003.)

**Patterson UTI** (PTEN \$35.77) – This U.S. land drilling company pays no dividend and has a high P/E of 51, but it has no debt, has a 5-year growth estimate of 20%, and its earnings per share are estimated to increase 44% in 2005 over 2004. S&P expects operating income to more than double in 2004, and earnings and cash flow growth to be significant. They have a 12-month price target of \$42 and rate the stock "Accumulate".

## Natural Gas

**Kinder Morgan** (KMI \$64.30) – KMI pays an annual dividend of \$2.25, a yield of 3.69%. Its 20 P/E is reasonable, its 5-year growth estimate of 13% is in line with the S&P 500 Index, and its earnings are estimated to increase almost 11% in 2005 over 2004, which S&P thinks will be 13% higher than 2003. Kinder Morgan is one of the largest U.S. natural gas and oil storage and transportation companies, operating 30,000 miles of gas and oil pipelines. It acts as general partner to Kinder Morgan Energy Partners, a limited partnership whose cash

distributions account for about half of KMI's earnings. S&P's 12-month target price is \$61, and they rate the company "Hold".

## USING EXCHANGE TRADED FUNDS<sup>6</sup> TO BUY ENERGY COMPANIES

There are three exchange traded funds (ETFs) that are comprised of energy companies:

- Select Sector SPDRs (XLE)
- iShares Dow Jones U.S. Energy (IYE)
- iShares S&P Global Energy Sector (IXC)

An ETF is a basket of companies, in this case all energy stocks, that can be purchased like an individual stock, including paying a commission when buying and selling. An ETF, which follows an index, is more cost efficient than a managed mutual fund in which the holdings change, incurring transaction costs. It is a good way to "own a sector" without having to choose the best stock.

These three ETFs have in common an overweighting of Integrated Oil companies, the Global iShares comprised entirely of integrated oils. The first two have 40% and 51% respectively in the same three holdings, although not in the same order: Exxon Mobil, ChevronTexaco, and ConocoPhillips. Their next largest group (as a percentage of total holdings) is the Exploration & Production companies. The biggest distinction, in my opinion, is that the SPDRs ("spiders") ETF has a lower expense ratio (.28% vs. .60% for the iShares), making it more attractive.

Income from an ETF is paid out as a distribution. XLE and IYE pay quarterly, and IXC pays annually (in January). For the last 12 months or for 2003 their distributions per share were:

XLE - \$0.484 = 1.6% yield      IYE - \$0.73 = 1.4%      IXC - \$0.6187 = 1.0%

Like the underlying companies, each ETF is currently near its 52-week high.

## CONCLUSION

If you believe, as I do, that our energy supply is finite and our demand for it seems limitless, then energy stocks seem poised to benefit from this scenario for quite some time. If you're less convinced about supply shortage, you still might want to consider investing in British Petroleum, ChevronTexaco, or Kinder Morgan as an income-producing stock.

These stocks are bound to continue having up and down moves in their stock prices, but I think over the long term the move will be upward. If you decide to buy one or more of them, I would recommend waiting for a dip since they are near their 52-week highs.

Choosing one of the ETFs is also a sensible way to gain exposure to the energy sector. However, the yield is not compelling. For income you would do better buying one of the integrated oil stocks.

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<sup>1</sup> Bruce Lanni, senior analyst at A.G. Edwards

<sup>2</sup> Schwab's Market Guide for Industries as of 3/14/04

<sup>3</sup> from Schwab.com bond quotes 3/16/04

<sup>4</sup> closing price 3/19/04

<sup>5</sup> based on price as of 3/15/04

<sup>6</sup> for an overview and details on ETFs see Fizone.com's article on ETFs under Security Types