

Sobek Analytics

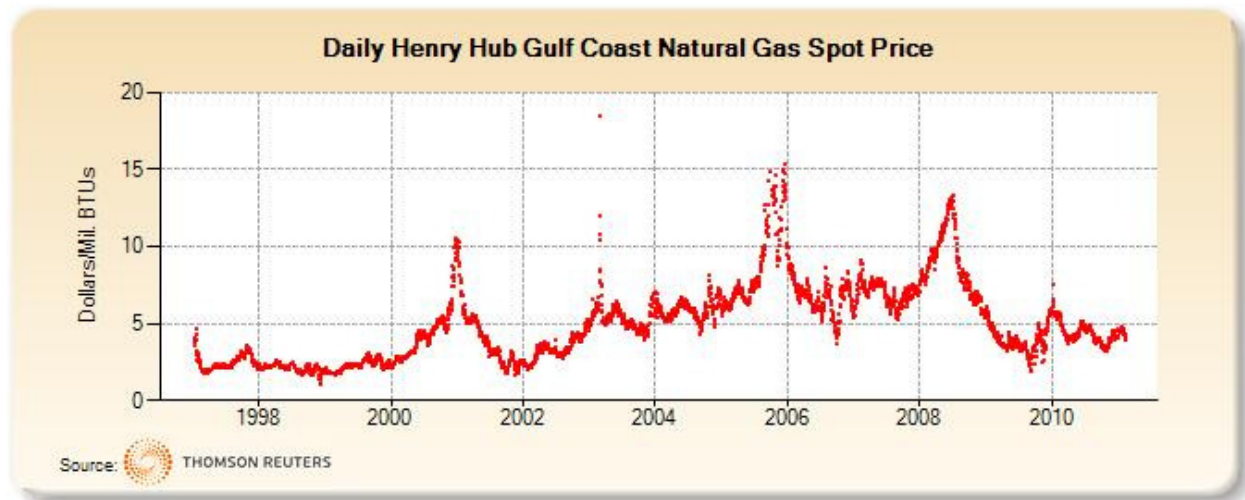
Report on Investing in Natural Gas Companies

Part I- Exploration and Production Plays

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Report:

Natural gas has been one of the most unloved commodities in what has otherwise been a tremendous bull market in commodities. Since peaking at just over \$13 per million BTUs in mid-2008, the price has been in a vicious bear market and currently rests just under \$4 per million BTUs. In addition, natural gas is not only cheap but cheap compared to oil. Historically oil trades at 6 times the price of natural gas and given the \$90 per barrel for this would put natural gas at \$15 per million BTUs. Clearly the price of natural gas is nowhere near \$15 per million BTUs.



Source: <http://www.eia.doe.gov/dnav/ng/hist/rngwhhdd.htm>

Despite the trend and despite the price, there are still ways to make money investing in natural gas. The key is not to focus solely on the price because for a company selling natural gas what matters is not the price *per se* but the margins. In other words, one needs to look for companies who can still make money in a low priced environment. One way to go about this is to look through the 100s of companies and figure out their margins but I think there is a better way (or at least faster). Rather than look for companies that can produce natural gas cheaply, why not first look at formations that have good economics? Then one simply needs to figure out who are the big players in those regions. One of my favorite slides from a

company presentation comes via Markwest (MWE). In particular, look at slide 8 from their Chickasaw MLP conference in December 2010

(<http://www.markwest.com/files/MWE/MarkWest%20Chickasaw%20MLP%20Conference.pdf>). Here they provide a list of 22 popular resource plays in the United States and rank them by NYMEX breakeven price for a 15% rate of return. In other words, it tells you what the price needs to be for companies to gain a reasonable profit in each resource play.

Of the 22 resource plays only 6 are profitable under \$4 per million BTUs (Granite Wash liquid rich horizontal, Eagle Ford Shale- liquid rich, Marcellus Shale- Southwest liquids rich, Cana Woodford shale, Marcellus Shale- Southwest, and Pinedale). In addition, two other plays are marginally profitable at just over \$4 per million BTUs (Horn River Basin and Eagle Ford shale- dry gas). Given that these resource plays are profitable at these prices, the next part of the equation is to think about where the price of natural gas is heading.

If the price is heading even lower, then you need to invest in the most economic resource plays. That being said it would be best to wait until prices settle as you are likely to get the companies more cheaply. If you believe (as I do) that prices are going to bounce around the bottom for awhile, then now is the time to put money to work. In particular, companies that have significant holdings in the 6 most economically viable resource plays. While I provide some links below that provide information about companies in various resource plays, two that have worked well for me are Linn Energy (LINE) and Forest Oil (FST). Of course, these are not the only companies working in these areas so for more information look at the following information.

If you think that prices are heading higher, then it would make sense to invest in companies that work in the marginally economic resource plays as these would show the largest profit growth as their production moves from uneconomic to economic. This is where the Horn River Basin and Eagle Ford Shale-dry gas companies would come into play. Of course, one need not run the risk of investing in these companies and might as well wait to see if prices move higher. In addition, higher prices will still benefit those in the most economic resource plays (it is just that their EPS will not grow as fast from a percentage standpoint). So at this time, it seems to make the most sense to look at companies in the economic resource plays.

For details on each play and the companies involved, see the links below.

Granite Wash

<http://oilshalegas.com/granitewash.html>

Eagle Ford Shale

<http://oilshalegas.com/eaglefordshale.html>

Marcellus Shale

<http://oilshalegas.com/marcellusshale.html>

Cana Woodford shale

<http://oilshalegas.com/woodfordshale.html>

Pinedale

<http://oilshalegas.com/greenriveroilshale.html>

In my next report on investing in natural gas, I will discuss secondary plays. Stay tuned.

If you have additional questions, please e-mail me at dsobek@sobekanalytics.com.

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General company information:

Disclaimer:

I am not a certified financial analyst. All the information provided in this report is my interpretation and may contain errors. Please, do not invest based solely on my opinions as it is critical for all investors to conduct their own due diligence and invest in ways that best fit their own needs. In addition, I am currently long LINE and MWE. I currently have no position in FST.