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Grab the Energy Chain

Oil's price will not collapse to \$28. Expect a stable \$35 level that will provide ample profit opportunity to owners of Btu | BY MICHAEL MAIELLO

Energy stocks are undervalued, say seers Daniel Tulis (seated) and Paul Elliot.

IN THE PAST 12 MONTHS THE PRICE OF oil rose 50% to \$45. The price of oil company shares (measured by the S&P 500 Energy Index) is up only 27%. Why is Wall Street so cool on the sector? Apparently out of a belief that oil prices will collapse in the near future, making the current gusher of oil industry profits a very short-lived phenomenon.

Energy savant Daniel Tulis has a different view. He thinks high prices are going to stick around for a while. Not as high as they are now, but high enough and long enough to make the energy-producing sector of the market a terrific buy. Tulis, 66, has been covering the sector ever since the first OPEC embargo 31 years ago. With some apparent success: Elco Energy, founded by Tulis' partner Paul Elliot in 1995, claims a 12.6% annual return since inception (after fees), besting the S&P 500's 11%.

If not stock traders, at least oil traders are expecting a future close to the one Tulis envisions. The December 2008 futures price for light sweet crude is \$35. From such expectations Tulis reasons that oil and gas stocks are undervalued, along

with stocks throughout what he calls the "energy chain," which starts with exploration and production and ends with power transmission.

Tulis oversaw electric power and natural gas research at Lehman Brothers, among other firms. When he entered the field in the early 1970s, dividend-paying utility stocks were all the rage. He has since lived through plenty of booms and busts. These, he believes, have taught investors, Wall Street analysts and energy company executives to expect price volatility and greet predictions of permanently high energy prices skeptically. During President Jimmy Carter's term, Tulis recalls, natural gas prices were inflated because the Administration predicted severe shortages and even mandated that gas be restricted to home heating and cooking. Carter was wrong, and new gas discoveries drove prices down to 80 cents per thousand cubic feet from \$3 highs.

The first Gulf war created artificial fears of oil shortages that drove the price to \$50 a barrel. But prices sank soon after, and in the late 1990s fell to \$11. From

then on investors have reacted by edging away from energy names. Energy stocks, excluding utilities, were 28% of the S&P 500 in 1980. They fell to 13% of the index in 1990 and are only 6% now, despite the resurgence in oil prices. As the chart shows, oil has come a long way in the past 30 years, but not as far as the stock market has.

Until recently Wall Street analysts have hewed to guidance from Saudi Arabia. Last year the Saudis said that the optimum oil price would be between \$22 and \$28 a barrel, and Saudi ambassador to the U.S. Prince Bandar bin Sultan indicates they are still targeting that level. But, says Tulis, the Saudis have lost their control over the price of oil, if indeed they ever had it.

The current \$45 price, Tulis thinks, can't be sustained, because new exploration and refining capacity will kick in to some degree. Yet he rules out a return to cheap mid-\$20s oil, since global demand is 80 million barrels a day and will be growing between 2% and 3%, while the supplying countries expect production growth of 1%. The Saudis are now pumping 9.4 million barrels per day. Tulis says they might be able to go to 10 million. Even if they do, China seems to gobble up half of every new barrel. Says Tulis: "Everyone expected 2004 to be a down year, so explorers didn't budget for drilling new wells. They have to catch up."

The refiners do, too. No large refinery has been built in the U.S. since the 1980s, and at the moment, as Americans still reel from sticker shock at gas pumps, up to 2 million barrels a day of available crude supply can't be absorbed because of refinery shortages.

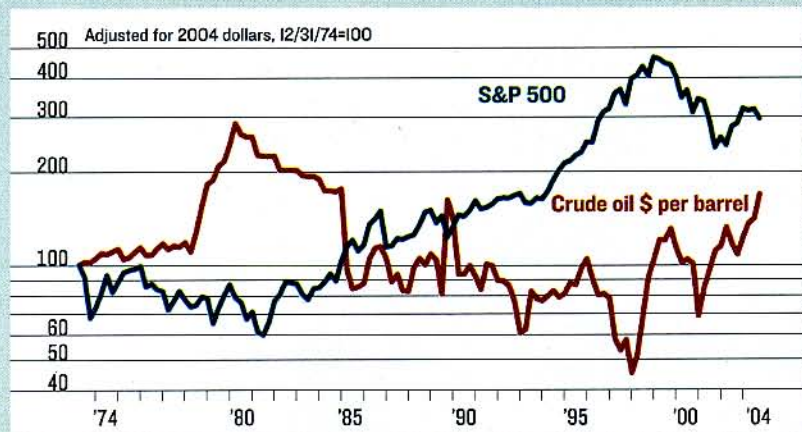
The big oil companies' stocks trade at midteens multiples. Some of them are real buys, says Tulis. Here's a survey of his favorites in the energy chain.

OIL. Tulis likes ChevronTexaco at \$94, despite its heavy \$10 billion debt and flat production forecast for this year. Tulis says Chevron should generate cash flow from operations of \$17.08 per share in 2004. The other oil giants trade at 7.4 times cash flow, versus 5.5 times for Chevron. Tulis suspects higher oil prices will lift Chevron's multiple to 8, meaning

Don't Panic

High oil prices may have drivers thinking about selling their SUVs, but investors shouldn't do the same with their stocks. Not yet, anyway. Spikes in oil prices have clobbered equities in the past, notes James Stack, editor of *InvesTech Market Analyst*. But they usually hurt stocks only when they are accompanied by a run-up in inflation and interest rates. At this point, Stack notes, inflation and the Federal Reserve remain pretty tame.

—Neil Weinberg



Sources: Bureau of Economic Analysis; InvesTech Research.

High Energy

These are among Tulis' favorites. By his estimates, the stocks trade below what they should (their intrinsic value) because investors expect another energy price slump.

	2005 ESTIMATE		Recent price	Intrinsic value ¹
	EPS	P/E		
EXPLORATION & PRODUCTION				
Anadarko Petroleum	\$5.41	11	\$57.40	\$71.00
Burlington Resources	2.71	14	36.73	44.00
MAJORS				
BP ²	3.63	15	55.54	66.00
ChevronTexaco	6.92	14	94.63	108.64
OIL SERVICES				
BJ Services	2.38	20	46.68	50.00
Schlumberger	2.47	25	62.33	72.00
GAS MERCHANTS				
AES	0.68	17	11.76	15.00
Williams Cos.	0.75	13	9.40	11.50
UTILITIES				
Sempra Energy	3.05	12	35.81	39.00
Southern Union	1.41	14	19.16	23.60

Prices as of Aug. 9. ¹Value of the company, per share, based on net asset value and an average multiple of future earnings. ²Traded as American Depositary Receipts.

Sources: Elco Management Co.; Thomson One Analytics; FT Interactive Data via FactSet Research Systems.

its stock should trade at \$108. A \$5 billion share buyback now under way and a 3% yield make it all the more attractive.

Cash flow (in this sense, essentially net income plus depreciation) is a measure not only of profitability but also of a company's ability to finance new exploration and development. Though ChevronTexaco is a Tulis favorite, he recommends all the multinational biggies with the exception of Royal Dutch/Shell, still reeling from the revelation that its reserves had been overstated.

EXPLORATION. With a sustained \$35 oil price, Tulis thinks, stand-alone exploration companies like Anadarko Petroleum and Burlington Resources look attractive. Increased demand for new wells will boost their fortunes. This industry sector, he says, has typically traded at 1.2 times net asset value. Burlington Resources, at \$37, has an NAV of \$39, says Tulis. Hence, that stock is worth at least \$44.

NATURAL GAS. Since natural gas is an oil alternative, prices will also be higher than Wall Street suspects, says Tulis. A hungry 170 gigawatts of gas-fueled power plants came on line between 2001 and 2004, even as gas production rates in North America slid by 3% a year. (A

gigawatt serves half a million people.)

Tulis believes gas will average Wall Street's 2004 consensus of \$5.88 per thousand cubic feet. It trades for \$5.79 now.

One winner: the Williams Cos., a gas explorer and pipeline operator. At \$9, Williams trades at a discount to its NAV of \$15. Debt of \$10 billion may explain the gap, but the company is moving to pare that. It recently sold off some Canadian power plants for \$540 million.

UTILITIES. Amid rising interest rates, Tulis is skeptical of utilities, which tend to carry a lot of debt, can't raise electric rates without regulatory approval and are shunned by investors when bond yields make their dividends less attractive. Still, he has found a few he likes. Southern Union, a natural gas utility trading at \$19, has nearly a million customers in Kansas City, Mo. and Rhode Island and recently acquired a 1,300-mile gas pipeline that connects the Texas panhandle to Michigan. It trades at 14 times likely 2005 earnings. Tulis says it will reach 17 times before the year is over. Tulis also likes Sempra Energy, an electric transmission company that serves 21 million customers, making it the largest electric supplier in the U.S. **F**