

Equity Research

Americas

U.S./Energy/Exploration and Production

February 28, 2001

BUY
USD 99.99

Oklahoma Energy

OKL

MID CAP

The Beauty of Oklahoma

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- We recently initiated coverage of Oklahoma Energy with a Buy rating and a 12-month target price of \$100, assuming 6.0 times our 2002 EBITDA estimate. Depending on the duration and magnitude of the current, strong price environment, we believe upside to the \$100-200 range is possible because of strong free cash generation.
- In a high price environment, the company is well positioned to create value through its aggressive drilling program. Financial risk has been reduced, as debt has declined to less than 2 times EBITDA from over 5 times a year ago.
- OKL's primary focus is in the Mid-Continent region in and around Oklahoma—a region that is gas-saturated and attractive in the current environment. OKL is well positioned to succeed in this region.
- We continue to look for companies that can take advantage of a strong price environment to create value, and OKL fits the bill. We expect OKL to provide a combination of strong internal production growth and continued debt reduction.

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Statistical Abstract

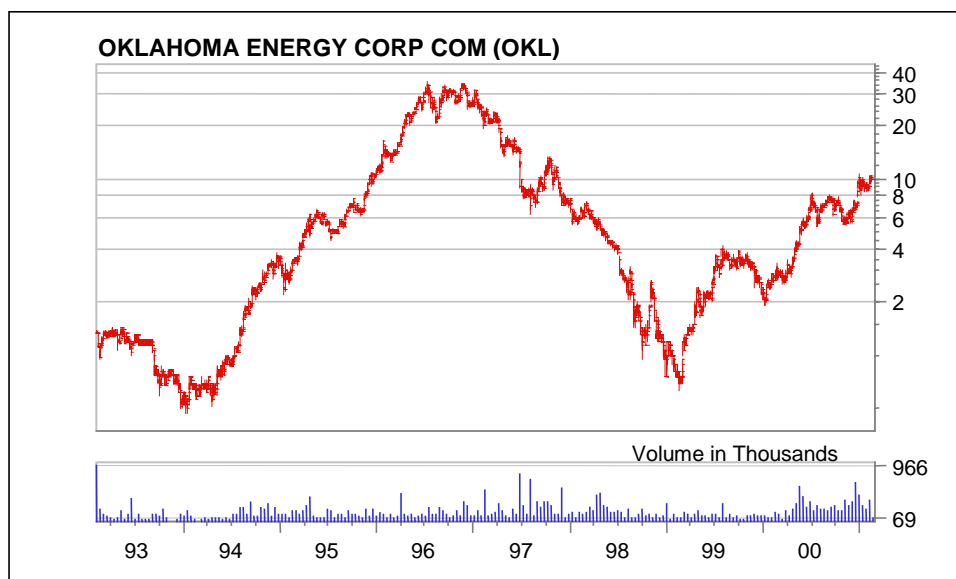
Oklahoma Energy						BUY
Price 2/28/01 ¹	Target (12 Months)	Dividend	Yield	Mkt. Value (Millions)	52-Week Price Range	
USD 99.99	\$100	—	—	\$1,000.0	\$90–100	
	Annual EPS	Prev. EPS	Abs. P/E	Rel. P/E	EV/ EBITDA	Cash Flow/ Share
12/02E	\$0.75		133.3X	67%	5.3X	\$2.15
12/01E	1.00		100.0	39	4.4	2.71
12/00A	2.00		50.0	37	6.9	1.94
	March	June	September	December	FY End	
2001E	\$0.50	\$0.50	\$0.25	\$0.80	Dec. 31	
2000A	0.25	0.25	0.25	0.25		
ROIC (12/00)	25.5%	Total Debt (12/01E)		\$970 mil.	NAV/Share (12/00) \$12.78	
WACC (12/00)	10%	Debt/Total Capital (12/00)		NM	Common Shares 100 mil.	
EP Trend ²	Up					

¹On 2/28/01 DJIA closed at 10495.3 and S&P 500 at 1239.9.

²Economic profit trend. NM = Not meaningful.

Oklahoma Energy Corporation is one of the 10 largest public independent natural gas producers in the United States with proved reserves of 1.6 trillion cubic feet of natural gas equivalent (tcfe).

Stock Price Performance



Source: CSFB

Investment Summary

Leverage cuts both ways

The Oklahoma Energy story has had its share of ups and downs. Fortunately, the future looks bright, as natural gas fundamentals create an environment that should allow OKL to not only survive its higher-than-average leverage but excel for years to come. In an industry long on capital and short on prospects, Oklahoma represents a departure from the norm. The company's focus is the Mid-Continent region in and around Oklahoma, a region rich with gas but also technically challenging because of its geological and land complexities. OKL's competitive advantage results from the scale and scope of its operations and also from its long-standing, aggressive approach to drilling to add value.

After several years of repositioning and restructuring, OKL has emerged as a focused player with a niche that can provide predictable and profitable growth. The Austin Chalk, the company's former focus area, currently represents less than 10% of reserves and 2001 capital spending. Less than two years ago, the company's market value was \$100 million versus \$1.2 billion in debt and preferred stock. Today, market value of equity is \$1.5 billion versus long-term debt of \$1.1 billion. Long-term debt is less than 2 times our EBITDA forecast of \$580 million. The leverage that hurt the company through the downturn is now working in favor of equity holders. The turnaround has been dramatic and is complete.

At current rates of drilling, the company's inventory of proven and unproven locations provides four to five years of visible growth. The asset base includes 1.6 tcf of proven reserves with 73% located in the Mid-Continent region (pro forma for the Gothic Energy purchase). While the Chalk's importance has declined, recent success in the Georgetown formation (deeper than the Chalk) provides another lever for OKL to increase its growth profile.

We expect production growth of 1% in 2000 and 27% in 2001. Excluding the Gothic acquisition, the internal growth rate in 2001 will exceed 10%, which compares with an industry average of 7% (which includes some acquisitions). For 2001, we expect EPS of \$1.15, CFPS of \$2.71, and EBITDA of \$580 million. OKL currently trades at 4.4 times EBITDA versus the industry average of 4.5 times. Our estimates assume \$4.20 natural gas in 2001 versus current strip pricing of \$5.90. At strip pricing, EPS, CFPS, and EBITDA increase to \$1.83, \$3.77, and \$765 million.

Table 1
2001E Comparative Valuation

	P/E	P/CF	EV/ EBITD	Natural Gas Production	Production Growth
Oklahoma	9.9	1.1	4.4	66%	11%
E&P	18.2	2.3	2.5	99%	7%
<i>CHK</i>	-29%	-22%	-3%		

E= Credit Suisse First Boston research estimates for 2001.

2001 Estimates assume oil and gas prices average \$23 per barrel and \$4.20 per mcf.

Background and strategy

We recently initiated coverage of OKL with a Buy rating and a 12-month target of \$12 per share. Importantly, our target is based on our 2002 outlook assuming \$18.50 for oil and \$3.50 for natural gas. If futures prices remain strong, OKL should generate \$685 million in free cash flow in 2001 and 2002 versus our base case assumption of \$300 million. The incremental free cash generated in a higher price environment would increase our price target for OKL to \$14 per share by mid-2002. If prices remain structurally in the \$5.00 per mcf range, which is possible but not likely in our view beyond 2002, the upside could increase to \$16 per share. We see modest risk from operations given the low-risk nature of the drilling program. The financial outlook is improving because of strong prices and management's commitment to reduce debt.

Knowing the background on OKL is helpful for understanding the company's position and outlook today. OKL is still thought of by many as just an Austin Chalk player even though the "Chalk" represents less than 10% of reserves today. In the glory days from 1993 to 1996, when the stock was exploding from less than \$1.00 per share into the \$30s, the driver was the Texas Austin Chalk. Our view at the time was that the play might work, but that the valuation of the shares did not leave much room for mistakes and the capital inefficiency that typically surrounds new exploration plays. In 1997, the company expanded the play aggressively into Louisiana utilizing too much debt capital in the process. When drilling results in the Louisiana portion of the Chalk did not meet expectations, OKL had little valuation support, limited access to capital, and an overleveraged balance sheet.

Importantly though, management is resilient and resourceful, and, as the owners of 24 million shares, the pain felt by shareholders was fully experienced by management as well. From 1998 to 2000, the company was repositioned into a mainstream, long-lived natural gas producer with a Mid-Continent stronghold. The company's acreage and reserve position is much stronger and more-diverse than in the past, and its strategy is lower risk.

Oklahoma remains committed to growth through drilling, and it uses acquisitions and leasing to sustain and grow its inventory of drilling locations. In our view, OKL has always played the game the way it should be played through a technical evaluation, which leads to leasing and drilling. High drilling activity is not only the source of value creation, but production from new wells also contributes to lower cost operations (newer, more-productive wells have lower unit costs than old wells).

The company's prior competitive advantage was its contrarian approach to the Chalk. Today, the competitive advantage results from its scale and scope of operations in Oklahoma, the heart of the Mid-Continent and where OKL is the third-largest natural gas producer (behind BP and Apache) and the most active driller during the past 11 years.

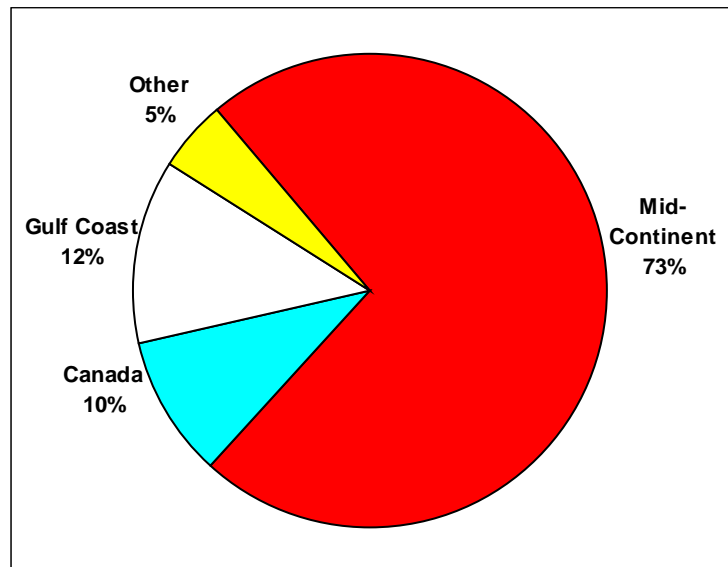
Oklahoma's past operational problems are not likely to be repeated because of the lower-risk nature of the drilling program. No one well is particularly important or expensive. In addition, the valuation is now very

close to the industry average. The primary risk shareholders face comes from how the company manages its financial resources, and recent performance is encouraging. The company appears committed to reducing leverage, and, in our view, has done an excellent job repositioning (against long odds) since 1997.

Assets

OKL’s reserve mix is detailed in Exhibit 1. The Mid-Continent region accounts for almost 73% of reserves. The most-significant areas being in and around four giant gas fields in southern Oklahoma (the Golden Trend, Bradley, Chitwood/Knox, and Cement fields, which have collectively produced 10 tcf of gas) and approximately 15 large fields in the Anadarko Basin and the Arkoma Basin. Importantly, the company’s position extends across Oklahoma and includes numerous different play types and prospects. Beyond Oklahoma, important regions include the Gulf Coast, including the Chalk, Canada, and southeast New Mexico.

**Exhibit 1
Pro Forma 2000 Reserve Mix**



Source: Company reports, January 2001

Why the greater Oklahoma area?

Oklahoma ranks as the fifth largest natural gas region in the United States with 12.5 tcf (ranking behind Texas, the Gulf of Mexico, New Mexico, and Wyoming). The reserve life in the state is 9.6 years versus 5.5 years in the Gulf and 12 years in Kansas. Interestingly, Oklahoma’s oil boom began around the turn of the 20th century. The first oil was accidentally found by a water well being drilled in 1859. The oil boom gave way to a natural gas boom in the 1970s, and today while there are almost three times as many oil wells as gas wells, the gas wells are 10 times more productive than oil wells (averaging 150 mcf per day per well). Of Oklahoma’s 77 counties, 70 have oil and/or natural gas production.

Hydrocarbons cover the state from north to south and east to west. Equally important, production ranges from 1,000 feet to 25,000 feet. Like the Gulf of Mexico, opportunities for serendipity abound because of multiple target objectives.

Unfortunately, just because the state is gas-saturated does not mean success is assured. In our opinion, the key to success is focus and execution.

Targets in the region range from low-risk 0.5 bcf wells to higher-risk 5-10 bcf wells. Success in the region requires the application of the latest 3-D seismic and drilling technologies and a large land inventory. The high cost of acquiring land and utilizing these technologies limits the competition from the smaller, private Independents. The relatively small reserve targets, the complexity of the land ownership, and the people intensity of exploring in the region tend to limit the competition from the largest players. The region is similar to the Gulf of Mexico in its geologic complexity, but land ownership is significantly more fragmented. Most Gulf of Mexico acreage is owned by the federal government, which conducts regular auctions with consistent lease terms. Oklahoma is dominated by private ownership of minerals, with every parcel having been sliced and diced for 100 years. Success requires equal focus on the land picture as it does on the underlying geology. OKL, having been founded by land men, is well suited to this task.

The company is active in at least 15 major plays in Oklahoma with over 400,000 net acres of developed and undeveloped leasehold. OKL currently has 18 rigs running in the state out of an industry total of 111 rigs in Oklahoma. The company plans \$163 million in spending in the region in 2001 versus the total company budget of \$260 million. To help ensure access to rigs and quality of rigs and crews, OKL is refurbishing five stacked rigs to work for its own account. This strategy is possible because of the generic and extensive nature of the company's prospect inventory. In a tight environment, this should improve the visibility and costs of the company's production profile.

Financial outlook

Oklahoma recently raised its production guidance for 2001 to 170-175 bcfe from 170 bcfe because of higher capital and recent drilling success. This compares with 2000 production of approximately 134 bcfe (160 bcfe including Gothic). Based on our knowledge of the drilling program and prospect inventory, these estimates should be easy to achieve. Assuming our \$4.20 per mcf and \$23 per bbl oil and gas price deck in 2001, this translates into EPS of \$1.15, CFPS of \$2.71, and EBITDA of \$580 million (see Table 2). Our forecast includes the effect of hedges, and OKL has locked in approximately 30% of its combined oil and gas production in 2001. If the 2001 gas price outlook of \$5.90 holds as implied by the futures market, EPS, CFPS, and EBITDA increase to \$1.83, \$3.77, and \$765 million. We estimate that every \$0.10 per mcf change in natural gas prices affects CFPS by \$0.08 per share.

For 2002, assuming oil and gas prices of \$3.50 per mcf and \$18.50 per bbl, we expect EPS of \$0.71, CFPS of \$2.15, and EBITDA of \$466 million. Our model assumes only 3% production growth to 175 bcfe. We assume no acquisitions and capital spending that is \$100 million less than cash flow. Free cash flow is channeled into debt reduction pending more visible uses of the capital. In reality, acquisitions are likely, and increased spending might provide better returns and more production growth.

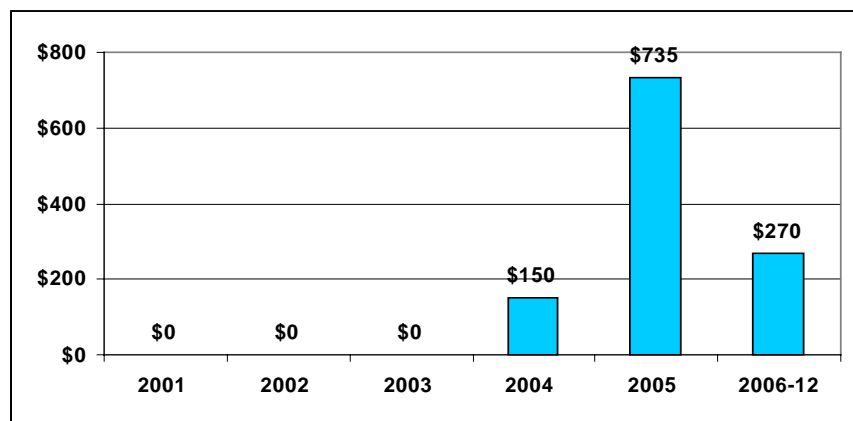
Oklahoma is highly leveraged to natural gas. Assuming our base case of \$4.20 and \$3.50 natural gas in 2001 and 2002, OKL generates approximately \$300 million in free cash flow. If strip pricing holds (\$5.90 and \$4.83 in 2001 and 2002), free cash flow increases to \$685 million and net debt could be reduced to \$500 million by the end of 2002. OKL's operating costs of \$0.74 per mcfe compares with an industry average of \$0.84 per mcfe (see Exhibit 3). Interest expense is still the weak spot at \$0.57 per mcfe versus an industry average of \$0.21. Our estimates for 2001 include Oklahoma's \$345 million Gothic Energy purchase that closed during January 2001. Gothic's assets are located in the Mid-Continent, in the heart of OKL's existing asset base. The acquisition price included 301 bcfe of proven reserves and added approximately 75 mmcfe/d in production.

Leverage and balance sheet

While OKL's leverage position has benefited substantially from higher natural gas prices, it remains a weak point for the company. Fortunately, the company's lack of current maturities enabled it to withstand the storm of low prices in 1998 and 1999. Of the total \$1.1 billion in long-term debt, less than \$50 million is bank debt at year-end 2000. The first substantial maturities do not begin until 2004. The maturity schedule for the next five years is as follows:

Exhibit 2**Leverage—Maturity Schedule (2001–2012)**

(\$ millions)



Source: Company reports

Net asset value

We expect free cash flow near term will be used to repay bank debt and repurchase preferred shares. By the end of 2002, we expect long-term debt to be reduced to at least \$885 million versus our EBITDA projection in 2003 of \$466 million. Declining long-term debt is also likely to coincide with decreasing average interest costs from 9.4% currently.

In a rising price environment, leverage is clearly working on behalf of the OKL equity holders. In a \$3.00 gas price environment (under \$20 oil and \$3.00 gas price deck), we calculate a net asset value of \$6.29 per share. In a \$4.00 environment, which we believe is much more likely for the next several years, the NAV increases to \$11.75 per share. Importantly, this assumes a constant value for undeveloped acreage of \$200 million. The decrease in the acreage value relative to the total clearly lowers the risk in the valuation. With capital efficiency increasing, the predictable drilling program and debt reduction efforts should allow for continued increases in the underlying value of OKL. We project that by the end of 2002, NAV can rise to \$10 per share under a \$3.00 per mcf case and to \$15.86 under a \$4.00 per mcf case.

Table 2
Pro forma Earnings Model

in millions of dollars except per-share amounts

	1999	2000	2001E	2002E	1Q00	2Q00	3Q00	4Q00
Oil production (MMBBLs)	4.15	3.07	2.92	2.74	0.86	0.79	0.76	0.65
Average price (\$ per BBL)	16.01	26.38	26.23	17.50	24.58	24.46	28.25	28.93
Oil revenue	66.39	80.95	76.58	47.91	21.24	19.35	21.50	18.86
Conventional gas production (BCF)	108.61	115.72	153.40	158.78	28.75	29.33	29.14	28.50
Average price (\$ per MCF)	1.97	3.36	4.07	3.33	2.30	2.76	3.52	4.90
Gas revenue	213.96	389.30	624.60	528.72	66.12	80.95	102.58	139.65
Total oil and gas revenue	280.45	470.00	701.18	576.63	87.29	100.22	123.97	158.51
Gas marketing	74.50	157.78	136.96	78.00	27.37	34.24	44.21	51.96
Service operations	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other revenue	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total revenue	354.95	627.78	838.14	654.63	114.66	134.46	168.18	210.47
Costs and expenses								
Oil and gas leasehold operating costs	59.56	74.93	108.73	95.92	17.76	18.30	17.89	20.97
Gas marketing	71.53	152.31	132.85	75.00	26.54	33.12	42.92	49.73
DD&A	102.85	108.77	161.02	175.39	26.35	26.71	27.08	28.63
Interest and other debt expense	81.05	82.61	101.14	88.27	19.67	20.15	20.81	21.98
General and administrative	13.48	13.18	17.00	17.50	3.03	3.19	3.38	3.58
Other	-8.56	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total costs and expenses	319.92	431.79	520.75	452.08	93.36	101.47	112.08	124.89
Earnings before taxes	35.03	195.99	317.39	202.55	21.30	33.00	56.11	85.59
Income tax expense	1.76	-259.41	117.44	80.01	0.10	1.36	1.42	-262.29
<i>effective rate</i>	5%	-132%	37%	40%	0%	4%	3%	-306%
Net income	33.27	455.40	199.96	122.54	21.20	31.63	54.69	347.87
Preferred dividends	16.71	8.48	2.18	0.00	4.04	2.91	0.97	0.57
Earnings available to common-- Cont. Ops	16.56	184.09	197.77	122.54	17.16	30.21	53.72	83.00
Earnings per share(a)-- Continuing Ops	0.17	1.43	1.26	0.78	0.17	0.26	0.37	0.54
Earnings per fully diluted share	0.16	1.21	1.15	0.71	0.15	0.23	0.34	0.50
Average shares outstanding (millions)	97.08	128.99	157.00	157.50	101.68	116.47	146.59	152.53
Diluted shares outstanding (millions)	102.04	151.56	172.00	172.50	140.13	146.11	158.85	164.52
Cash flow from operations								
Net income	\$16.56	448.39	\$197.77	\$122.54	\$17.16	\$30.21	\$53.72	\$347.30
DD&A	102.85	108.77	161.02	175.39	26.35	26.71	27.08	28.63
Deferred taxes	1.76	-258.66	112.74	76.81	0.10	1.36	1.42	-261.54
Other	4.18	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Capitalized interest	5.00	3.89	7.00	5.00	0.69	1.30	1.90	0.00
Total cash flow from operations	\$120.35	\$294.62	\$464.54	\$369.74	\$42.92	\$56.98	\$80.32	\$114.40
Per share	\$1.24	\$2.28	\$2.96	\$2.35	\$0.42	\$0.49	\$0.55	\$0.75
Diluted cash flow per share	\$1.18	\$1.94	\$2.71	\$2.15	\$0.31	\$0.39	\$0.51	\$0.70

Source: Company reports; E= Credit Suisse First Boston Research estimates

AMSTERDAM 31 20 5754 890	MADRID 34 91 423 16 00	SEOUL 82 2 3707 3700
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BOSTON1 617 556 5500	MUMBAI 91 22 230 6333	TOKYO 81 3 5404 9000
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