

Time to Re-Energize

by Tim Eriksen, *m100 member*

Energy was up 29% in 2004 and is up 27% this year. A lot of investors are concerned that the energy run is over and they should get out. With the gains from our PetroKazakhstan (nyse:PKZ) investment, it's a good question to ask. Fortunately, we have access to an extensive database of the best investors at Marketocracy. They are telling us to stay with energy so I asked Tim Eriksen, the m100 member that made a 952% return on PKZ, what he was investing in with his proceeds from PKZ. Here's what he had to say:

My two favorite buys in energy now are Edge Petroleum (nasdaq: EPEX), a natural gas play, and due to its recent share price decline, Chaparral Resources (otc: CHAR) an oil company with production, like PKZ, in Kazakhstan.

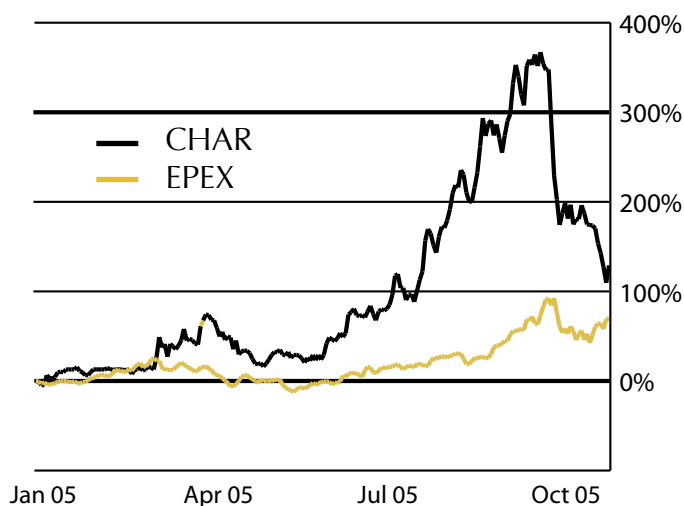
Edge focuses on the on-shore exploration of natural gas and has a high drilling success rate. Natural gas prices are very volatile. What I like about Edge is that its hedging program eliminates a lot of the uncertainty. Edge has about 40% of its production hedged, but it is not at fixed prices, rather it is through the use of zero cost collars. A collar guarantees a minimum price to be paid and a maximum price. If prices fall below the minimum, they will get paid the minimum guaranteed price. For 2006, Edge has 40% of its gas locked in at a guaranteed minimum price of \$7 per mcf. That eliminates a lot of uncertainty.

The beauty of a collar is that the company can still benefit from higher prices. Half of Edge's collars have a maximum price of \$10.50 per mcf and the other half is at \$16 per mcf. Thus if prices stay high, Edge will do extremely well. Wall Street has current estimates for Edge of \$2.42 per share for 2006, which puts the stock at 10 X forward earnings. My analysis says that estimate is based on an average natural gas price of about \$7.50 per mcf. By my calculations, for every \$1 per mcf increase in the average yearly price of natural gas, Edge will earn an additional \$0.50 per share. Thus, thanks to Edge's collars, I can eliminate most of the uncertainty and still get nearly all the upside potential.

Chaparral saw its stock decline from \$6 to about \$3.25. Some say you should sell your losers, but my belief is that you have to know the difference between a loser and just a decliner. If the share price falls but the underlying investment thesis has not changed, my philosophy is to buy more.

Stock Prices

Edge Petroleum (nasdaq: EPEX) & Chaparral Resources (OTC: CHAR)



Chaparral's share price has been hit with a combination of factors such as selling by its second largest shareholder and the Kazakh government placing restrictions on the sale of oil and gas assets in the country. The biggest factor though is fear brought about by the buyout of its majority owner, Nelson Resources, by Lukoil, a Russian oil company that seems heavy-handed in its dealings. Many investors fear that CHAR shareholders will be forced to accept a "lowball" buyout offer from Lukoil, just like Nelson Resources did. Fortunately, CHAR is a U.S. company, based in Delaware so any buyout would have to be at fair value as determined by a Delaware court.

None of these issues have impacted Chaparral's operations. Oil prices are still high and earnings should be very strong. In Q2, when Brent crude averaged \$52 per bbl., the company earned \$0.17 per share. In Q3 Brent was near \$60 and the company has been increasing production. I think CHAR could earn \$0.20 to \$0.30 per share in both Q3 and Q4. Assuming annual earnings of \$0.80 to \$1.20 per share, CHAR is trading at about 4 times current earnings. That is a very attractive price to me.

Energy is the most important area for you to invest in during the coming year. Now's the time to buy CHAR and EPEX, when fear and uncertainty are driving other investors away, lowering the price and providing you downside protection.