

December 27, 2012

Current Price: \$19.66
Intrinsic Value Estimate: \$21.00
(Long-run US\$95 oil / US\$5 gas)

FLASH: Encana Corporation (TSX, NYSE: ECA)**BAH HUMBUG: ENCANA DIVESTS KITIMAT ON CHRISTMAS EVE**

On the last, yule-shortened trading day before Christmas, Encana and EOG Resources announced their exit from the Kitimat LNG project, with each party selling a 30% stake to Chevron for an undisclosed sum. Encana and EOG, along with their remaining partner Apache, had been shopping a 30% interest to be shared by an equal reduction in ownership.

Instead, Apache has closed a deal with Chevron to set up a 50/50 partnership in the project, with its two former partners bowing out. The Apache/Chevron partnership remains open to finding an equity partner that is a 'foundation customer' for the project, meaning an LNG customer with distribution in Asia that is willing to pick up a share of construction and development costs, and pay an LNG price that makes Kitimat economic.

We surmise that Encana and EOG got embarrassingly low offers for their stakes, given that the transactions were announced on possibly the least watched news day of the year (the day before Christmas), with no terms disclosed. We can nonetheless estimate a roundabout deal value based on disclosed transactions between Chevron and Apache. We peg this value at approximately \$339 million to Encana.

The reason for the lowball offers also seems clear: cost estimates for B.C. LNG projects are rising – Kitimat could cost \$9+ billion in an optimistic case – and this particular project was not gaining traction with customers, judging by the lack of interest in the original 30% deal. Meanwhile, cheaper brownfield U.S. projects are moving forward with lower LNG prices locked in, highlighted by the recent cost-plus contract signed by Cheniere Energy at its Sabine Pass LNG Terminal. Greenfield projects such as Kitimat LNG are fast becoming uneconomic.

We had generously estimated the option value of West Coast LNG to Encana at \$1.45 per share. This deal now looks likely to generate closer to \$0.45 per share, reducing our intrinsic value estimate to \$21.00 per share (long-run US\$95 oil / US\$5 gas). Even this valuation may be optimistic, given that it assumes a return to US\$5 natural gas this decade.

With a bearish outlook for gas in 2013, we continue to recommend staying out of this stock. SELL.

STEP ONE: PRICING ENCANA'S ACREAGE

Working from Apache's press release, the first transaction of note is between Chevron and Apache, transferring 50% of Apache's Horn River and Liard acreage for \$550 million. We estimate that this transfer to Chevron from Apache comprised 291,500 acres as follows:

- Half of 159,000 Horn River acres held by Apache (220,000 combined Horn River acres, less 61,000 held pre-transaction by Encana and EOG); plus
- Half of 424,000 Liard acres held by Apache pre-transaction.

This works out to \$1,887 per acre (\$550 million divided by 291,500 acres) paid to Apache by Chevron.

The equivalent value paid by Chevron for Encana's 32,500 Horn River acres is \$61.3 million (32,500 acres multiplied by \$1,887 per acre).

December 27, 2012

Current Price: \$19.66
Intrinsic Value Estimate: \$21.00
(Long-run US\$95 oil / US\$5 gas)

FLASH: Encana Corporation (TSX, NYSE: ECA)**STEP TWO: PRICING ENCANAS 30% FACILITY AND PIPELINE INTEREST**

The first transaction gives Chevron a lopsided interest at 60% equity in the proposed Pacific Trail Pipeline ("PTP") and the Kitimat processing facilities and 140,500 Horn River acres (made up of 79,500 Horn River acres from Apache and 61,000 acres from Encana/EOG).

To reduce Chevron's interest to 50%, Apache pays the equivalent of \$150 million to Chevron for additional Horn River acreage and an incremental 10% of the pipeline and facilities. This results in a disclosed net proceeds to Apache of \$400 million (\$550 million less \$150 million).

Equalizing acreage requires that Chevron send Apache 30,500 Horn River acres acquired from Encana/EOG, which at the same \$1,887 per acre, represents a cost to Apache of \$57.5 million. This means that Apache paid roughly \$92.5 million for its 10% equity interest in the facilities (\$150 million less \$57.5 million).

Based on this figure, Encana's 30% interest in the facilities would be worth \$277.4 million. Adding \$61.3 million for acreage, the total deal value to Encana would be \$338.7 million, paid by Chevron, or approximately \$0.45 per share.

WHAT IF CHEVRON PAID ENCANAS MORE FOR ACREAGE?

Had the cost to Apache been greater for Encana and EOG's acreage – both were thought to have superior Horn River lands – Apache's equity interest in the facilities, as the remainder in our calculations, would be lower, reducing the implied deal value to Encana.

At \$3,000 per acre for Chevron's Horn River transfer, Apache's 10% facility and pipeline interest is worth \$58.5 million (\$150 million less \$91.5 million from 30,500 acres at \$3,000 per acre). In this case, a 30% facilities interest is worth \$175.5 million. At \$3,000 per acre, Encana's 32,500 acre Horn River divestiture would be valued at \$97.5 million to Chevron. Adding the \$175.5 million for facilities, Encana's deal value would be \$273 million.

Lastly, we should also mention the question of Encana's commitments to building and operating the Cabin gas plant, which now pass to the new partnership. These commitments may have further reduced the price paid to Encana by Chevron.

A BIT MORE CASH, BUT THE SAME PROBLEM: BLEAK GAS PRICES

Using Apache's limited disclosure of the deal metrics, we believe Encana's Kitimat deal will generate proceeds of less than \$0.45 per share for Encana, or \$339 million. In our view, this deal does not materially improve Encana's outlook, with the lost option on West Coast LNG reducing our intrinsic value to \$21 per share from \$22 (long-run US\$95 oil / US\$5 gas). Given our bearish outlook for natural gas, which forecasts US\$3.35 Henry Hub in 2013, and the risks associated with Encana's proposed liquids-rich shift, we prefer to remain on the sidelines. SELL.

Veritas Investment Research Corporation ("Veritas") its directors, officers, employees and their immediate families are prohibited from trading any position in the securities profiled in a report thirty (30) days before and five (5) days after the publication date where the report involves coverage initiation or a change of opinion. Veritas has not offered any consulting, financial advisory, investment banking or underwriting services to the companies mentioned. Veritas does not accept research fees from the companies profiled herein. The information contained in this report has been obtained from sources believed reliable however the accuracy and/or completeness of the information is not guaranteed by Veritas, nor does Veritas assume any responsibility or liability whatsoever. All opinions expressed are subject to change without notification. This report is for information purposes only and does not constitute and should in no way be construed as a solicitation to buy or sell any of the securities mentioned herein. The intention of this report is to provide a forthright discussion of business, accounting and financial reporting issues, as well as generally accepted accounting principles and the limits of their usefulness to investors. As such, please do not infer from this report that the accounting policies of any company mentioned herein are not allowed within the broad range of generally accepted accounting principles, or that the policies employed by that company were not approved by its auditor(s). This report may not be reproduced in whole or in part without the express prior written consent of Veritas. Veritas is a 100% employee owned firm. © 2012 Veritas Investment Research Corporation