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Enerplus Resources Fund (ERF) Analysis

High Yield But Too Many Unknowns.

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Enerplus Resources Fund

A High Yield Stock With Many Imponderables

Outlook and Strategy

We are avoiding this stock.

The underlying fundamentals are strong as profitability is being driven by higher energy prices and the potential for further acquisitions. The current yield is 10.83%.

The stock gapped higher in early June and is currently consolidating those gains. However, changes to tax laws and the potential for lower commodity prices keep us on the sidelines.

Analysis

ERF is an energy investment trust organized and based in Calgary, Alberta. The purpose of the trust is to generate monthly cash distributions. It was formed in 2001 from the merger with EnerMark Income Fund. It has subsequently acquired additional companies.

It is now the world's largest and most liquid oil and natural gas income fund.

Reserves

One of the keys that drive income funds is the future of their reserves. For example, some funds have a high yield because they are effectively returning the capital to the investor. As a result, their capital is always being depleted and they eventually wither to nothing.

Investors should note that ERF does this to a certain extent in that cash distributions are nearly always greater than cash flow. For example, dividends were \$3.30 in 2003 while earnings were \$2.23. How do they do that? The key is that their cash flow was \$4.29 in the same year. Every year, they run a higher cash flow than dividends.

ERF has been able to maintain and even increase their reserves through clever purchases of additional properties. ERF now has 13.3 years of reserves at current production rates but this is an increase over previous years due to acquisitions and exploration though down slightly from last year's 13.8 years.

Production

Production continues to climb for natural gas but decline slightly for crude oil. Production for the first quarter of this year was 262,096 Mcf/day of natural gas compared to 232,911 last year and crude oil production was 23,248 barrels/day this year in the first quarter versus 24,500 last year in the same time. We look for production to remain stable throughout the year, excluding the possible acquisition of new production, and for a slight seasonal dip in the second quarter.

Financials

The stock took a hit recently on what we believe to be concerns over new accounting treatments affecting net income and a drop in the price of the products leading to lower income.

Net income was reported to be 52% less in the first quarter compared to the previous year. This came mainly on the back of a new accounting treatment of hedging gains/losses in Canada. ERF has been hedging some of their energy production to try to maintain a more stable cash flow. Unrealized gains and losses are now included in the income statement because they are no longer counted as hedges. Please note that this is not having any impact on cash flows and therefore not affecting the dividend.

The big issue for the financials was the sharp drop in the selling price of their production. Even though production was up slightly in the first quarter, funds flow from operations was down 23% from the previous year.

However, the dividend was essentially the same as the previous year at \$1.05 versus \$1.07 last year. And cash flow was \$1.28 so the dividend was well covered. We do not look for a further significant drop in the dividend.

This drop was the likely major reason for the stock dipping and this factor should now be fading.

However, there are several factors that raise the risks. We do not like investing in stocks that have a lot of potentially negative event risk, particularly if it is political in nature. There are several proposed tax changes that could have a major impact on the stock, particularly for US investors. The following bullet points come directly from the ERF's press release of May 7, 2004:

- ② In March of 2004, the Canadian federal government proposed amendments to the Canadian Income Tax Act, which, if enacted in their present form, could have an

impact on the Income Trust sector. The first proposal is an additional withholding tax applied to the return of capital portion of distributions paid to non-Canadian resident unitholders. Our non-resident unitholders are currently subject to an existing Canadian withholding tax on approximately 85% of the monthly distributions paid. This proposal would see the remaining 15% of the cash distribution also taxed at a rate of 15% representing an approximate 2.2% increase in the amount withheld from distributions paid to non-residents of Canada.

- ② The second proposal is a requirement that could put some restrictions on the number of the Funds' units that could be owned by non-residents. This change would require that Enerplus "not be maintained primarily for the benefit of non-residents" in order to maintain its mutual fund trust status. The legislation as proposed would give us until January 1, 2007, or well over two years, to meet this ownership restriction. Enerplus' current foreign ownership is estimated to be 64%.
- ② The final budget proposal that could affect trusts relates to restrictions of ownership of "business income trusts" by Canadian pension funds. We do not believe we would be affected by this proposal as we believe we would qualify as a "resource royalty trust" that will not be subject to pension ownership restrictions. As this is still proposed legislation, we feel it would be premature to initiate changes to deal with these proposals until there is greater certainty around their final form and enactment. We are, however, assessing our options to deal with these proposals should they become enacted substantially in their current form.

Conclusion

Frankly, the company appears to be well run. We are disappointed about the shortsightedness of the Canadian authorities. This puts a major amount of uncertainty into the investment into this stock.

Our motto is "When in doubt, stay out" and that applies here.

The Bottom Line

We are highly attracted to the high yield of ERF and believe that management has done an excellent job of managing the company. But we are very concerned over the potential tax changes on the ownership of Americans

As a result, we are avoiding the stock for now until the legal and tax status is clarified.