Initiating Coverage of Linn Energy (LINE)

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Price(2/25/2011): $39.17

Market Capitalization: $5.77 Billion

Enterprise Value: $8.04 Billion

Current Distribution Yield: 6.80%

Initiating Coverage of Linn Energy- Buy

Overview

Linn Energy is a Master Limited Partnership (MLP) that focuses on the exploration and production (E&P) of natural gas and oil resources. The company operates in four main regions: Mid-Continent (61% of total reserves), Permian Basin (19% of total reserves), Michigan (12% of total reserves), and California (8% of total reserves). Of the total reserves (2.4 Tcef), 52% is oil and NLGs and 48% natural gas and its reserve life index is greater than 20 years.

What separates Linn Energy from its competitors is its organic growth potential. Given that MLPs need to return a large portion of their cash flow to maintain the tax advantaged position, MLPs grow through acquisition. These purchases are mainly paid with a combination of debt and cash raised through secondary stock offerings. While Linn Energy is likely to continue to growth through acquisitions, its Granite Wash (in Mid-Continent) and Wolfberry (in Permian Basin) holdings create an organic growth potential that few other E&P MLPs can offer. As such, Linn Energy will likely increase its distributable cash flow at a greater rate leading to a larger compound annual growth (CAGR) of its distribution.

2010- Solid Operational Performance

Linn Energy recently announced it 4th quarter and full year results (http://finance.yahoo.com/news/LINN-Energy-Announces-Fourth-pz-3799558276.html?x=0&.v=1) and they were another solid performance. Production increased 22% to 265 MMcfe/d with a realized price (hedged) of $94.71 Bbl and $8.52 per Mcf. The distribution coverage for 2010 improved to 1.23x from 1.14x in 2009. The company also guided to a $3.28 distributable cash flow per unit for 2011 and a full year coverage ratio of 1.24x.

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Granite Wash, Wolfberry, and Organic Growth

The Granite Wash is a highly economic resource play (http://sobekanalytics.com/yahoo_site_admin/assets/docs/naturalgas_investing.51205051.pdf) as it contains high amounts of NGLs. Linn Energy has over 77,000 net acres in the Granite Wash with over 100 locations suitable for horizontal drilling. In 2010, the company drilled 8 locations and had initial productions ranging from 18.5 MMcfe/d to 60.2 MMcfe/d. Currently there is one well with flowback, two that are completing, and five waiting on completion.

The company added to its acreage in the Wolfberry trend in 2010 and plans to have 5 rigs operating in 2011 and drill 130 wells. Initial productions in the Wolfberry Trend average over 130 Boe/d to as much as 710 Boe/d. Again the economics of the resource play are great with rates of return over 50%. While the company does not offer specific guidance, slide 13 from its Hollywood Investor presentation in February (http://files.shareholder.com/downloads/LINE/1179110879x0x438567/C7AA723F-16BD-4B2C-BA05-420D83E297B1/Hollywood_Investor_Presentation_February_FINAL.pdf) shows that organic growth alone can raise production from 320 MMcfe/d in 2010 to 450 MMcfe/d in 2015 (about 7% CAGR).

The Granite Wash can produce rates of returns that start at 20% for the most pessimistic assumptions to 1,700% for the most optimistic.

Importance of Compound Annual Growth

Investors often turn to MLPs in a search for yield but reaching for yield at any cost can harm returns in the long run. In general, E&P MLPs have a higher yield than their Gathering and Processing (G&P) brethren. This difference derives from the G&Ps getting more of their earnings from fee based services and thus have less exposure to commodity prices. For investors willing to take on the extra risk of the exposure to commodity prices, E&P MLPs are good bet.

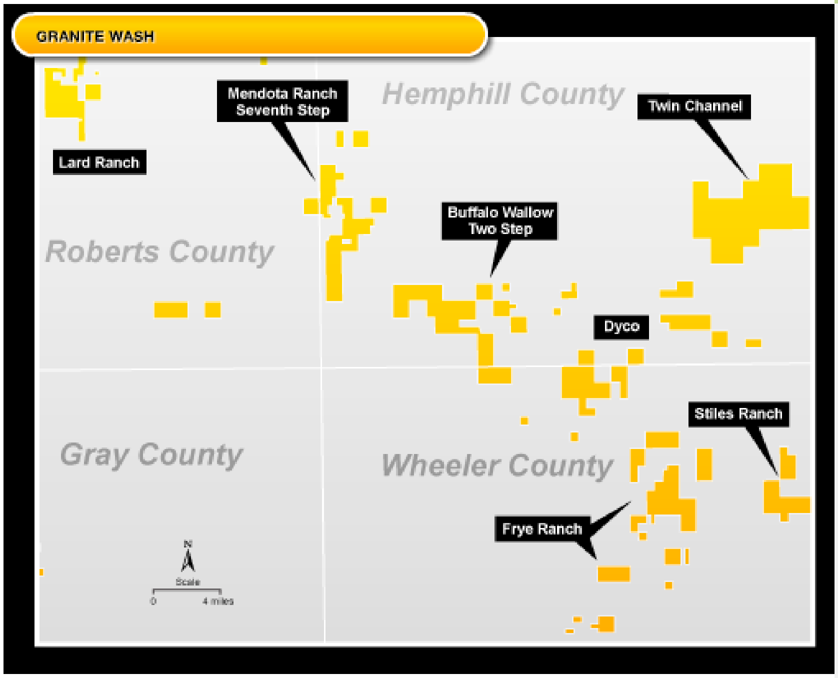
Within the E&P space, however, higher yields are not necessarily better. Higher yields imply more risk and can result from two main factors. First, companies vary in their hedging strategies and thus a higher yield could signal a less aggressive hedging strategy. Thus, while you get more yield, the risk is that the distributions may be vulnerable in the future if prices fall.

The second factor comes from the ability of a company to grow the distributions in the future. This is critical if one is investing for the long term. A 9% yield may seem tempting but there may be little chance of it increasing in the future. As such, it would be better to accept a lower initial yield if the company is able to grow it quickly. Overall, Linn Energy offer a good yield and nice growth prospects.

The Economics of the Granite Wash

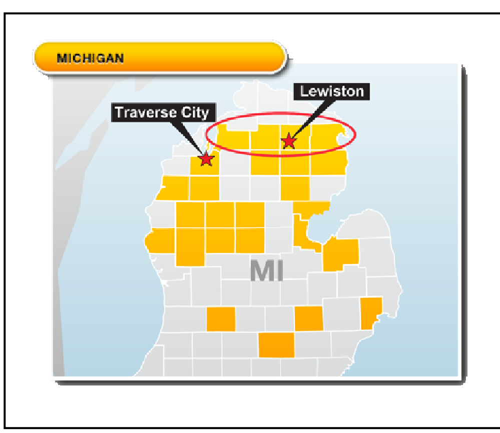
The Granite Wash is one of the most economic resources plays in the United States. If you assume a price deck of oil at $80 and natural gas of $4, a 25% royalty burden, and $9 million in total well costs, then returns will range from 20% to over 1,700% given initial production and NGL realization. For instance, if the initial production were only 15 MMcfe/d and NGL realization 20%, then the rate of return would be roughly 20%. Keep in mind that the lowest initial production achieved in 2010 from a Granite Wash well was 18.5 MMcfe/d, so the 15 MMcfe/d is likely overly conservative. Bumping the initial production up to 20 MMcfe/d (a more realistic number) raises the rate of return up to 50%. At that same 20 MMcfe/d initial production, an increase in NGL realization from 20% to 40% would increase the rate of return to 75%. While it is not known what the average NGL realizations are for the company, if one assumes that it is between 20% to 40% this gives a rate of return on the Granite Wash wells of between 50% and 75%. Keep in mind that these rates of returns are with relatively conservative estimates of the price of oil and gas.

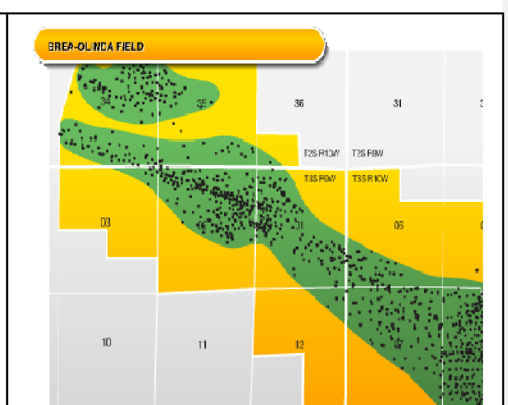
In fact, the company has hedged both its oil and gas production out to 2015 to lock in attractive rates of return. In 2011, for instance, natural gas is hedged at an average price of $8.24 (more than twice the price deck assumed for the Granite Wash economics) but that decreases to $6.07 in 2012 down to $5.66 in 2015 (still above the price deck). In terms of oil, the average hedged price in 2011 is $84.09 which increases to $93.58 in 2014 but down to $87.04 in 2015. Again, all of the oil prices are above the price deck so the rates of returns in the Granite Wash are likely conservative. Also, it is important to keep in mind that while the prices are hedged out to 2015, this does not cover the entire expected production. Out to 2013 100% of the production is hedge but that drops to 80% in 2014.



The Rest of Linn Holdings

While Granite Wash and the Wolfberry Trend represent the bulk of organic growth opportunities, Linn Energy operates in a number of other areas where we may see bolt on acquisitions. The company, however, may also divest some of these holdings to expand in the more economic regions. Regardless, the company has current operations in Michigan and California. In Michigan, the acreage lies in the Antrim shale, which often produces methane and requires fracturing. For more general information on the Antrim Shale, see (http://oilshalegas.com/antrimshale.html). Linn Energy is also looking into the Utica-Collingnwood shale in Michigan as well (http://oilshalegas.com/collingwoodshale.html). In California Linn's holdings are in the Brea Olinda field, which has a long history of producing oil (http://en.wikipedia.org/wiki/Brea-Olinda_Oil_Field). In fact, this is probably the oiliest region for Linn Energy.





02/24/11
10:00 AM CT **Q4 and YE 2010 Earnings Conf. Call**
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Feb 28–Mar 2, 2011	**JPMorgan Global High Yield and Leveraged Finance Conference** Remind me
Mar 6–9, 2011	**Raymond James Conference** Remind me
03/08/11 2:00 PM - 3:00 PM ET	**LINN Energy Investor Update - Orlando** Additional Information Remind me
04/02/11	**KCI Summit - Panel Discussion** Remind me
04/11/11	**IPAA OGIS New York** Listen to webcast Remind me
May 9–12, 2011	**Money Show Las Vegas** Link to website Remind me
May 25–26, 2011	**NAPTP Investor Conference** Remind me
Jun 6–7, 2011	**RBC Energy & Power Conference** Remind me
Aug 10–12, 2011	**Money Show San Francisco** Link to website Remind me
Aug 14–18, 2011	**EnerCom Oil and Gas Conference** Remind me

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