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Day of Reckoning

By VITO J. RACANELLI

WHEN ENERGY PRICES RALLY sharply, as they are doing now, investors love to prospect among the oil majors. And the higher into the stratosphere that petroleum and gas prices go, the better even smaller and riskier exploration and production (E&P) plays look.

Stuart Goldenberg

In five of the past seven quarters, Delta has missed initial production guidance.

Delta Petroleum (ticker: DPTR) is one of the small fry, but it's unlikely to become the gusher of gains that many of its fans expect. When the company reports third-quarter results Thursday, shareholders probably will focus more on the Denver company's most important drilling programs than on the quarterly numbers.

In particular, they'll look for good news on projects the company has touted as potentially big natural-gas plays. Given Delta's funding needs, tepid cash-flow growth and history of over promising and underperforming on gas production, any disappointment could batter the stock, now around 17, versus a high of 24 earlier this year.

Without a major gas find soon, the shares could sag further, perhaps by 20% or more. Analysts generally expect Delta to bleed red ink this year and maybe next. And, Merrill Lynch warns, it might need to go to the capital markets again next year to fund 2009 operations.

Stock/Ticker	Earnings Per Share '07E	Earnings Per Share '08E	EV/Ebitda '07E	EV/Ebitda '08E	EV Per/ Mcfe*
Berry Petroleum/BRY	$2.18	$3.13	8.2x	7.3x	$2.89
Bill Barrett/BBG	0.86	1.41	8.6	6.4	5.07
Delta Petroleum/DPTR	–0.47	–0.06	NM**	12.5	5.14
Whiting Petroleum/WLL	2.53	2.83	7.0	6.3	2.01
Group Average***			9.4	8.5	3.82

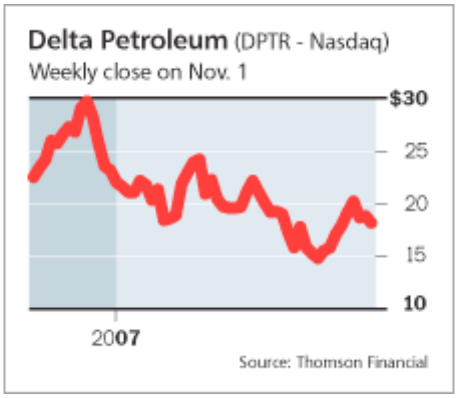
EV=Enterprise value. Ebitda=Earnings before interest, taxes, depreciation and amortization. E=Estimate. *Millions of cubic feet of natural-gas equivalent proven. ** Not meaningful. ***Group includes 11 companies. All data as of Oct. 29. Source: Merrill Lynch

Expensive Gas: Among small-cap E&P stocks, Delta Petroleum sells at a rich premium, though it's operating in the red and appears to lack the prospecting prowess that its multiple would imply.

Delta has already raised over $300 million in four equity transactions in the past 30 months, of which some $178 million came in early 2007 after it violated debt covenants and restrictions. It's now in compliance.

DESPITE THE RISKS, DELTA Petroleum continues to trade at a high valuation compared with its peers. This year, shares of this $1 billion market-value producer of mostly natural gas have reflected excitement over a couple of ballyhooed U.S. gas fields, especially in the Columbia River Basin straddling the Washington and Oregon border, and in Utah. For much of 2006 and 2007, the CRB was front and center in investors' minds.

Speculation ran high, beginning in 2006, about a possible jackpot there.

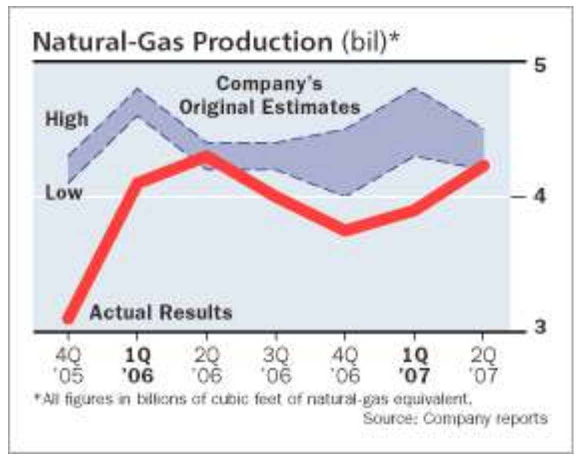


Yet more than 12 months later, little has come from the CRB play, though Delta Petroleum began drilling two wells there in 2006's first half. This is especially worrisome because the basin accounts for some 34% of the company's net undeveloped acreage and is considered by many investors as Delta's most important bet.

In a Sept. 26 press release, Delta said that it was looking for a partner to continue drilling on another CRB well in the fourth quarter, but didn't mention the two wells it drilled there last year. On Oct. 25, **EnCana** (ECA), a much larger E&P firm that has worked with Delta in the Columbia River Basin, said that it was concluding its own program there after drilling three wells. While few dispute that natural-gas fields exist in the CRB, they are very deep and under a large layer of basalt, making the gas not economical to extract. Thus, much will be riding Thursday on news of Delta's fields elsewhere, none of which appear to have the gas potential that CRB was thought to have.

In the past, Delta has had disappointments at other fields, including the DJ Basin field in Colorado and the Howard Ranch Wyoming project. At another site, the promising Paradox Basin in Utah, Delta Petroleum has run into mechanical problems, notes Robert Lynd, a Simmons & Co analyst who downgraded the stock Oct. 3 to Neutral from Overweight.

Adding to the pressure on Delta Petroleum is that, in five of the seven quarters, the company has missed initial production guidance. It has a similarly checkered history of missing analysts' earnings estimates.



No Guidance Counseling: Although Delta Petroleum has a checkered history on meeting gas-production and profit guidance, its high valuation suggests that investors still believe that it will hit a major natural-gas find.

THE NEAR FUTURE DOESN'T look rosy. The consensus expectation is for losses of 65 cents a share this year and 39 cents next year. In the first half, Delta lost $113 million, or $1.94 a share, thanks partly to $69 million in asset-impairment charges and dry-hole costs. The latter rose to $15 million from $1.4 million a year earlier, suggesting that Delta isn't finding as much gas as investors expect. In 2006, revenue jumped 64%, to $176 million, but much of that came from drilling and contract-trucking fees, while oil and gas sales rose less, at 27%. Annual profit fell to one cent a share from 13 cents in 2005. After extraordinary gains are stripped out, the loss from continuing operations was 26 cents, the same as 2005.

David Trainer, president of New Constructs, an independent stock researcher, calls Delta "a terribly unprofitable business." Its shares get a Dangerous rating from his firm, which ranks 3,000 U.S. stocks. To justify its rich price, he estimates, Delta Pete must show annual increases of 20% a year in revenue and 42% in net operating profit after taxes for the next decade or so -- a tall order for even the top E&P outfits.

Cash flow is crucial to fund drilling. Last year, it rose less than $3 million, to $53.4 million. And it slid by $4 million in 2007's first half, to $24.7 million. Delta has a 2007 drilling budget around $245 million-$255 million and expects the same for 2008.

Merrill Lynch analyst Eric Hagen sees the company outspending its cash flow from operations by $217 million through 2008. On Aug. 9, he put a Sell rating on the shares, with a fair value of 13. In a report following the company's Sept. 26 press release, he wrote: "At midyear, Delta had roughly $90.3 million in cash from proceeds of its debt and equity offering and $130 million available on its line of credit, or $220 million in total available capital. Assuming the company executes on its production-capex forecast, we estimate it will exit 2008 with minimal cash, a tapped-out line of credit and a 51% net-debt-to-capital ratio."

Hagen estimates that to "execute a similar [drilling] program in 2009, Delta will need to pursue an additional $170 million in capital to fill the gap between our flat capex assumption and $100 million from cash flow from operations."

To make up the shortfall, the company would have to sell potentially lucrative acreage or obtain external financing by selling stock or raising debt. Earlier this year, it sold 9 million new shares at prices of 20.50 and 20.98, diluting existing stockholders' interest by roughly 20%.

Delta stock is valued at about $5.14 a million cubic feet of gas equivalent in proven reserves, a third higher than the peer average of $3.82. Hagen figures that Delta receives a premium worth about $6.00 a share for exploration potential. Should Delta, which didn't return phone calls from Barron's, not produce the natural-gas finds for which investors are paying so dearly, a chunk of that big premium could evaporate. It's often said that no news is good news. But, come Thursday, no news might be bad news for Delta investors.

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