ENCORE ACQUISITION CO
Form 10-Q
August 06, 2004

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-Q

(Mark One)

[x] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended June 30, 2004
or
[   ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from __________ to __________

Commission file number 1-16295

ENCORE ACQUISITION COMPANY

(Exact name of registrant as specified in its charter)

Delaware	**001-16295**	**75-2759650**
(State or other jurisdiction of incorporation)	(Commission File Number)	(IRS Employer Identification No.)

777 Main Street, Suite 1400, Fort Worth, Texas	**76102**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: (817) 877-9955

Not applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [x] No [   ]

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2)

Yes [x] No [   ]

Number of shares of Common Stock, $0.01 par value, outstanding as of July 23, 2004 32,559,782

ENCORE ACQUISITION COMPANY
TABLE OF CONTENTS

	Page
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements	
Consolidated Balance Sheets as of June 30, 2004 and December 31, 2003	1
Consolidated Statements of Operations for the three and six months ended June 30, 2004 and 2003	2
Consolidated Statement of Stockholders Equity for the six months ended June 30, 2004	3
Consolidated Statements of Cash Flows for the six months ended June 30, 2004 and 2003	4
Notes to Consolidated Financial Statements	5
Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	10
Item 3. Quantitative and Qualitative Disclosures About Market Risk	20
Item 4. Controls and Procedures	20
PART II. OTHER INFORMATION	
Item 4. Submission of Matters to a Vote of Security Holders	21
Item 6. Exhibits and Reports on Form 8-K	21
Signatures	23
Rule 13a-14(a)/15d-14(a) Certification	
Rule 13a-14(a)/15d-14(a) Certification	
Section 1350 Certification	
Section 1350 Certification	

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

ENCORE ACQUISITION COMPANY

CONSOLIDATED BALANCE SHEETS

(in thousands except shares and per share amounts)

	June 30, 2004	December 31, 2003
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,791	$ 431
Accounts receivable	36,950	27,640
Inventory	8,992	6,019
Derivatives	3,175	5,588
Deferred taxes	5,439	3,592
Other current	3,919	1,673
Total current assets	61,266	44,943
Properties and equipment, at cost successful efforts method:		
Proved properties	1,021,181	739,288
Unproved properties	10,478	921
Accumulated depletion, depreciation, and amortization	(144,282)	(124,646)
	887,377	615,563
Other property and equipment	9,200	3,831
Accumulated depreciation	(2,983)	(2,586)
	6,217	1,245
Goodwill	38,623	
Debt issuance costs	8,632	5,304
Other assets	7,557	5,083

Total assets	$1,009,672	$ 672,138
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 14,966	$ 10,668
Derivatives	19,997	8,026
Accrued and other current	33,453	26,301
Total current liabilities	68,416	44,995
Derivatives	19,290	3,514
Future abandonment costs	6,559	5,341
Deferred taxes	130,256	80,313
Long-term debt	353,000	179,000
Total liabilities	577,521	313,163
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $.01 par value, 5,000,000 shares authorized, none issued and outstanding		
Common stock, $.01 par value, 60,000,000 authorized, 32,559,842 and 30,335,693 issued and outstanding	326	303
Additional paid-in capital	312,267	253,865
Deferred compensation	(5,359)	(2,528)
Retained earnings	152,258	117,365
Accumulated other comprehensive income	(27,341)	(10,030)
Total stockholders equity	432,151	358,975
Total liabilities and stockholders equity	$1,009,672	$ 672,138

The accompanying notes are an integral part of these consolidated financial statements.

1

Table of Contents

ENCORE ACQUISITION COMPANY

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands except per share amounts)
(unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2004	**2003**	**2004**	**2003**
Revenues:				
Oil	$52,885	$40,704	$ 99,649	$ 87,136
Natural gas	17,237	10,539	29,764	19,894
Total revenues	70,122	51,243	129,413	107,030
Expenses:				
Production				
Lease operations	10,921	9,140	21,163	18,093
Production, ad valorem, and severance taxes	7,161	5,095	13,000	11,264
Depletion, depreciation, and amortization	11,249	7,703	20,512	15,486
Exploration	1,697		1,697	
General and administrative (excluding non-cash stock based compensation)	2,530	2,340	4,758	4,790
Non-cash stock based compensation	307	150	617	295
Derivative fair value (gain) loss	965	(576)	1,123	(1,836)
Other operating	1,091	712	2,093	882
Total expenses	35,921	24,564	64,963	48,974
Operating income	34,201	26,679	64,450	58,056
Other income (expenses):				
Interest	(6,308)	(4,039)	(10,214)	(8,210)
Other	106	39	157	86
Total other income (expenses)	(6,202)	(4,000)	(10,057)	(8,124)

Income before income taxes and cumulative effect of accounting change	27,999	22,679	54,393	49,932
Current income tax provision	(919)	(591)	(2,004)	(1,358)
Deferred income tax provision	(9,089)	(7,855)	(17,496)	(17,226)
Income before cumulative effect of accounting change	17,991	14,233	34,893	31,348
Cumulative effect of accounting change, net of income taxes of $529				863
Net income	$17,991	$14,233	$ 34,893	$ 32,211
Income before cumulative effect of accounting change per common share:				
Basic	$ 0.59	$ 0.47	$ 1.15	$ 1.04
Diluted	0.58	0.47	1.13	1.04
Net income per common share:				
Basic	$ 0.59	$ 0.47	$ 1.15	$ 1.07
Diluted	0.58	0.47	1.13	1.06
Weighted average common shares outstanding:				
Basic	30,726	30,089	30,456	30,063
Diluted	31,120	30,284	30,847	30,253

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

ENCORE ACQUISITION COMPANY

CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

June 30, 2004
(in thousands)
(unaudited)

	Common Stock	Additional Paid-In Capital	Deferred Compensation	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders Equity
Balance at December 31, 2003	$ 303	$253,865	$ (2,528)	$117,365	$(10,030)	$358,975
Exercise of stock options	1	1,880				1,881
Issuance of common stock	20	53,076				53,096
Deferred compensation:						
Issuance of restricted common stock	2	3,332	(3,334)			
Amortization of expense			617			617
Other changes		114	(114)			
Components of comprehensive income:						
Net income				34,893		34,893
Change in deferred hedge loss, net of income taxes of $10,610					(17,311)	(17,311)
Total comprehensive income						17,582
Balance at June 30, 2004	$ 326	$312,267	$ (5,359)	$152,258	$(27,341)	$432,151

The accompanying notes are an integral part of these consolidated financial statements.

3

Table of Contents

ENCORE ACQUISITION COMPANY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)
(unaudited)

	Six months ended June 30, 2004	Six months ended June 30, 2003
Operating activities		
Net income	$ 34,893	$ 32,211
Adjustments to reconcile net income to net cash provided by operating activities:		
Depletion, depreciation, and amortization	20,512	15,486
Deferred taxes	17,496	17,226
Non-cash stock based compensation	617	295
Cumulative effect of accounting change		(863)
Non-cash derivative fair value (gain) loss	6,106	(892)
Exploration expense	1,697	
Other non-cash	779	3,472
Loss on disposition of assets	109	129
Changes in operating assets and liabilities:		
Accounts receivable	(3,882)	(376)
Other current assets	(8,357)	(692)
Other assets	(309)	(7,456)
Accounts payable and accrued liabilities	4,829	(7,390)
Cash provided by operating activities	74,490	51,150
Investing activities		
Proceeds from disposition of assets	425	590
Purchases of other property and equipment	(6,597)	(292)
Acquisition of oil and natural gas properties	(98,608)	(259)
Acquisition of Cortez Oil & Gas, Inc. (net of cash acquired)	(123,023)	
Development of oil and natural gas properties	(70,573)	(46,198)
Cash used by investing activities	(298,376)	(46,159)
Financing activities		
Proceeds from issuance of common stock	53,900	
Payment of offering costs of common stock	(900)	

Proceeds from long-term debt	169,000	24,500
Payments on long-term debt	(145,000)	(40,500)
Proceeds from issuance of 6¼% notes	150,000	
Payment of debt issuance costs	(3,128)	
Other	2,374	777
Cash provided by (used in) financing activities	226,246	(15,223)
Increase (decrease) in cash and cash equivalents	2,360	(10,232)
Cash and cash equivalents, beginning of period	431	13,057
Cash and cash equivalents, end of period	$ 2,791	$ 2,825

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents

ENCORE ACQUISITION COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2004
(unaudited)

1. Formation of Encore

Encore Acquisition Company (Encore or the Company), a Delaware corporation, is a growing independent energy company engaged in the acquisition, development and exploitation of North American oil and natural gas reserves. Since the Company s inception in 1998, Encore has sought to acquire high-quality assets with potential for upside through low-risk development drilling projects. Encore s properties are currently located in four core areas: the Cedar Creek Anticline (CCA), of Montana and North Dakota; the Permian Basin of West Texas and Southeastern New Mexico; the Mid Continent area, which includes the Arkoma and Anadarko Basins of Oklahoma, the North Louisiana Salt Basin, the East Texas Basin and the Barnett Shale near Fort Worth, Texas; and the Rocky Mountains.

2. Basis of Presentation

In the opinion of management, the accompanying unaudited consolidated financial statements of Encore include all adjustments necessary to present fairly our financial position as of June 30, 2004, results of operations for the three and six months ended June 30, 2004 and 2003, and cash flows for the six months ended June 30, 2004 and 2003. All adjustments are of a recurring nature. These interim results are not necessarily indicative of results for an entire year.

Certain amounts and disclosures have been condensed or omitted from these consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Therefore, these consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes thereto included in the Company s 2003 Annual Report filed on Form 10-K.

Employee stock options and restricted stock awards are accounted for at intrinsic value in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25). Accordingly, no compensation expense is recorded for stock options that are granted to employees or non-employee directors with an exercise price equal to or above the Company s stock price on the date of grant. However, compensation expense is recorded for the fair value of the restricted stock granted to employees. During the second quarter of 2004, the Company awarded 57,161 shares of restricted stock under the Company s 2000 Incentive Stock Plan. The shares vest in equal annual installments over the next three years and are contingent only upon continued employment. Deferred compensation of $1.6 million was recorded in conjunction with the grants, and will be expensed over the related vesting period.

If employee stock options were accounted for at fair value in accordance with the provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, the Company s reported net income and net income per share amounts would have been adjusted to the pro forma amounts indicated below (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2004	**2003**	**2004**	**2003**

As Reported:				
Non-cash stock based compensation (net of taxes) (a)	$ 190	$ 95	$ 383	$ 186
Net income	17,991	14,233	34,893	32,211
Basic net income per common share	0.59	0.47	1.15	1.07
Diluted net income per common share	0.58	0.47	1.13	1.06
Pro Forma:				
Non-cash stock based compensation (net of taxes)	$ 518	$ 523	$ 924	$ 946
Net income	17,663	13,805	34,352	31,451
Basic net income per common share	0.57	0.46	1.13	1.05
Diluted net income per common share	0.57	0.46	1.11	1.04

(a) For the quarter ended June 30, 2004, 6,509 shares of employee stock options and 1,810 shares of restricted stock, which were issued and outstanding at March 31, 2004, were forfeited. For the first half of 2004, 12,685 shares of employee stock options and 9,176 shares of restricted stock, which were issued and outstanding at December 31, 2003, were forfeited.

Table of Contents

3. Business Combinations

Cortez Acquisition

On April 14, 2004, the Company purchased all of the outstanding capital stock of Cortez Oil & Gas, Inc. (Cortez), a privately held, independent oil and natural gas company, for a total purchase price of $126.3 million, which includes cash paid to Cortez former shareholders of $85.8 million, the repayment of $39.4 million of Cortez s debt, and transition costs incurred of $1.1 million.

Encore funded the acquisition with a portion of the net proceeds from the issuance of the 6¼ Notes (see Note 4). The net proceeds from the notes were placed in escrow upon the closing of the offering and were released to fund the Cortez acquisition in accordance with the terms of the escrow agreement with the initial purchasers of the 6¼% Notes.

The acquired oil and natural gas properties are located primarily in the CCA of Montana, the Permian Basin of West Texas and Southeastern New Mexico and in the Mid Continent area, including the Anadarko and Arkoma Basins of Oklahoma and the Barnett Shale north of Fort Worth, Texas. Cortez operating results are included in Encore s Consolidated Statement of Operations for the period April through June 2004.

The calculation of the total purchase price and the calculation of the fair value of net assets acquired at April 14, 2004, are as follows (in thousands):

Calculation of total purchase price:	
Cash paid to Cortez former owners	$ 85,793
Cortez debt repaid	39,449
Transaction costs	1,050
Total purchase price	$126,292
Calculation of fair value of net assets acquired:	
Cash	$ 3,269
Current assets	5,574
Proved oil and gas properties	120,503
Unproved oil and gas properties	3,011
Goodwill	38,623
Total assets required	170,980
Current liabilities	(5,426)
Non-current liabilities	(996)
Deferred income taxes	(38,266)
Total liabilities assumed	(44,688)

Fair value of net assets acquired	$126,292

The purchase price allocation resulted in $38.6 million of goodwill primarily as the result of the difference between the fair value of oil and gas properties and their assumed tax basis. None of the goodwill is deductible for income tax purposes. Furthermore, in accordance with SFAS No. 142, Goodwill and Intangible Assets, goodwill is not amortized, but is tested for impairment on a quarterly basis, which involves the use of estimates related to the fair market value of the business operations and reporting unit with which goodwill is associated. Currently, Encore has one reporting level. Losses, if any, resulting from impairment tests will be reflected in operating income in the Consolidated Statement of Operations.

4. Debt

Issuance of 6 ¼ % Senior Subordinated Notes

On April 2, 2004, the Company issued $150.0 million of 6¼% Senior Subordinated Notes maturing April 15, 2014 (the 6¼% Notes). The offering was made through a private placement. The 6¼% Notes were resold by the initial purchasers pursuant to Rule 144A and Regulation S. The Company estimates net proceeds of approximately $146.2 million after paying all costs associated with the offering. The net proceeds were used to fund the acquisition of Cortez (see Note 3) and repay amounts outstanding under the Company s revolving credit facility. Concurrently with the issuance of the 6¼% Notes, the Company entered into a registration rights agreement whereby Encore agreed to file a registration statement offering to exchange the 6¼% Notes for registered notes with substantially identical terms. The Company filed the registration statement on June 30, 2004 on Form S-4. The registration statement was declared effective by the SEC on July 14, 2004, and the related offer to exchange the outstanding Notes for registered notes was launched on July 21, 2004. The exchange offer expires at 5:00 p.m., New York City time, on August 19, 2004.

The 6¼% Notes mature on April 15, 2014, and all amounts outstanding will be due and payable at that time. Interest is paid semi-annually on April 15 and October 15. The indenture governing the 6¼% Notes contains substantially the same covenants and restrictions as the 8 % Notes.

Letters of Credit

The Company had $14.4 million of outstanding letters of credit at June 30, 2004. These letters of credit are posted primarily with two counterparties to the Company s hedging contracts and are used in lieu of cash margin deposits with those counterparties.

5. Asset Retirement Obligations

In August 2001, the Financial Accounting Standards Board issued SFAS 143, Accounting for Asset Retirement Obligations, which the Company adopted as of January 1, 2003. This statement requires the Company to record a liability in the period in which an asset retirement obligation is incurred in an amount equal to the discounted estimated fair value of the obligation. Also, upon initial recognition of the liability, the Company must capitalize an equal amount of asset cost. Thereafter, each quarter, this liability is accreted and, if needed, adjusted up to the final cost. Accretion expense is included in Other operating expense in the Company s Consolidated Statements of Operations.

The adoption of SFAS 143 on January 1, 2003 resulted in a cumulative effect of accounting change adjustment to record (i) a $4.0 million increase in the carrying values of proved properties, (ii) a $2.1 million decrease in accumulated depletion, depreciation, and amortization, (iii) a $5.2 million increase in non-current liabilities, and (iv) a gain of $0.9 million, net of tax.

The following table shows net income and basic and diluted net income per common share as reported, as well as pro forma amounts as if the Company had adopted SFAS 143 prior to January 1, 2003 (in thousands, except per common share amounts):

	Six months ended June 30,	
	2004	**2003**
As Reported:		
Net income	$34,893	$32,211
Basic net income per common share	1.15	1.07
Diluted net income per common share	1.13	1.06
Pro Forma:		
Net income	$34,893	$31,348
Basic net income per common share	1.15	1.04
Diluted net income per common share	1.13	1.04

The Company s primary asset retirement obligations relate to future plugging and abandonment expenses on our oil and natural gas properties and related facilities disposal. As of June 30, 2004, the Company had $3.0 million held in an escrow account from which funds are released only for reimbursement of plugging and abandonment expenses on our Bell Creek property. This amount is included in Other assets in the accompanying Consolidated Balance Sheet. The following table summarizes the changes in the Company s future abandonment liability from January 1, 2004 through June 30, 2004 (in thousands):

Future abandonment liability at January 1, 2004	$5,341
Property acquisitions	995
Wells drilled	126
Accretion expense	148
Plugging and abandonment costs incurred	(51)
Future abandonment liability at June 30, 2004	$6,559

6. Income Taxes

Reconciliation of income tax expense with tax at the Federal statutory rate is as follows (in thousands):

Table of Contents

	Six months ended June 30,	
	2004	2003
Income before income taxes and the cumulative change in accounting	$54,393	$49,932
Tax at statutory rate	19,038	17,476
State income taxes, net of federal benefit	1,632	1,498
Section 43 credits generated	(1,663)	(30)
Other	493	(360)
Total	$19,500	$18,584

7. Earnings Per Share (EPS)

The following table sets forth basic and diluted EPS computations for the three and six months ended June 30, 2004 and 2003 (in thousands, except per share data):

	Three months ended June 30,		Six months ended June 30,	
	2004	2003	2004	2003
Numerator:				
Income before cumulative effect of accounting change	$17,991	$14,233	$34,893	$31,348
Cumulative effect of accounting change				863

&