The Three Best Natural-Gas Stocks Money Can Buy

A special report from The Yield Shark Research Team

MAULDIN ECONOMICS

There is a revolution going on in North America. We aren’t talking about the Tea Party or the Occupy Wall Street crowd.

We’re talking about an energy revolution. In fact, it won’t be long before the United States is finally, and permanently, energy independent.

With new technology, American energy companies are going gangbusters. They’ve increased our daily energy production to 6.5 million barrels per day, a 15-year high.

As a result, they’ve slashed our dependence upon foreign oil from a whopping 60.3% in 2005 to a hair over 49% today.

That is simply astounding progress. Coupled with our country’s rich natural-gas and other hydrocarbon reserves, we can now all be proud that energy independence could be less than 20 years away.

We have found so much natural gas and oil in this country, with new procedures and new technology, that we can become energy independent in less than 20 years, maybe even by the end of the decade.”
– John Mauldin

There are vast reserves of oil and natural gas trapped in shale formations deep beneath the earth’s surface.

According to the United States Geological Survey, the number of recoverable barrels of shale oil/gas is around 1.8 trillion. To put that number into perspective, Saudi Arabia is estimated to have roughly 2.6 trillion barrels.

Going With the Flow

Natural-gas futures, daily settlement price on the continuous front-month contract

Source: Thomson Datastream
The Wall Street Journal

That is enough natural gas to serve all the energy needs of the United States for at least the next 100 years, and that is the key to our energy independence.

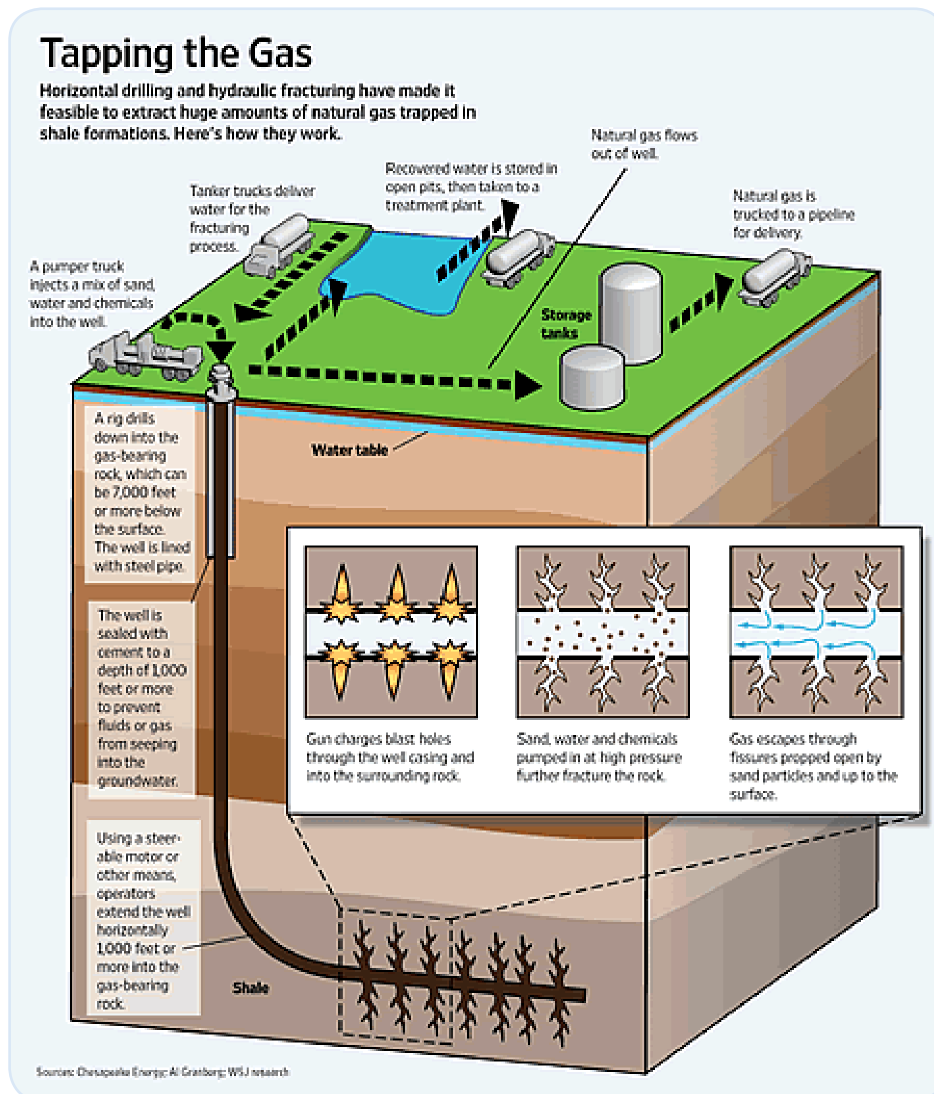
According to a recent report from the Manhattan Institute, the United States is now the fastest-growing producer of oil and natural gas in the world.

Our country’s vast natural-gas reserves have already revived many local and state economies by providing tax revenues and high-paying job opportunities in Texas, Louisiana, Oklahoma, Arkansas, Colorado, Pennsylvania, and especially North Dakota, where an economic boom is occurring.

The catalyst for this natural-gas boom is new technology that has unlocked previously unavailable vast deposits of natural gas. That new technology is called hydraulic fracturing or "fracking."

Here's a link to a free,six-minute video about fracking: http://www.youtube.com/watch?v=VY34PQUiwOQ

The technology of fracking has allowed for the recovery of resources once thought impossible, is the driving force behind the drop in natural-gas prices, and is an energy source that will make the US completely energy independent in the very near future.



Along the way, some natural-gas companies are going to make mountains of money. The three below are our very best income-producing investment picks.

Natural-Gas Winner #1: Line Energy

Will the next major move take oil prices to $150 or $50, and cause natural-gas prices to also double or triple? If you knew the answer to that question, you could make a mountain of money.

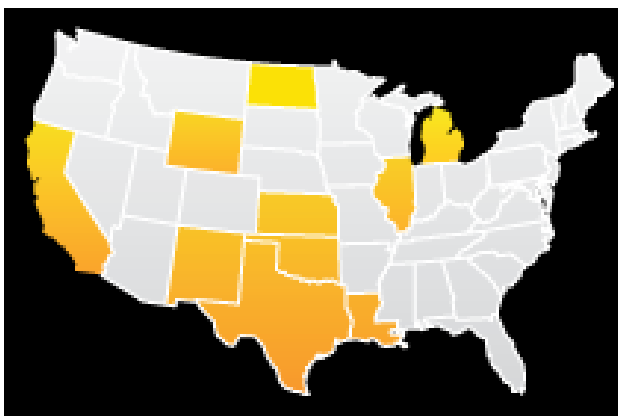
However, we've uncovered a little-known energy gem that will make money no matter which way energy prices move.

That's right; whether oil and gas prices go up or down, this stock should profit, as well as throw off a nearly 8% TAX-FREE dividend to you. That makes it the very best energy stock you can own today.

That company is Linn Energy (Nasdaq:LINE).

Most investors haven't heard of Linn Energy, but it is the eleventh-largest independent oil and natural-gas company in the US, with over 15,000 very productive oil and natural-gas wells.

Plus, Linn Energy has 4.3 trillion cubic feet equivalent of proven natural gas reserves, which is like money in the bank. At its current rate of production, Linn Energy has 21 years' worth of proven reserves.



Today, Linn Energy has approximately 1,000 employees, spread across more than two dozen locations in the United States.

The company's wells are located in the Midwest, the Southwest, Michigan, California, and North Dakota.

In 2006, Linn Energy became the first publicly traded, independent oil and natural-gas limited-liability company in the US, and is now **structured as a master limited partnership, or MLP.**

Master Limited Partnerships (MLPs) combine the tax benefits of a limited partnership with the liquidity of common stock. They are a product of the US Tax Reform Act of 1986 and the US Revenue Act of 1987.

To qualify, a firm must earn 90% of its income through activities or interest and dividend payments relating to natural resources, such as petroleum and natural-gas extraction and transportation. Like other limited partnerships, MLPs pay no income tax.

Distributions Are Tax Free

Instead of dividends, MLPs pay quarterly required distributions (QRD). These distributions are not taxed when they are received. They are treated as a return of capital, thus reducing the cost basis of the investment. MLPs are extremely tax efficient.

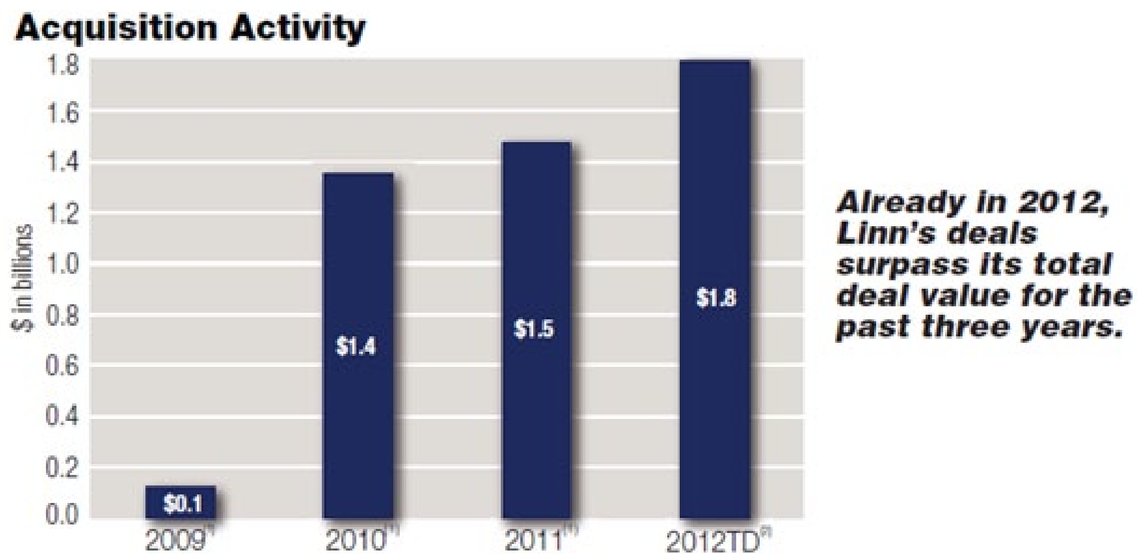
Once a year, each investor receives a K-1 statement providing details of the unit holder's share of the partnership's net income. Each year the share basis is adjusted down by the amount of cash distributions and also adjusted by the unit holder's allocation of net income. You should always consult with your tax accountant when you receive a K-1.

Since its IPO in 2006, Houston-based Linn has grown through a series of accretive acquisitions – deals that immediately increase cash flow per partnership unit, the ultimate goal.

Linn Energy isn't a speculative wildcatter that drills holes in the ground, praying to find oil. What Linn does is buy established oil and natural-gas properties and use its expertise and economies of scale to maximize the profits from those existing wells.

Linn's business model is really quite simple: it acquires mature oil- and gas-producing assets and hedges the majority of its production for five years into the future to lock in gains.

Starting with a $12-million deal in its first year, Linn Energy has made 52 transactions worth $8 billion, with a focus on acquiring producing wells and increasing their output.



Fifty-two deals may sound like a lot, but Linn Energy is extremely selective. In just the first six months of 2012, Linn Energy looked at 80 potential acquisitions, bid on only six of them, and actually closed on three of them, for a total of $1.8 billion.

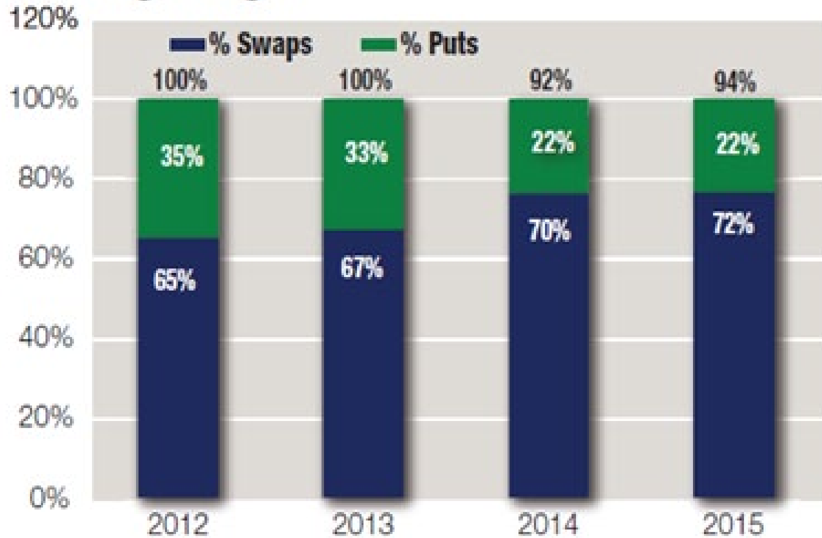
Despite its track record of successful acquisitions, the company's organic growth hasn't taken a back seat. Production grew 40% in 2011, and the management team expects growth this year to exceed 20%.

That combination of acquisitions and organic growth has translated into very impressive revenue and profit growth. Over the last five years, Linn has grown revenues and profits by an average of 43% and 52%, respectively.

Locking In Profits and Hedging Away Risk

Oil and natural-gas stocks are prone to big swings, up and down. Linn Energy has an extremely effective hedging strategy that ensures a steady stream of high dividends and provides a big, soft cushion of safety against wide swings in energy prices. These hedges provide stability for the company and investors.

One investment banker called this strategy the "secret sauce" that makes Linn Energy so profitable.



Linn uses a combination of swaps and puts, with the puts allowing participation in price upside for an up-front cost.

What Linn Energy does is employ a combination of swaps and puts that protects it from falling oil prices but still preserves a reasonable amount of upside.

Linn Energy has hedged 100% of its natural-gas production through 2017, and its oil is 100% hedged through 2015 and 94% through 2016.

That's right; no matter how far oil and natural-gas prices fall, Linn Energy is protected.

More important for income investors, this strategy secures a guaranteed stream of future cash flow that will enable Linn to continue to pay its dividend while investing for growth.

Today, that value of that cash-flow hedge stands at approximately $5.50 per Mcf for natural gas through 2015, and approximately $100 per barrel of oil – for 100% of the company's oil through 2015 and 94% through 2016.

Of course, hedging can work against you, too. In Linn Energy's case, if the price of oil shot back up to $150 a barrel, it would still only receive $100 a barrel.

The end result is that Linn Energy isn't a stock that is going to skyrocket if oil prices take off, but neither will it get clobbered by falling oil prices.

Meanwhile, you are going to get paid very well.

Love That Juicy Dividend

Linn Energy has paid out 24 consecutive quarters of dividends without fail since its inception in 2006. And it hasn't cut its dividend, despite falling energy prices that have caused many other energy trusts and master limited partnerships to rein in their payouts.

It pays out nearly $3.00 per share in dividends, which is equal to almost a 7% yield. The company has also hiked its dividend by an average of 4% a year.

Even better, because the company is structured as an MLP, the dividends are classified as a return of capital, making them 100% TAX FREE.

Let me say that again: TAX FREE!

So if you buy $10,000 worth of its shares – or $100,000 – all the payments you receive until you get back the value of your total investment are completely tax free.

Plus, regardless of what the politicians in Washington, DC do with taxes, the tax-free status of the payments you receive from the company is safe and your dividend remains tax free.

It's equivalent to a 9.33% pre-tax yield if you're in the current 25% tax bracket… 9.72% for a 28% bracket… 10.45% for a 33% bracket…

And a whopping 10.77% if you're in the highest income bracket of 35%.
If you're in a high-tax state such as New York, it's even better – it's equal to an 11.56% yield!

Finally, we believe the dividend is extremely safe, because of Linn Energy's hedging strategy as well as a super-conservative payout ratio of 56%.

Between dividends and stock appreciation, Linn Energy investors have been well rewarded. Since its 2006 inception, Linn Energy has returned an average of 17% a year.

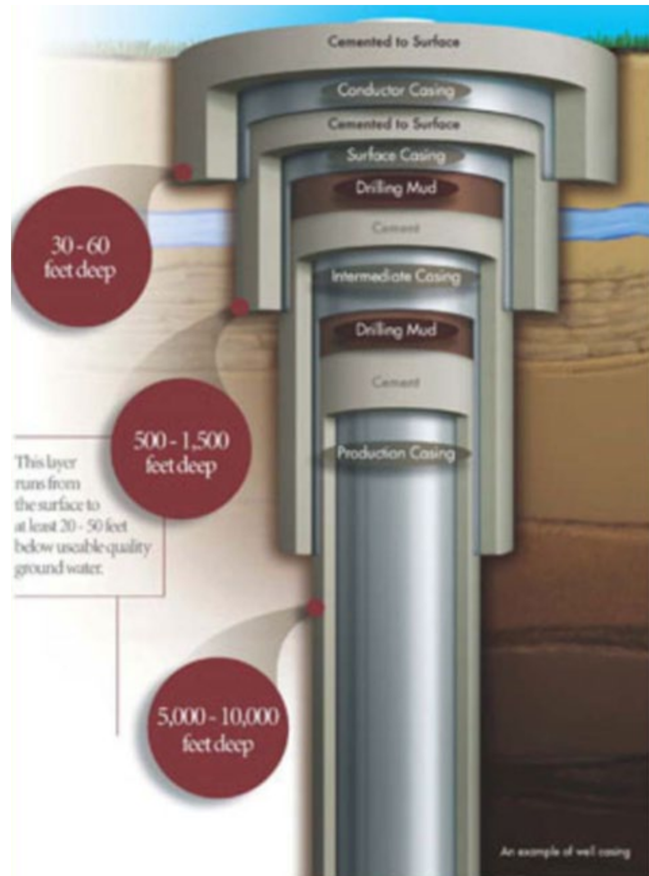
Simply put, we believe that Linn Energy is the very best energy stock an income-seeking investor can own. Here’s what to do:

Assuming a $100,000 portfolio , BUY 100 shares of Linn Energy, symbol LINE, at the market.

Natural-Gas Winner #2: Poseidon Concepts

Unlike deepwater drilling, fracking is not new. In America, oil and gas producers have been using hydraulic fracturing since at least the 1940s to enhance recoveries from older oil wells.

More important, fracking is the new technological breakthrough that has driven the price of natural gas from $10 to $3 and the reason that America is on the path to energy independence.

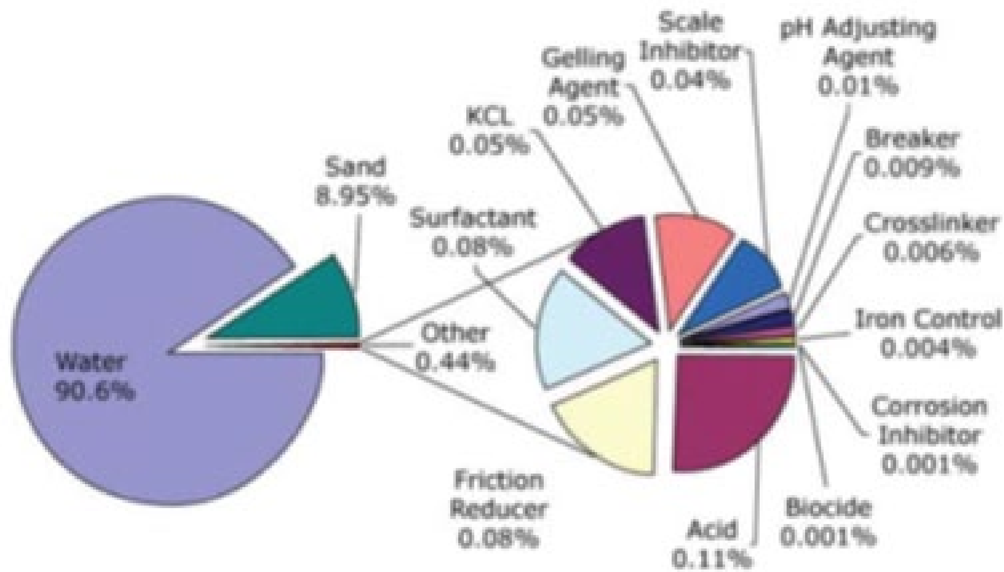


Graphic Courtesy of Texas Oil and Gas Association

Fracking is a process where fluids made of water, sand, and some chemicals are pumped into underground shale formations.

When the pressure from the fluids exceeds the strength of the rocks, the rock fractures, and the granules of sand prop the fractures open.

Once the fracturing is completed, the internal pressure from the formation pushes the injected fluids to the surface again.



Fracking is a controversial technology, and three drawbacks are cited by critics.

- The chemicals used in fracking can pollute the groundwater.
- Hydraulic fracturing uses lots of water – an average of 5 million gallons of water per well.
- The fluids that flow back to the surface after a fracturing need to be properly stored.

This fracking process uses an average of 5 millions of gallons of water per well. All of that water must be hauled to the drill site and then the flowback, which is generally 20% but can be as high as 50%, must be either treated on site or hauled away to be treated elsewhere.

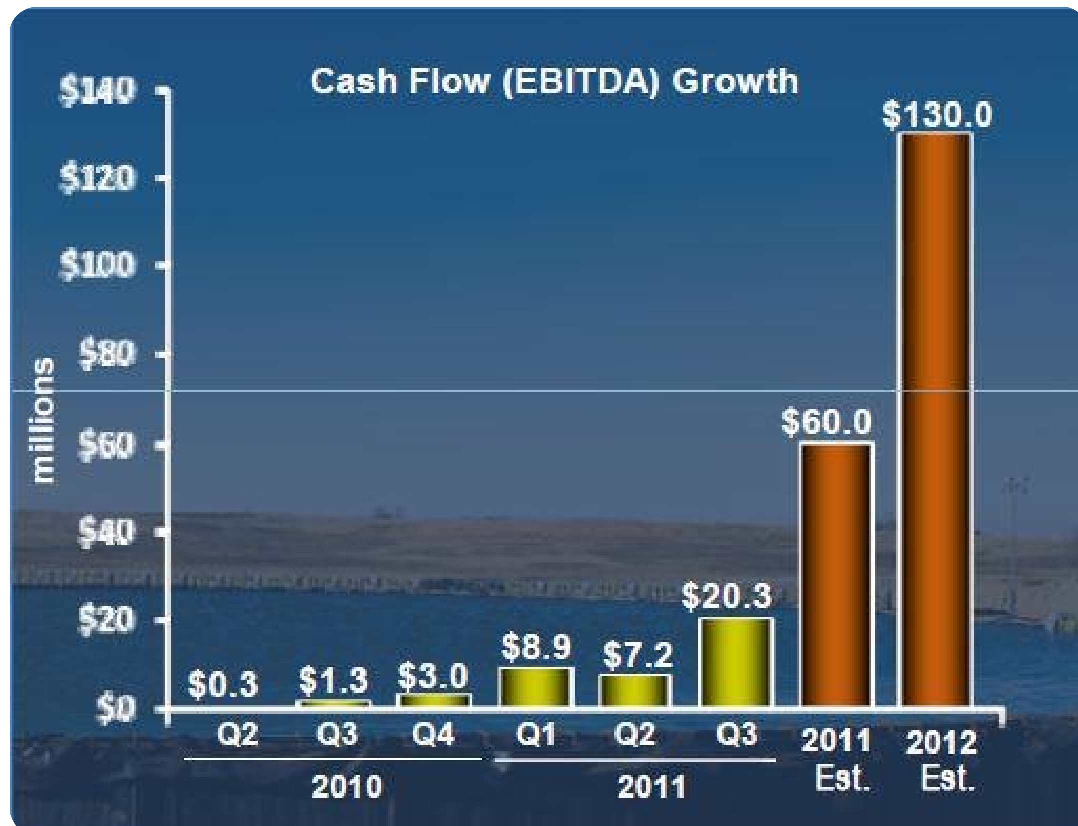
In the past, drillers would dig pits and dump all the untreated water into those pits.

Our #2 natural-gas pick, Poseidon Concepts, solves those environmental problems. Poseidon was born out of a need to better manage the massive water quantities needed for fracking and the resulting waste which is a byproduct of fracking.

Poseidon Concepts offers a safe, innovative fluid-handling solution that solves environmental issues. Poseidon produces a fleet of modular tank systems on a leased basis to deliver the water used for fracking as well as storing the flowback fluid.

Profits on Fire!

Poseidon is growing like crazy, growing from nothing in mid-2010 to a forecast annual EBITDA of $130 million in 2012. In the most recent quarter, Poseidon reported a 400% increase in EBITDA.



In the three months ended June 30, 2012, Poseidon:

- Had record EBITDA of $46.0 million ($0.57 per basic and diluted share), an increase of 535% from the second quarter of 2011
- Had record profits of $31.2 million ($0.38 per share), an increase of 552% from the same period a year ago
- Revenues grew to $54.9 million, an increase of 469% from a year ago

Poseidon currently has roughly 400 of its tank systems in place but believes that it can ultimately put up to 4,000 systems in place.

75% of Poseidon's systems are in the United States, with the other 25% in Canada.

(thousands except per share amounts)	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
Revenue	$ 54,875	$ 9,647	$ 107,004	$ 20,974
EBITDA [1]	46,008	7,245	89,711	16,083
Per basic share	0.57	0.12	1.12	0.28
Per diluted share	0.57	0.12	1.11	0.27
Net income from continuing operations	31,183	4,781	60,822	11,062
Per basic share	0.38	0.08	0.76	0.19
Per diluted share	0.38	0.08	0.75	0.19
Net working capital surplus (debt) (end of period)	$ 101,751	$ (44,251)	$ 101,751	$ (44,251)
Weighted average shares outstanding				
Per basic share	81,081	60,317	79,959	57,492
Per diluted share	81,343	62,584	80,632	58,920

Monthly Dividend Flow

Poseidon has been paying dividends on a monthly basis since December 15, 2011 and is currently set at $0.09 per share.

Dividend History 2011

EX-DIVIDEND DATE	RECORD DATE	PAYMENT DATE	DIVIDEND AMOUNT ($/SHARE)	TAXATION YEAR
November 28, 2011	November 30, 2011	December 15, 2011	$0.09	2011
December 28, 2011	December 30, 2011	January 16, 2012	$0.09	2011
Total dividends declared per share			$0.18	2011

Dividend History 2012

EX-DIVIDEND DATE	RECORD DATE	PAYMENT DATE	DIVIDEND AMOUNT ($/SHARE)	TAXATION YEAR
January 27, 2012	January 31, 2011	February 15, 2012	$0.09	2012
February 27, 2012	February 29, 2012	March 15, 2012	$0.09	2012
March 28, 2012	March 30, 2012	April 16, 2012	$0.09	2012
April 26, 2012	April 30, 2012	May 15, 2012	$0.09	2012
May 29, 2012	May 31, 2012	June 15, 2012	$0.09	2012
June 27, 2012	June 29, 2012	July 16, 2012	$0.09	2012
July 27, 2012	July 31, 2012	August 15, 2012	$0.09	2012
August 29, 2012	August 31, 2012	September 17, 2012	$0.09	2012
September 26, 2012	September 28, 2012	October 15, 2012	$0.09	2012
October 29, 2012	October 31, 2012	November 15, 2012		2012

Poseidon Concepts is a Canadian company, but its shares are traded on the US over-the-counter (also known as pink sheets) exchange under the symbol POOSF.

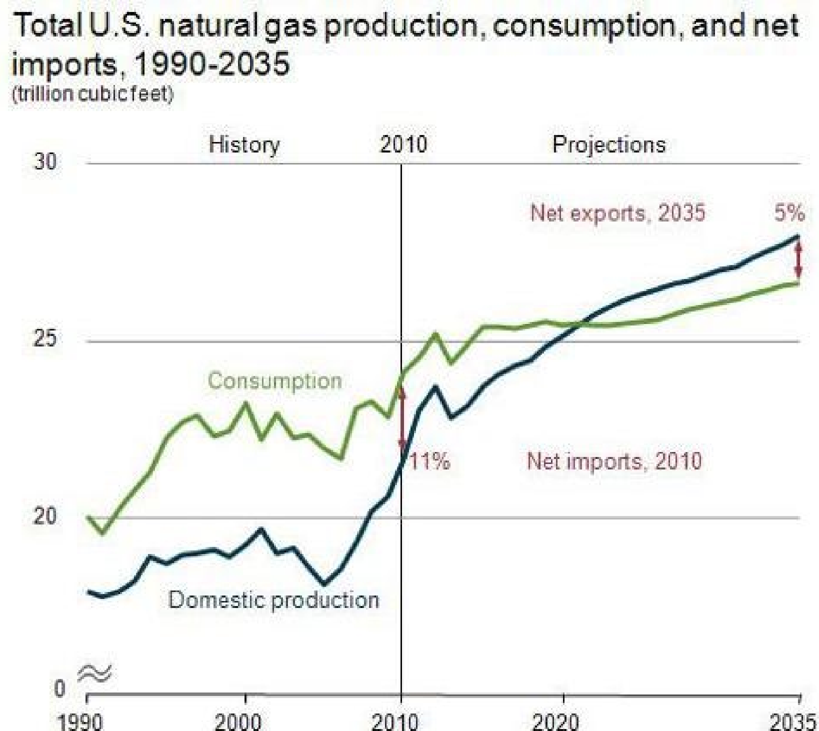
At the time of this writing, Poseidon is in the $16 range, and unlike Linn Energy – which we consider an immediate "buy" – we recommend that you wait for a new buy signal in Yield Shark before jumping in.

Don't worry; it won't be long.

Natural-Gas Winner #3:

Fracking has unleashed a newfound abundance of natural gas in the US, but all that gas has been landlocked in the US due to a lack of liquid natural-gas production facilities to export the fuel to other international markets, where natural-gas prices are much higher.

Liquefied natural gas (LNG) is natural gas that is converted to a liquid form through a refrigeration process. In liquid state, natural gas takes about 1/600th of the volume it occupies in gaseous form and is easy to transport.



Outside of the US, natural gas fetches significantly higher prices than the US market rate. Liquefying the cheap US gas and shipping it out to places where they pay four to five times as much makes a lot of sense.

We believe the best way to profit from that exporting boom is through Cheniere Energy Partners (NYSE:CQP), which operates the Sabine Pass LNG terminal in Louisiana.

Ironically, this company initially built its pipeline and liquefaction plant to **import** natural gas. That was when natural gas prices were 400% higher and the US was a net importer of natural gas. Now that natural gas exports have exploded, CQP has essentially reversed its systems to accommodate the booming foreign demand for LNG.

This shift from import to export is what makes the company misunderstood and undervalued.

Plus, CQP has started a two-stage expansion project on its Sabine Pass facility that will make it the largest exporter of LNG in the US.

Here is where it starts to get exciting. CQP is the first US company to receive permission from the US Department of Energy to export LNG to any country in the world that is not on a US trade sanctions list.

CQP has gone great guns at lining up billion-dollar deals with some of the world's largest LNG importers.

It has signed three deals worth $32 billion with the United Kingdom, Spain, and India that are multi-decade and multiple billions of dollars.

Deal #1: United Kingdom. The BG Group signed a 20-year, $8-billion deal to buy 3.5 million tons of LNG.

Deal #2: Spain. Natural Fensoa also committed to 3.4 million tons of LNG a year for $9 billion for 20 years, with the option of extending it for another 10 years.

Deal #3: India. State-controlled Gail India Ltd. is also contracted for 3.5 million tons for 20 years, starting in 2017, for $15 billion.

We estimate that the BG deal will generate $400 to $450 million in revenue per year; the deal with Natural Fensoa will generate another $420 to $460 million a year; and the Gail India Ltd. Deal will bring in another $480 to $550 million.

That translates into roughly $1.3 to almost $1.6 billion a year in income above and beyond what it already makes. All together, Cheniere could soon be pulling in close to $3 billion a year in revenue.

The future looks even better.

That's a lot of business, but it is about to get even better. The US Department of Energy has already given Cheniere permission to expand its liquefaction capacity by 77%, from 9 million tons to 16 million tons.

Construction has already started and will be completed in 2015. That expansion will send profits to the moon.

Those signed, sealed, and delivered contracts, as well as the new business Cheniere will generate from the expansion, is a substantial safeguard to not only to secure the current dividend but allow for substantial increases down the road.

We say that because due to its partnership structure, Cheniere is required under law to pass ALL of its profits – *without any corporate tax imposed* – directly to its investors.
Cheniere Energy Partners currently pays a $0.425-cents quarterly dividend in January, April, July, and October.

One word of caution. The main risk of investing in CQP is that it has taken on a lot of debt to finance its expansion and now has $2.2 billion of debt.

Assuming a $100,000 portfolio , BUY 200 shares of Cheniere Energy Partners, symbol CQP, at the market.

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