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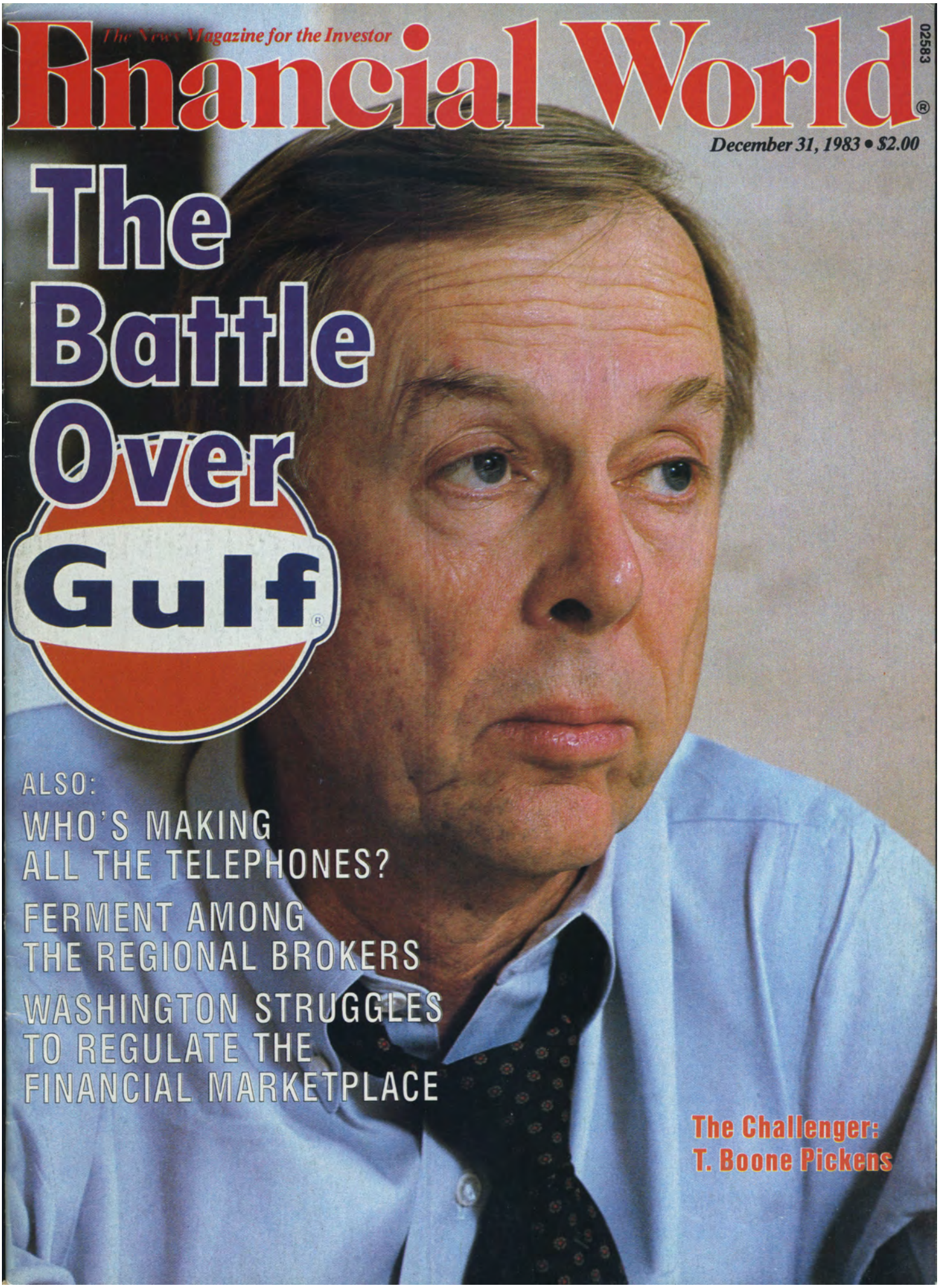

The Battle Over Gulf®

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The Challenger: T. Boone Pickens

Financial World®
December 31, 1983

Pickens vs. Lee

The battle over Gulf

A brutal struggle between a raider from Texas and deeply entrenched management may well end up changing the structure of the oil business

by Hilary Rosenberg

The way T. Boone Pickens Jr. tells it, you'd think that his move to become the largest shareholder in Gulf Oil Corp. is all in a day's work at Mesa Petroleum Co., of which he is chairman. The Daniel Boone of the oil frontier, and a distant relative of that pioneer, Pickens says his decision last summer to buy a major chunk (now 10.8%) of the nation's fifth largest oil concern was the result of a routine review of several big oil companies—the type of review that Pickens and his team of five financial sharpshooters do on a regular basis at their Amarillo, Tex., headquarters. "We look at companies all the time," Pickens says, "and over a long period of time we become very familiar with them."

Lately, Pickens has not only become very familiar with a string of oil firms, but on occasion he has taken the relationships a step further by making low-priced tender offers or taking large stock positions in a number of them. In fact, he seems to stick his nose into other people's oil companies with the same regularity that his own company goes on drilling for oil and gas reserves. As he sees it, both activities are equally important in running Mesa, especially now that the oil and gas industry is slumping and, with low prices, there is much less profit to be found in production than in past years.

While these tactics may be the usual way of doing business at Mesa, Pickens' raids on the stocks of other oil firms have won him a certain notoriety as a wheeler-dealer in the industry. Managements of the companies that catch his eye have reason to feel nervous, since he has often changed the fate of his targets in the very process of reaping a gain for Mesa.

In his latest venture, Pickens has confronted Big Oil for the first time because, he says, that is where the best investment values lie nowadays. Gulf was an obvious choice. Like other companies of its size, Gulf seemed undervalued at less than $40 per share when firms such as John S. Herold Inc. of Greenwich, Conn., appraised its value at some $114 per share. But what distinguished Gulf from its brethren was that it had been poorly managed over the years and subject to some misfortune as well. The Pittsburgh-based company's oil and gas reserves have declined dramatically as production has been unable to keep pace with their depletion. James E. Lee, 61, has revamped Gulf's operations and growth strategies in the two years he has been chairman and chief executive, but he has not yet turned the giant around.

RADICAL IDEAS

Enter Pickens, who knows that dissatisfied shareholders are like a disgruntled citizenry waiting to be rallied to a cause. Having gathered some partners, including the Belzberg brothers of Canada, notorious for their takeover maneuverings and three U.S. energy firms, Pickens purchased nearly 18 million Gulf shares from August through October for $790 million. He plans to spend another $300 million to up the group's holding to 15%. Mesa itself will be furnishing $700 million of the total. Along with his investment, the Texas oilman brought his fellow Gulf shareholders a radical idea: to spin off some of Gulf's mature oil and gas reserves and distribute the income to stockholders in the form of a royalty trust, bypassing the corporate tax on oil earnings. "Gulf Oil is very simply a liquidating situation because they haven't replaced reserves for 10 years," says Pickens in his relaxed Texan drawl. "So they need to reduce their size, and we want to help them do that, to reduce their reserve base to a maintainable level. Now there's a method for removing those reserves, putting them in the hands of stockholders and enhancing the value for those stockholders." Pickens' pious hope was that Lee would work with him, since he knew that in the past the Gulf chairman had expressed a commitment to improve shareholders' value.

Needless to say, Lee and his board did not appreciate Pickens' lesson in management, and, in fact, they have vowed to fight him all the way. Insisting that Pickens promotes short-term satisfaction while Gulf is working toward "lasting" shareholder value, Lee argues, "We're going to defend management's actions vigorously." To do so, the Gulf leader swiftly called a special shareholder meeting for Dec. 2 to consider proposals to reincorporate in Delaware and change the voting rules to make it difficult for gunslingers like Pickens to win a seat on the board. He also raised the quarterly dividend from 70¢ to 75¢ to secure shareholder support. At the same time, the Gulf directors beefed up their defenses with a $4 billion addition to their credit line for a total of $6 billion. Meanwhile, Gulf showed its establishment muscle when four banks that have close ties to the company withdrew multimillion-dollar lines of credit to Mesa.

Pickens claims he was surprised at Lee's violent reaction to his proposals. "I would not have that attitude toward somebody who had bought 10% of Mesa," says Pickens, who agrees that no one has ever done so. "I would have called them up and told them that I was glad to have them on board, and that if

they have any ideas that would enhance the stockholders' value, I'd be glad to come and see them."

Perhaps so, but Pickens is no ordinary investor. The 55-year-old Oklahoma native has a long record of unfriendly takeover attempts and bold investment schemes that have given him the power to move a company's stock by virtue of his mere presence as an investor. He is driven, so he says, by a concern for Mesa's shareholders; he himself is a major one, with 2.1% of the 66.8 million shares. Because he has done so well for his shareholders, Pickens is the envy of some oil executives. Companies like Gulf consider him a predator.

His latest string of guerrilla raids began in June of 1982 when he tried to take over Cities Service Co. of Tulsa, Okla. Gulf had some involvement in that one, too, having come in as the white knight only to back out shortly afterward, leaving Cities to be picked up by Occidental Petroleum Corp. By the end of the affair, Pickens had no acquisition, but Mesa was $31.5 million richer in pretax profit. He also failed to acquire General American Oil Co. in December 1982, only to have Phillips Petroleum Co. supersede him. That operation added up to $45 million in profit for Mesa. During the summer, Pickens picked up 3.94 million shares, 3%, of Superior Oil Co.'s stock at $34. Superior bought them back in September for $42 a share. The gain: $32 million.

WARFARE

Now Mesa's restless leader has thrown himself and his company into a fierce proxy fight with Gulf Oil over the voting issue. Gulf, 75 times Mesa's size, is no easy match. Yet Pickens is confident that Mesa can win both the proxy battle and the push for a royalty trust, and make a good profit on its investment. But there are doubters on Wall Street. "Pickens is a dynamic man; he's profit-motivated, but I think he may get stung on this one," says Edward P. Reilly, who follows oil companies for Fahnestock & Co.

Pickens' proposal of a royalty trust is as threatening to Gulf's management as Pickens himself. It would not only reduce the size and influence of the huge oil company but whittle away the corporate stature of its officers. In fact, the royalty trust idea has wide implica-

Gulf

IMPORTANT MESSAGE TO ALL

GULF OIL CORPORATION

SHAREHOLDERS!

Dear Fellow Gulf Shareholder:

It is now evident that T. Boone Pickens of Mesa Petroleum intends to engage in a proxy contest in an attempt to defeat the proposal strongly recommended by your Board of Directors to restructure Gulf Oil Corporation as a holding company. **We firmly believe that this move by the Mesa group is not in the best interests of Gulf shareholders and should be rejected.**

In fact:

- Pickens, in a television interview discussing the Mesa group's investment in your company, said: "I just work for one crowd: that's the Mesa stockholder."
- The Mesa group, as recently as three months ago, did not own a single share of Gulf stock; more than half of the stock that they presently own is represented by borrowed funds.

The activities by the Mesa group against Gulf are disruptive and, if successful, will interfere with the important restructuring program now underway at your company.

We caution you not to sign any opposition proxy and urge your support **FOR** the reorganization proposal at the Special Meeting of Shareholders scheduled for Friday, December 2, 1983.

Important additional information is being prepared and will be sent to you at the earliest practicable time. Meanwhile, we remind you of the significance of our planned reorganization to the development of Gulf's opportunities and to the goal of maximizing value for our shareholders.

Please take the time to express your support of the proposal by signing, dating and mailing the WHITE management proxy.

Thank You.

On Behalf of the Board of Directors

Sincerely,

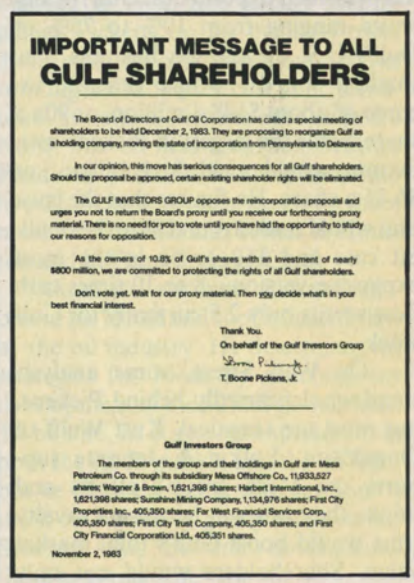
Chairman of the Board and Chief Executive Officer

November 4, 1983

If you have any questions or need assistance in voting your shares you are encouraged to call D. F. King & Co., Inc. at (212) 269-5550 in New York, (312) 236-6681 in Chicago, or (415) 788-1119 in San Francisco or Georgeson & Co. at (212) 440-9800. Please call collect. Gulf has also established the following tall free numbers (800) 231-[illegible] for Pennsylvania residents only (800) 222-2152.

KIM STEELE

Lee, left, and Pickens are in a face-off over the fate of Gulf Oil Corp. At right, two of the ads the opponents have placed in national newspapers to secure shareholder support at the Dec. 2 special meeting.



IMPORTANT MESSAGE TO ALL GULF SHAREHOLDERS

The Board of Directors of Gulf Oil Corporation has called a special meeting of shareholders to be held December 2, 1983. They are proposing to reorganize Gulf as a holding company, moving the state of incorporation from Pennsylvania to Delaware.

In our opinion, this move has serious consequences for all Gulf shareholders. Should the proposal be approved, certain existing shareholder rights will be eliminated.

The GULF INVESTORS GROUP opposes the reincorporation proposal and urges you not to return the Board's proxy until you receive our forthcoming proxy material. There is no need for you to vote until you have had the opportunity to study our reasons for opposition.

As the owners of 10.8% of Gulf's shares with an investment of nearly $800 million, we are committed to protecting the rights of all Gulf shareholders.

Don't vote yet. Wait for our proxy material. Then you decide what's in your best financial interest.

Thank You.
On behalf of the Gulf Investors Group
T. Boone Pickens, Jr.

Gulf Investors Group

The members of the group and their holdings in Gulf are: Mesa Petroleum Co. through its subsidiary Mesa Offshore Co., 11,933,527 shares; Wagner & Brown, 1,621,398 shares; Harbert International, Inc., 1,621,398 shares; Sunshine Mining Company, 1,134,976 shares; First City Properties Inc., 405,350 shares; Far West Financial Services Corp., 405,350 shares; First City Trust Company, 405,350 shares; and First City Financial Corporation Ltd., 405,351 shares.

November 2, 1983

tions for the oil industry as a whole, since most of the integrated oil companies are considered undervalued in the stock market. With Gulf's management standing in strong opposition, Pickens' success depends on his ability to convince Gulf's shareholders that a royalty trust is feasible for an oil mammoth like Gulf and good for them. The royalty trust is a complicated concept involving many tax questions that are not easy to answer without the actual situation in hand. Pickens spent all of November trying to get his view of the matter across to shareholders before the Dec. 2 meeting, where he hopes to defeat the proposal to eliminate cumulative voting and retain the option of running for the board at the annual meeting.

As the first to use a royalty trust when he spun off some of Mesa's assets in 1979 as the Mesa Royalty Trust, Pickens relies on his own experience when he argues that the idea will work. For example, since the Mesa Royalty Trust and, in 1981, the Mesa Offshore Trust were spun off, the combined value of Mesa stock and the royalty trust units in the market has grown to 127% of the value of the stock before the trusts' formation. As in Mesa's case, Gulf would be left a viable company and a more efficient one, since it would have fewer reserves to replace, he says. Pickens argues that the value of Gulf's stock has diminished over the years as its reserves have lost value, and this decline could continue. "An oil company's only worth its assets and the cash flow it can generate," says Gregory L. Stoerner, an oil analyst at Lovett, Mitchell & Webb in Houston.

As a guide for Gulf shareholders—and a complicated guide it is—Pickens has presented hypothetical Gulf royalty trusts ranging from 10% to 75% of Gulf's U.S. oil and gas business. The smallest spin-off would generate income of about $148.4 million, or 90¢ a share, while the largest in Pickens' estimation would yield $1.1 billion, or $6.73 a share. He figures that the trust unit would trade around $8 in the smallest case and $60 or so in the most expansive version—8 to 10 times cash flow versus only 2.5 currently for Gulf stock.

On Wall Street, some analysts stand wholeheartedly behind Pickens, but most are skeptical. Kurt Wulff of Donaldson, Lufkin & Jenrette supports the Mesa group's efforts and thinks they can win because a royalty trust would boost Gulf's total market value. Shareholders would not only avoid a corporate tax, he argues, but would also get a depletion allowance and have control over the reinvestment of cash flow where now they depend on Gulf management. In a study done earlier this year on Getty Oil, Wulff found that "alternatives to the integrated structure [such as a royalty trust] would enhance stockholder value by 50% to 130%."

EXPERIMENTATION

Gulf's Lee refutes these arguments, saying that a royalty trust cannot work at a major oil company, and he does not want Gulf to be the "guinea pig" in an experiment with the idea. He claims that because Gulf, unlike Mesa or Sabine, has a huge backlog of retained earnings, spinning off a royalty trust would burden shareholders with a tremendous initial tax payment on the distribution. Individual shareholders, who own 77 million of the 165 million Gulf shares, would presumably be the ones to suffer, since many of the institutions that hold about 45% of the stock would be exempt from taxes. Lee also claims that shareholders will not get the increased value that Pickens promises, since in the long run the value of the trust unit would reflect the decline in the company's stock after the spin-off.

A royalty trust would also deal a severe blow to the Gulf Corp., Lee contends, since it would take away the cash flow needed to sustain exploration activities and to maintain good growth rates and would impair the company's ability to borrow. Some analysts concur with this view. "Gulf needs the cash flow from those operations," says Alan Gaines of Gaines, Berland, Shaffer & Silversheim, New York money managers and institutional brokers. "They make money at the wellhead though they might lose it at the pump." That is, Gulf's profits from production have made up for the losses it has suffered in refining while prices have been weak. And although Gulf wouldn't have to pay a tax on the distribution, it would lose the $100 million saved in 1982 because of a ceiling on the windfall profits tax, one analyst points out.

Which side is right about the royalty trust is yet to be determined. The question of shareholder taxes on the distribution is especially knotty. Pickens shoots down Lee's argument, terming it a scare tactic. "Nobody ever thought that the shareholders were going to make money and not have to pay taxes," he says. "There's no mystery

continued on page 12

"A classic country boy"

Thomas Boone Pickens Jr. doesn't sleep much at night. In fact, it was when he was lying awake in bed at his Amarillo, Tex., home that he came up with the idea of creating a royalty trust for the shareholders in his company, Mesa Petroleum.

At the time, he had been worrying that there might be problems in keeping Mesa's reserves up to snuff and that if Mesa's production couldn't replace them, the stockholders would lose value. But as he lay in bed that night in 1978, the idea came to him, and though it was 3 A.M., he woke up his wife to tell her the news. "I said to Bea, 'I think I've got it figured out,' and I got up and went into the study and wrote some things down. Then we started checking it out and, by golly, it worked." Actually, after Pickens thought up the concept of spinning off reserves for stockholders to share, it took about a year to develop, a director of the company pointed out.

Pickens, 55, who has been described as "a classic country boy" because of his easygoing manner and dry humor, insists that he is driven by a concern for the Mesa shareholders; and there is the ring of truth about this, for he is one of the largest, with a 2.1% chunk. But Pickens, who has put the oil industry on edge with his innovative strategies, has a characteristic need to keep moving and a competitive spirit that simply makes him an active manager. "He doesn't let grass grow under his feet," observes David Culver, a fellow Amarillan and chairman of Pioneer Corp., an oil and gas firm. And when the oil and gas industry is in the dumps, as it is now, Pickens occupies himself and his company with acquisition attempts and hefty investments in other oil companies instead of stepping up exploration. "Sure you can sit back and wait for something to happen, but that has never been our style," he says. "While you're waiting for something to happen, you're liable to get a stomach ache, and you might even get an ulcer."

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If this is the way Pickens stays

healthy, he must be in tip-top shape. Since June of 1982, Pickens has made four acquisition attempts and several investments in other firms, including Gulf Oil Corp., where he is now trying to sell the royalty trust idea. Says Pickens innocently: "Managements have a very hostile attitude toward us for some reason."

He resents the charge that he is a hit-and-run artist. "If you go back and look at my history, the two best-performing oil stocks on the New York Stock Exchange in 1982 were Cities Service and General American [two of his 1982 acquisition targets]. Now who made money out of that? The Cities Service and General American stockholders made a lot of money." In fact, he says, two stockholders from those companies sent him gifts: one was two tins of caviar, and the other a tree for his office with a sign saying, "I like winners."

Says William Burt of Endowment Management & Research, a Boston investment firm that has owned Mesa stock: "Pickens has not been one to involve himself in just the bureaucratic turnings of his company. He's always watching the market." Pickens has used acquisitions to build his company, though he has never pursued this route as actively as he does today. His first coup was in 1969, when Mesa took control of Hugoton Production Co., a firm 20 times Mesa's size that greatly expanded exploration and production operations. But Pickens stumbled in his next takeover attempt, a try at Southland Royalty in 1970. Three years later, Mesa picked up Pubco Petroleum. Then, in 1976, the 1970 failure came back to haunt him when Southland outbid Mesa in a try for Aztec, a gas company.

Pickens' vitality permeates his life outside of the office as well. Active in the community, he and his wife worked on a project to build an ambulatory cancer center in Amarillo. In the political realm, Pickens, a Republican, has campaigned for Texas politicians and for Reagan.

He also channels much of his energy into competitive sports. As a quail hunter, Pickens has often challenged Wales Madden, a Mesa director and an Amarillo attorney who has known Pickens since high school. They try to outdo each other in the number of birds they can bag. Pickens' competitive drive most revealed itself to Madden when they were out hunting prairie chickens in Saskatchewan, Canada, and got lost in the sand hills. "He wanted to go one way and I wanted to go another," Madden recalls. So they agreed to go 10 minutes one way and, if that was wrong, 10 minutes the other. "But neither one of us wanted to go the other's way, and as a result we stayed lost. We ended up going in a circle. They found us late that night."

Racquet sports also appeal to Pickens. He plays tennis at his own indoor court and ends every workday with a game of racquetball at the courts in the fitness center he built for his 725 employees. The health facility includes a gymnasium with a track, basketball courts, workout centers, four racquetball courts, a doctor and two exercise specialists who help employees design their own fitness programs. As a show of their appreciation, the Mesa workforce commissioned an artist to sculpt a statue of Pickens playing racquetball and had it placed overlooking the courts.

OKLAHOMA CITY TIMES

Pickens as a work of art.

It was his family that got Pickens interested in a career in the oil business. Born in the small town of Holdenville, Okla., on May 22, 1928, the only child of Thomas Boone and Grace Pickens, Pickens acquired an affinity for the oil patch from his father, a lawyer in the land acquisitions division of Phillips Petroleum Co. The son got his start on the scientific side of oil as a geologist. Graduating from Oklahoma State University in 1951, an especially tough time for the oil industry, Pickens was one of the four in his class of 50 who got work. He spent four years as a well-site geologist at Phillips.

But he soon became restless as a mere employee and wanted to go into business for himself: With $2,500 and a $100,000 line of credit, Pickens started Petroleum Exploration Co. in 1956, which went public as Mesa in 1964. Today the company has $1.95 billion in assets and last year took in $407 million in revenues. Oil analysts consider Pickens' exploration and production skills to be top-notch and commend him for his adeptness at spotting trends in the industry. For instance, Pickens got his company out of Canada in 1979, at a time when the country looked like fertile ground for American oil concerns. But it wasn't long before Canada took everyone else by surprise by implementing a new energy policy greatly favoring Canadian enterprises. Meanwhile, Pickens, who had first entered Canada in 1959 with $35,000, escaped unscathed with more than $600 million.

Also in 1979, Pickens withdrew from the North Sea, netting $65 million in the process. By doing so, he avoided a new British tax on North Sea oil production.

In the latest industry slump, Pickens saw that prices were going to drop and pulled back on his spending budget before any of the other independent oil companies, says Gregory Stoerner of Lovett, Mitchell & Webb in Houston. Now, he is trying to steer Mesa more toward oil markets, since the bulk of the company's production has been natural gas. The company's production operations are focused in the Gulf of Mexico, the Rocky Mountains and the Midwest.

One of Pickens' greatest assets in the business has been his wife, whom he married in 1972. She usually accompanies Pickens on his business trips, doing what she can to help out, such as running the slide projector at presentations. In return, Pickens once named a North Sea oil field after her: Beatrice Field. In addition to their Amarillo home, Pickens owns a ranch 90 miles north of Amarillo and homes in Houston and in Palm Springs, Calif.

Analysts attribute Pickens' success to his broad and sophisticated view of the oil industry. He determines his strategies for Mesa by watching the development of the oil and gas markets. To be sure, he is an active speculator in both the stock market and the oil field, but he plays the game with caution. "I think he's actually pretty risk-averse," Stoerner says. "But that's not the same thing as sitting still."

here in this whole affair. But this is the big scare card. Run and tell them that they're going to have tax penalties. And that's what they're doing." While he concedes that shareholders will have taxes to pay, he is confident that the taxes will not exceed the gain.

Analysts are split on the issue. "My suspicion is that the individual shareholder would end up with a tax liability of several thousand dollars, and it would take years to make that up," says one. The high taxes could force individual shareholders to sell their Gulf stock in order to pay them. But if the royalty trust idea goes through, Gulf's stock would go up before the spin-off, and many shareholders will want to sell the stock anyway, argues another.

WATCH OUT FOR CONGRESS

A proposal before a Senate Finance committee to eliminate the tax benefits of royalty trusts could clear everything up; it would destroy Pickens' whole case. One recommendation is that a corporation pay a capital gains tax on the appreciated value of any property distributed to shareholders; the corporation now pays no tax. A second idea is to treat a distribution as ordinary dividend income and tax it as such; now, only accumulated earnings and profits are taxed. If the recommendations become law, "a royalty trust wouldn't any longer escape double taxation," says Barry Good of Morgan Stanley.

The main impetus behind the proposed taxes, which have not yet been drafted as a bill and probably won't be until next year, is a search for ways to stem the growth of the Federal deficit. So far, Good says, "the potential loss to the Treasury has been minimal, compared with the sum that would be involved if the major oil companies move in a wholesale fashion to utilize these devices [royalty trusts]." However, in a sense the royalty trust really does not deprive the Government of much, if any, tax revenues. Corporations get tax credits and deferrals that "leave very little tax for the Government to collect," one analyst says. Gulf, for instance, pays taxes at only an 8% rate instead of the 46% corporate tax rate. In a royalty trust, however, the individuals pay taxes over the life of the reserves in the trust. "Frankly, I think the Government would be a net collector of taxes," the analyst says. For his part, Pickens doubts that any proposed tax legislation will pass, at least before 1985. And once any royalty trust is formed, new laws should not affect it.

Considering the energy industry as a whole, some analysts like Good question the wisdom of breaking up the integrated oil companies merely for the "instant gratification" of shareholders. In Good's view, the integrated structure is an effective one for international, multidivisional corporations. However, by themselves, royalty trusts would not necessarily destroy the integrated structure of a company, but rather would remove only some of the reserves, leaving the company intact, though smaller. Even so, separating the exploration and production side of the business from refining and marketing might be a good idea, according to some analysts like DLJ's Wulff. "Integrated companies are selling for half the value of their properties," he says. "The stock market is saying that integrated companies are not efficient entities."

A Gulf frontier: The Gulf of Mexico.

Even more worrisome, some analysts fear that the widespread creation of royalty trusts could reduce overall exploration and production, leaving the nation in a vulnerable position in the case of an energy crisis. While this is a legitimate concern, it is doubtful that royalty trusts could induce an oil shortage. Exploration and production should continue at healthy levels when the price of oil and demand are such that these activities will be profitable. But more exploration might be done by limited partnerships of investors and independent exploration companies. "There would be more efficient allocation of capital," says Lovett, Mitchell's Stoerner. "It would go to those who are best at exploration."

THE OUTCOME?

What the Gulf shareholders decide on Dec. 2 and, if the Mesa group persists, at the annual meeting in May, may depend more on their dissatisfaction with Gulf's performance than on who has the best argument about royalty trusts. Pickens claims that so far he has gotten a very good response from Gulf shareholders, institutions and individuals alike. He's coming from a very good position. Mesa is a top-performing energy concern with excellent profit margins and exploration and production operations. Last year, the firm earned $116 million on $407 million in revenues, a 28% net margin. Gulf, on the other hand, has had a poor earnings record lately. Last year, the company earned $900 million on $30.6 billion in revenues for a 2.9% margin.

Gulf has had a rough time in the past decade. Profits slumped in the mid-1970's for a variety of reasons. Foremost was a crude-oil shortage resulting from the nationalization of Gulf's major reserves in Kuwait and Venezuela in 1975. That year, Gulf's net income dropped to $700 million from $1.07 billion the year earlier. Earnings finally found their way back to the billions in 1979, when the Government lifted oil-price controls and the Iranian crisis tightened supplies. The company's prosperity continued into 1980 when Gulf earned $1.4 billion, up from $1.3 billion, despite a recession and a decline in consumption as conservation efforts took hold. But then a deeper recession and the oil glut deflated profits to $900 million last year, 36% below the 1980 record. Especially hard hit were the company's refining, marketing and chemical operations, which tumbled from $700 million in 1980 to a $250 million loss last year.

Amid the ups and downs of the past several years, Gulf's production of crude oil has plummeted. In the early 70's, the company was pumping three million barrels a day. During the first nine months of this year, total production amounted to only 846,000 barrels a day. Hard-pressed to replace its U.S. reserves with new finds, Gulf saw its domestic crude reserves shrink to 748 million barrels at the end of last year from one billion barrels in 1977. Natu-

ral gas reserves have declined from six trillion cubic feet to 3.9 trillion cubic feet during that period.

In the meantime, Gulf's reputation and growth rate have been damaged by poorly negotiated contracts and legal entanglements. A 1964 contract to deliver 4.4 trillion cubic feet of natural gas over 26 years at 19¢ to 22¢ has reportedly left Gulf paying $20 million to $25 million a month in out-of-pocket expenses to meet the obligation, one analyst says. So far, the company has delivered about 3.4 trillion cubic feet of gas. In another matter that was closed in 1981, the company reached a settlement with Westinghouse Electric Corp. in a 1976 antitrust case charging that Gulf participated in a uranium cartel. The agreement called for Gulf to pay $25 million and to deliver 13 million pounds of uranium.

Like its operations and markets, Gulf's management has also run into turbulence over the years. In 1976, Jerry McAfee, who had been running 60%-owned Gulf Canada in Toronto, assumed the chairmanship after questionable payments by Gulf forced Robert Dorsey to resign. Lee, who started at Gulf in 1943 as a lab assistant, took over in December 1981 and has since redirected the company's operating strategies.

In the refining and marketing area, Lee has sold $2 billion of refining and marketing assets, mostly in Europe. Once he sells Gulf's Italian refining facilities, the company's only remaining foreign refining operations will be in Britain. Gulf's chairman has also shifted exploration and production activities to high-risk domestic frontier regions and has started to rebuild reserves. The company has been acquiring leases in the Beaufort Sea off the California coast and in the Gulf of Mexico. A cost-cutting program in refining operations and in the workforce helped boost third-quarter earnings to $276 million from $159 million in the year-ago period while revenues steadied at about $7.5 billion in both quarters. Still, return on equity was only 9.2% for the past 12 months, compared with 15% in 1980. In a move to help increase shareholders' value, Lee spent $1 billion repurchasing 30 million shares, 15%, from mid-1981 through last August.

Guaranteed repair work is part of Lee's drive to improve Gulf's marketing.

EXPECTATIONS

Wall Street has applauded Lee's progress so far. Gulf's stock has risen nearly 50% since January, though some analysts attribute about $10 of the gain to speculation over the Pickens battle. Most analysts consider Gulf overvalued, although they seem to like it for the long term. For now, they say, Gulf should be trading in the mid-to-upper 30's. Analysts expect Gulf to earn about $5.25 per share this year and $5.75 in 1984 versus $4.98 last year.

Some Wall street analysts have been recommending the sale of Gulf stock on the basis that Pickens will probably not win his case for a royalty trust. "Since I don't think Mesa will succeed, I think the stock is overpriced," says Sanford Margoshes of Shearson/American Express. Margoshes agrees with Gulf's argument that a royalty trust would not work in Gulf's case. Other analysts doubt that Gulf is as undervalued as Pickens says in the first place. Ann Mobley of E.F. Hutton in Houston disputes John S. Herold's appraisal value of $114 a share, saying that the company is worth only about $80 a share. In her analysis, Mobley values Gulf's oil and gas reserves and its refining, marketing and chemical facilities at less than the amount that Herold ascribes to them.

For his part, Lee hopes that shareholders will decide that his long-term strategy of enhancing shareholders' value is more lasting than Pickens' instant method. In emphasizing the inherent risks in Pickens' proprosals, Lee has attacked the man as well as his ideas, claiming that he is the "hit-and-run" type. That is, he gets into a fight, makes a profit and then sells his shares, leaving other shareholders in the lurch as the stock falls. Lee has said that Gulf will not buy back Pickens' shares under any circumstances. "We're in a fight," he says. "It's a fight we didn't ask for, but we don't intend to lose it."

Pickens is rather confident that he and his cohorts will be victorious in the conflict that they started. They have told Gulf that they will not sell back their shares to the company, committing themselves to stick it out for the long haul, that is, until they win the royalty trust argument or fail.

On the sidelines, some observers consider Pickens a good bet in this one. One point in his favor is that arbitrageurs on Wall Street still resent Gulf for pulling out of the Cities Service deal and leaving them with huge losses. The Gulf shareholders, who year after year have seen declining asset values, could also side with the maverick. Not only do they want to hear a fresh idea, but Pickens has a very convincing one. And he insists that the royalty trust is a long-term solution to some of Gulf's problems, since it reduces the company's reserve base to a maintainable level. Although he does not have everyone's support in this effort, Pickens just may have enough to make it count. So while he may be taking a risk, it's a well-calculated one. As in drilling for giant oil reserves, says one oil analyst, "the probabilities may be low, but you still drill if the risk-to-reward ratio looks very good." ■