Budget decisions for US shale players

Background

Budgeting was relatively straightforward for tight oil players from 2014 to 2018. Despite being in the early days of the oil price downturn, investors still demanded growth. Capital markets supported it. Debt was cheap and public markets backed new equity raises.

Production volumes grew massively because of the investment intensity. Total US liquids production increased by 10 million b/d from 2010. The majority of this was from tight oil in the Bakken, Eagle Ford, and most importantly Permian. US liquids reached a record 18 million b/d by end-2019. The country lifted the crude export ban in 2015. Last year export volumes eclipsed 2.0 million b/d.

But all sectors mature, and investor demands change to reflect that. It's near impossible for an industry to be both high growth and high return and US E&P is going through that tough transition today.

Investor antipathy – the oil and gas sector's weighting in the S&P 500 halved in the 2010s

Source: S&P, Refinitiv Datastream

The shear length of this downturn has forced shale E&Ps to change their business strategies. Growth targets have been replaced with new metrics that focus on return on invested capital and how companies will directly reward their investors.

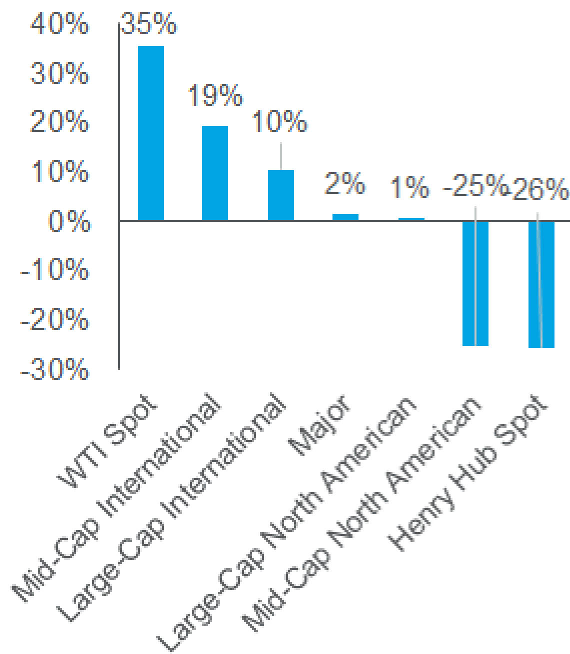
Today, two of most common financial strategies for tight oil are: retiring debt to help prop-up equity values and increasing dividends.

Market conditions

As the chart below shows, even with WTI trending up in 2019, North American E&Ps (i.e. the US shale mid-caps) have lagged their international peers in winning back investor support.

This highlights the severity of the challenge ahead for US tight oil players. How do they win back sponsorship from Wall Street and how does the shale sector manage risk going forward? For the generalist energy investor, the Majors and International E&P peer groups appear superior.

2019 annual share price change: Majors, North American Mid-caps, and peer group averages



Source: Wood Mackenzie, Factset

Considering countless challenges for the shale sector, what is the right fiduciary strategy for tight oil players in 2020? They need to improve their track record.

We can look at clues, signals, and messages from two outlier tight oil companies that had better equity performance in 2019.

- **Pioneer (PXP)** – The company is strongly messaging capital discipline and gone as far as delaying its million boe/d production goal for the Permian. Pioneer is prioritizing **cash flow** over volumes, having **reduced annual growth** the last couple of years from roughly 25% to 11% today.

- **ConocoPhillips (COP) –** ConocoPhillips laid out a comprehensive 10-year plan in its 2019 Analyst and Investor Meeting. The company provided detailed guidance on its **shareholder distributions** and investment plans out to 2029. Differentiated returns, **balance sheet strength**, and disciplined growth remain at the core of its strategy. Shareholders will be the big winners – and in many cases the priority – in the competition for capital in the next decade.

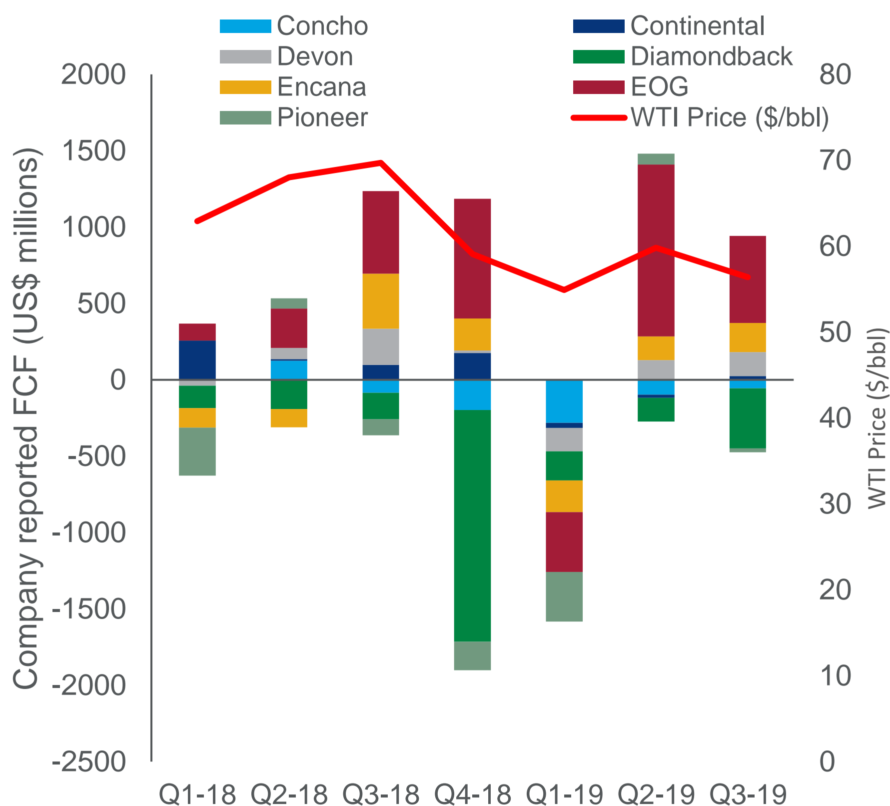
The challenge

But remember the tight oil business came about when prices were much higher than they are today – roughly US$75/bbl. It's tough to make the same business model work at commodity prices just 2/3 of that without some drastic changes.

Additionally, capital markets have started to withdraw finance from the sector which makes financing a strategy shift costly, if even possible at all.

Some operators are finding ways to successfully meet today's investors needs. Free cash flow (FCF) – a key Wall Street metric – isn't great today, but it's more robust than it was two or three years ago. Spending reductions (i.e. drilling less wells) has been the easiest way to try and right the ship.

Select tight oil operators' cash flow evolution



Source: Wood Mackenzie, company filings

But so much of cash flow hinges on commodity prices and forecasts are inherently uncertain. Operators need to be prepared for all scenarios. What if prices rebound? What should tight oil players do? How do management teams plan for this?

It's the multi-billion dollar question for operators and investors. The ramifications are profound. Get it right and you could win back investors. Get it wrong, and the consequences could as dire as bankruptcy.

The longer-dated forward curve isn't signalling a big price rally. But as we've seen lately, largely unforeseen geopolitical events can impact the market. When prices surged at the New Year, some producers added hedges or quickly refinanced debt at advantageous terms.

And as of late-January, there's a bullish undertone coming from some producers. We see this in messaging. CEOs aren't talking about possible further investment cuts. Instead, they're talking about potential excess cash flow and the uses of that.

A conundrum

How elastic should investment levels be if prices improve though? How should companies invest FCF and how should they message this strategy to investors and lenders?

One option could be to return it to investors. Old habits are hard to break though. Drilling and completion costs have fallen throughout the downturn and breakeven metrics for new individual wells are some of the strongest tight oil producers have ever seen.

And importantly, the simple costs of drilling and fracturing news wells aren't what got the tight oil players into their challenged relationship with investors. What did then? It was the additional project costs like leasing, infrastructure, exploration, G&P build-out, and M&A. All those costs have all been incurred and expensive infrastructure has been depreciating for years.

Today, assuming a stable cost of capital, half-cycle well economics has a stronger impact on company performance.

Source: Wood Mackenzie

Core case study question

What should US tight oil players do if prices appreciate considerably in 2020 and 2021?

Should they stick to their messaging of returning ALL available cash flow to investors and lenders? Ought they instead invest more in their core upstream business and drill more wells?

Should their debt retirement schedule differ? How should their strategy change? Should it even include M&A if there is arbitrage value to be captured?

Deliverables

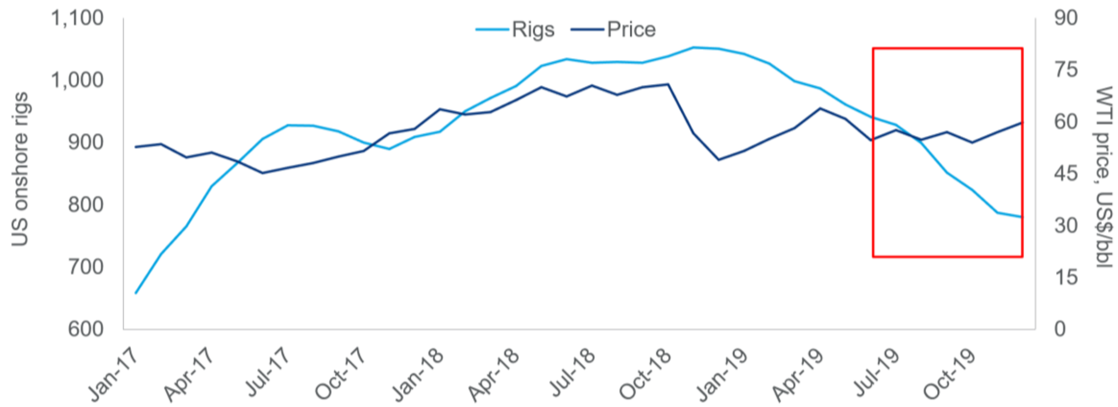
Please select one of the four tight oil companies listed below and present your view on how their investment intensity should change with a US$15/bbl increase in oil price.

Full details of these companies' current plans can be found here as well as in SEC filings:

- Devon - https://investors.devonenergy.com/investors/default.aspx
- Encana - https://investor.encana.com/
- Continental - http://investors.clr.com/
- Diamondback - https://www.diamondbackenergy.com/investors

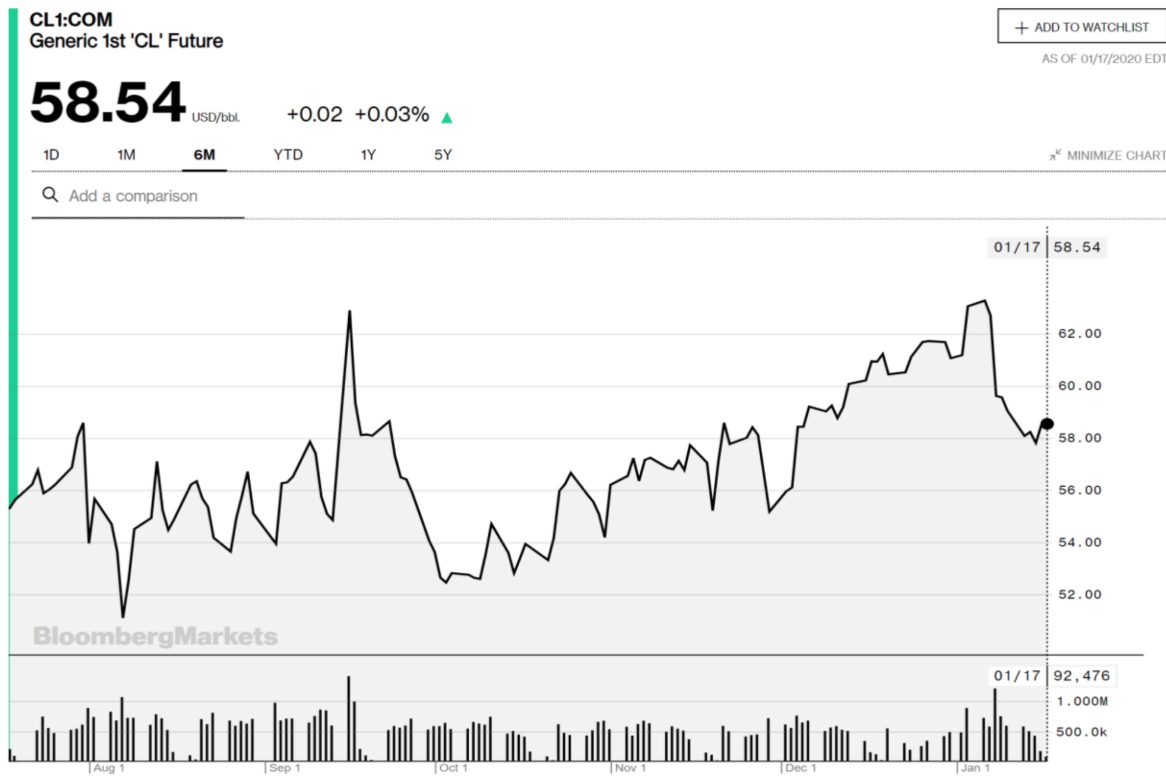
You will have 20 minutes to present your investment argument. There is a 10-slide limit and every team member must be an active participant.

Appendix



Source: Baker Hughes, www.macrotrends.net

WTI: Optimism emerging or not?

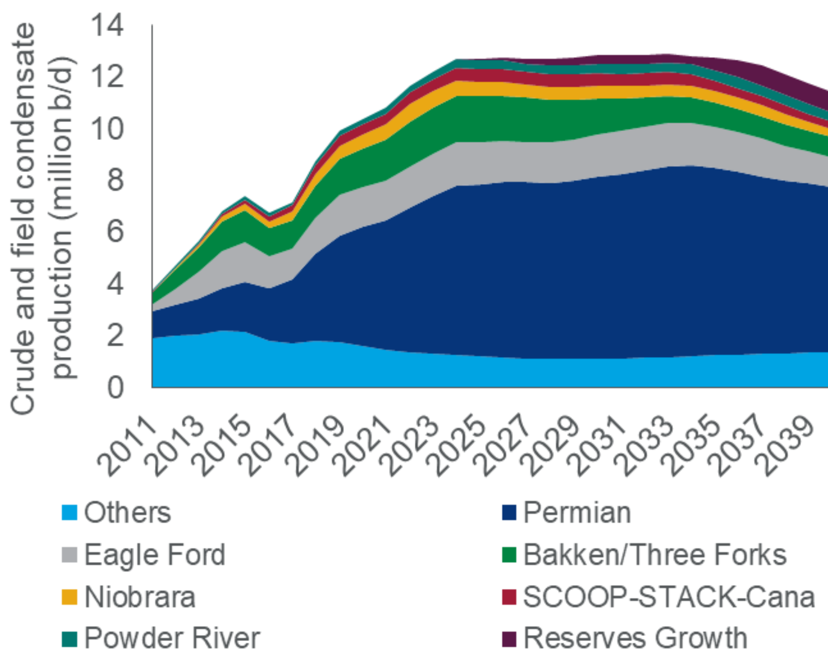


Source: Bloomberg Energy

US shale M&A deal count

Source: Wood Mackenzie

Wood Mackenzie H1 2020 US Lower 48 liquids forecast



Source: Wood Mackenzie