Onshore E&P Industry

Certain Permian Producers Slowing Activity Amid Crude Oil Retreat as E&Ps Prioritize Discipline, Shareholder Returns

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The decisions by Diamondback Energy and Parsley Energy to curtail activity in the Permian Basin next year in response to the collapse in crude prices could be the first of many as the historically capital-hungry energy sector prioritizes capital discipline and shareholder returns over production growth.

"Due to the dramatic decline in oil prices, realized pricing in the Permian Basin is near levels not seen since the end of 2016 while service costs have increased by ~35% during the same time period," Diamondback CEO Travis Stice said in a press release on Dec. 18. Diamondback, rated Ba1 by Moody's and BB+ by S&P, is a Permian pure play with nearly 400,000 net acres across the basin. The company recently completed a $9.2 billion acquisition of Energen. "As a result, and as a sign of our commitment to capital discipline, we are reducing our planned 2019 activity to levels where we can operate within cash flow." Should commodities prices fall further, Stice said, the company would dial back activity even further "to match our budget with expected operating cash flow."

In November, Parsley Energy, also a Permian-focused E&P, with 209,000 net acres across the Midland and Delaware basins and rated Ba1/B+, asserted that it would reach free cash flow breakeven by the middle of next year. On Dec. 19, announcing its plans to reduce development activity, the Austin, Texas-based company said that on the basis of $50 West Texas intermediate and a static service cost environment, it expects to outspend cash flow from operations by less than $250 million in 2019, a decline of more than 50% from last year. Should prices fall further, Parsley would undertake additional activity reductions, "likely in combination with lower service and equipment costs," according to a press release. And should prices rise, the company said, it would remain disciplined.

"Despite a less favorable commodity price environment, we still intend to take a significant step toward free cash flow generation in 2019. In fact, we are committed to a material reduction in operational outspend no matter the commodity price environment," CEO Matt Gallagher said in the release.

The decisions by Diamondback and Parsley reflect the dilemma facing operators in U.S. shale, which in less than a decade has completely remade the global energy landscape. OPEC is no longer the dominant power as the U.S., for the first time in three-quarters of a century, becomes an exporter of crude. LNG terminals are popping up along the Gulf Coast to ship natural gas from Texas and Louisiana to foreign markets. However, investors are increasingly demanding predictability - a concept not generally associated with commodity businesses - in terms of both capital spending and returns.

Indeed, the efficiency of shale operators is a challenge to predictability. As EvercoreISI notes in its 2019 E&P Spending Report, "The repeatable success rates of unconventional development combined with the ability to be able to quickly ramp up and down continues to change the industry, as operators can react quickly to changes in commodity prices. Reservoirs are not damaged when shutting in wells waiting to be completed and can serve almost as shadow storage where operators can almost choose when to bring production online."

This in part has led to commodity cycles growing even shorter. "While the U.S. rig count has continued to grind higher in the fourth quarter, it is partially masking how the cycles have becoming increasingly shorter. What used to be a 3-4 year cycle followed by a few quarters slowdown has been more like 3-4 quarters of growth before a slowdown occurs."

Ultimately, the industry needs to attract capital in a sufficient amount to drive consolidation, and to undertake the ultimate shift from development to manufacturing mode - for the Permian, and others as well. Recognizing this, E&Ps with the balance sheet to do so have prioritized shareholder returns, and those still seeking breakeven cash flow are looking to do so. This is a change from the debt-fueled boom encouraged by the Fed's ultra-low interest rates, when shale pioneers such as Aubrey McClendon levered their companies to the hilt in pursuit of acreage and production. Now, many E&Ps are promoting a "new model" oil company: one that focuses on return to shareholders along with production from the ground.

Perhaps even more significant was Diamondback's decision to prioritize investor returns over chasing the last marginal barrel of crude reflected in its boost to its dividend to 75 cents from 50 cents. "In 2019, we will continue to target a business plan that operates within cash flow and a 50% increase to our dividend," Stice said. "This strategy reflects the next step in capital discipline for Diamondback, where we will not focus solely on maximizing growth within cash flow, but rather deliver both growth and increasing return of capital to shareholders."

Should oil prices continue lower, or even hold around $50, it will be the first test of that model. Oilfield service firms could be more at risk than E&Ps, a subject Reorg will explore in a later article. Yet some industry observers are bullish on the industry - which is not far removed from the 2014-2016 downturn described by some as the worst ever - and its ability to adapt and adjust. Oil companies "can cope with whatever's thrown at them in 2018," according to Tom Ellacott, a senior vice president at consultant Wood MacKenzie. "Portfolios are set to weather low prices, and the recent slide in prices justifies the sector's conservative mindset."

During the last week of November, the selloff has had many fathers, not the least of which is the Federal Reserve's increase in interest rates. But a significant portion of the collapse can be attributed to the astonishing productivity of U.S. shale, thanks to which the United States during the last week of November became a net exporter of crude oil for the first time in 75 years.

The Energy Information Agency estimates that U.S. crude production averaged 11.5 million barrels per day in November, up 150,000 b/d from October. Production will average 10.9 million barrels per day in 2018, the agency said, increasing to 12.1 million b/d next year. U.S. crude oil inventories, at 442 million barrels in the week ended Dec 7, are about 7% above the five-year average for this time of year.

Amid the year-end carnage, WTI has fallen further below the psychologically important $50 level as market participants weigh the supply glut against concerns over a slowing global economy. OPEC's promise to cut production by 1.2 million b/d in January appears to have been completely discounted.

"The average price that would prompt lower spending in 2019 is $48.14/bbl WTI, about 10% below current spot levels," Evercore ISI analysts wrote in their global spending outlook published on Dec. 10. "While we do not expect commodity prices to test these levels in the near-term, **risk is clearly to the downside for budget revisions as more than 70% of our survey respondents would decrease spending with oil at $50/bbl**. The remaining 30% would decrease spending with oil in the $50-56/bbl range."

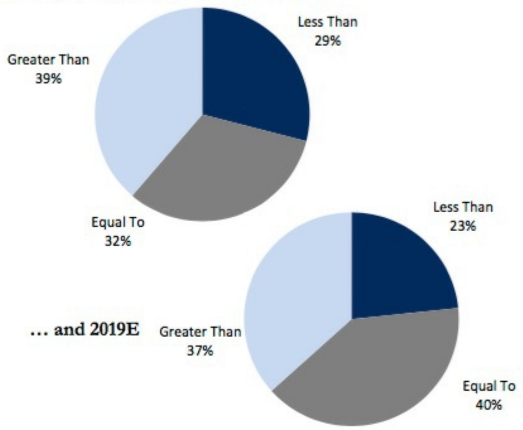
The equity and debt of energy names have been roundly pummeled - the S&P 500's energy sector is down some 19% since Sept. 20, when the benchmark reached its high for the year, according to S&P Indices' Howard Silverblatt. The high-yield primary market - historically a preferred source of capital for the industry - has been effectively closed since late November. No deal priced in December, compared with 10 deals for $5.13 billion in November.

The theme of capital discipline preceded the current rout, however. Evercore notes that E&Ps have increasingly emphasized spending in line or less than cash flows over the past three years. "For 2019, a leading 40% of our survey respondents expect to spend in line with cash flow while 37% expects to spend greater than cash flow and 23% expects to spend less than cash flow. This represents a slightly more austere capital outlook than a year ago, when a leading 39% expected to spend in excess of cash flow but a combined 60% planned to spend in line or within cash flow."

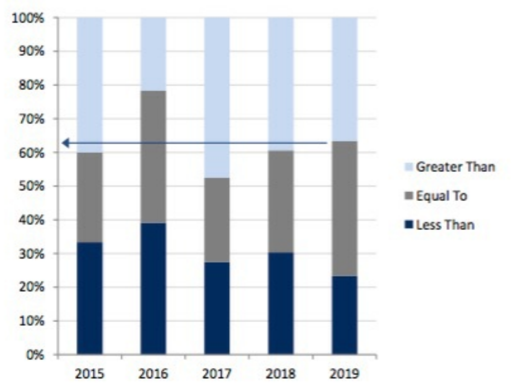
Operators Are Planning To Spending Within Cash Flow

- For 2019, a leading 40% of our survey respondents expect to spend in line with cash flow while 37% expects to spend greater than cash flow and 23% expects to spend less than cash flow.
- While 39% of our survey respondents actually outspent cash flow in 2018 (in line with our initial 2018 survey), 32% spent in line with cash flow (slightly above the 30% plan) and 29% underspent relative to their cash flow (slightly below the 30% plan). **2018 is the first year in recent memory that fewer operators outspent their cash flow than initially planned** (70bps differential).
- While E&Ps have increasingly emphasized spending in line or less than cash flows over the past three years, the current 63% total of those in our 2019 survey planning to spend within cash flow is still below the 78% peak referenced in our 2016 survey.

E&P Spending Vs. Cash Flow In 2018E …



E&P Spending Vs. Cash Flow Expectations In Initial Surveys



Evercore also notes that 2018 is the first year in recent memory in which fewer operators are outspending cash flow than initially planned. But increasingly, shareholder returns are becoming a focus for E&Ps. Concho Energy, which since its founding in 2004 has grown to be the largest unconventional shale producer in the Permian and whose third-quarter production exceeded the high end of its 287,000 boe/d guidance, initiated a regular 50 cent quarterly dividend. The company's usual business model - estimating cash flow and setting a level of capex based on production growth - has evolved toward an emphasis on serving shareholders, according to CEO Timothy Leach.

"We said that a new model was on the horizon for Concho and our industry," Leach said on the company's third-quarter call. "We're well-positioned to deliver on a model that provides competitive oil growth, a dividend to our shareholders and free cash flow. And with the free cash flow, we'll have the flexibility to make additional returns to shareholders, reinforce our balance sheet and play offense."

Leach said he sees 2019 capex of $3.4 billion to $3.6 billion. "We used $55 to $60 oil as a starting point to plan activity based on our view that we expect more volatility, not less in oil prices," Leach said. An analyst asked if the company was "going to be careful" not to put too high a dividend in place, given commodity price volatility. In response, Leach said that having discovered "one of the largest reserves of oil in the world" - a reference to the Permian Basin - "job number one" is optimizing its development.

"But then describing to our shareholders how they are going to profit from all this is really a big part of our business," Leach said. "But the outlook is so positive that we thought now that sending the signal that we see growing free cash flow over time, this was the best time to initiate that."

Other companies highlighting shareholder returns include the following:

Apache Corp. reinitiated its share repurchase program in addition to its 25 cent quarterly dividend. During the third quarter, the investment-grade-rated company sold $1 billion of 10-year notes and tendered for some $800 million of notes with maturities from 2019 to 2037.

EOG Resources noted that it had increased its dividend 31% this year. “And we want to work on increasing the dividend,” CEO William Thomas said, also noting that the company had reduced debt by $350 million by this year and plans to retire another $900 million next year, with a goal of $3 billion over the next four years.

Cimarex Energy said that as far as returning cash to shareholders was concerned, “nothing was off the table. ... We certainly want to have a healthy and growing dividend.”

Chevron which continues to invest in the Permian, said in early December that it was allocating $3.6 billion to the Permian and $1.6 billion to other shale investments next year, for a total of $5.2 billion from its $20 billion capex budget. In 2018 it allocated $4.3 billion. “Our investments are anchored in high-return short-cycle projects, with more than two-thirds of spend projected to realize cash flow within two years,” CEO Michael Wirth said in the release.

Underlying these actions is the industry’s need to “broaden its investor base” - or, put another way, to attract capital from market participants who are still smarting from the 2014-2016 collapse or who are concerned that the next $10 move in WTI might be to the downside.
Energy currently represents 5.5% of the S&P 500, according to S&P’s Silverblatt. It was 13.3% in 1990, fell to 6.6% in 2000 and rose to 13.3% in 2008. It was 12.3% in 2011, when Exxon was the most valuable company in the market-cap-weighted index.

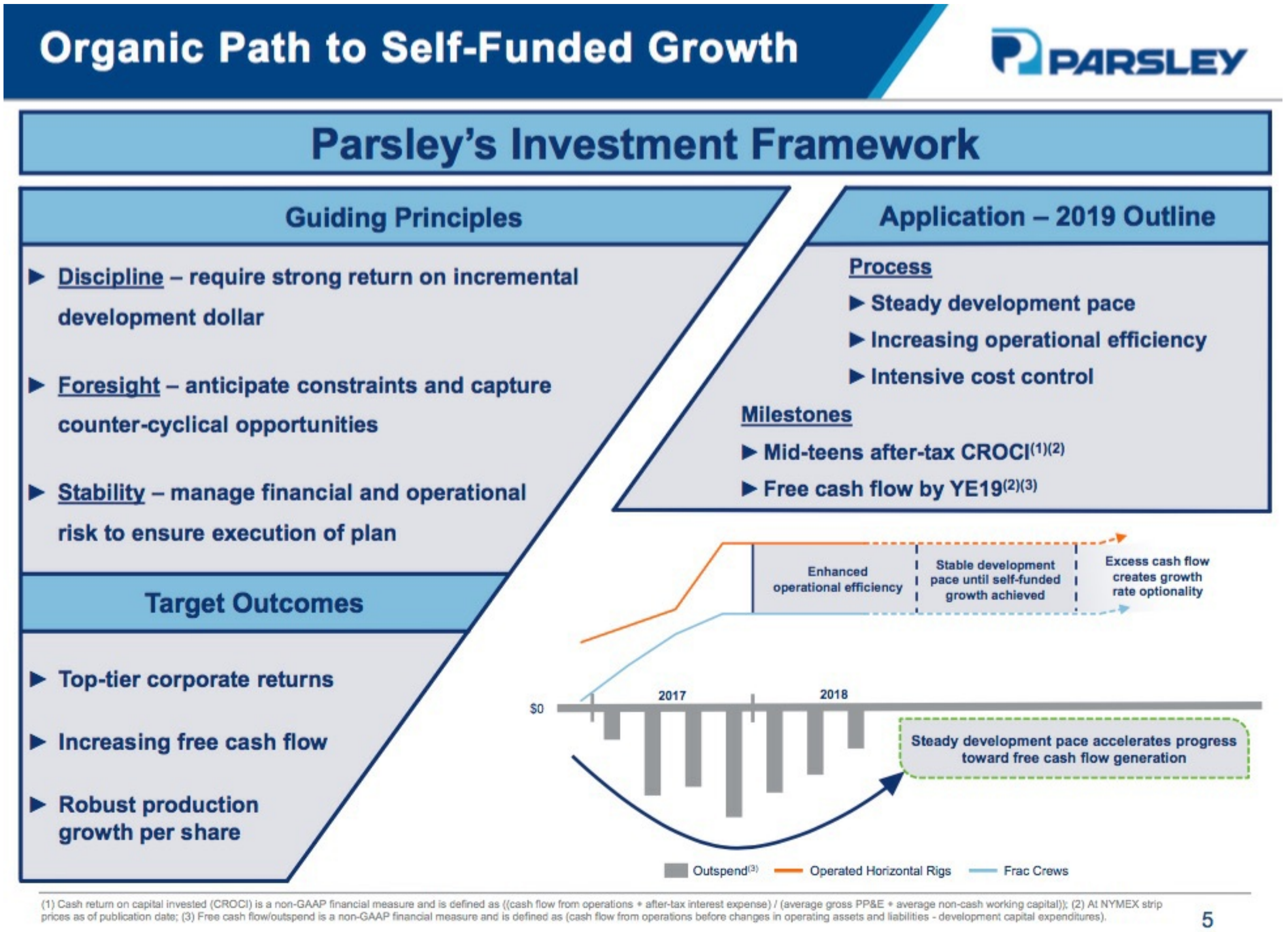
The weighting has been in decline ever since. With diminishing demand from passive index managers, many management teams are presenting their companies as fiscally prudent, with the financial strength to withstand inevitable commodity-cycle volatility and the ability to generate competitive returns for investors.

“It’s really refreshing to see some of the higher-quality companies taking that step to returning cash,” Douglas Leggate, head of Bank of America’s oil and gas equity research, said to William Giraud, EVP at Concho, at a conference in November. “You're competing with investors for mind share, not just in other E&P companies, but why do I need to own an energy company. So when you put all that into the equation, what comes out the other end for Concho in terms of what is the right level of growth and the right level of cash return?”

“We've got to make it look like a widget business,” Giraud said. “You've got to make it look like a high-quality industrial, which trades at a much higher multiple. I think to the extent our industry can get to that widget model, where I put money in the front and I get growth and free cash flow out the back and show that reliably, I think that's how we're going to attract generalists back to the space. I think there's people using very strong terms like the energy space is uninvestable. I think it's going to be a really interesting discussion about what the optimal level of growth is plus free cash flow.”

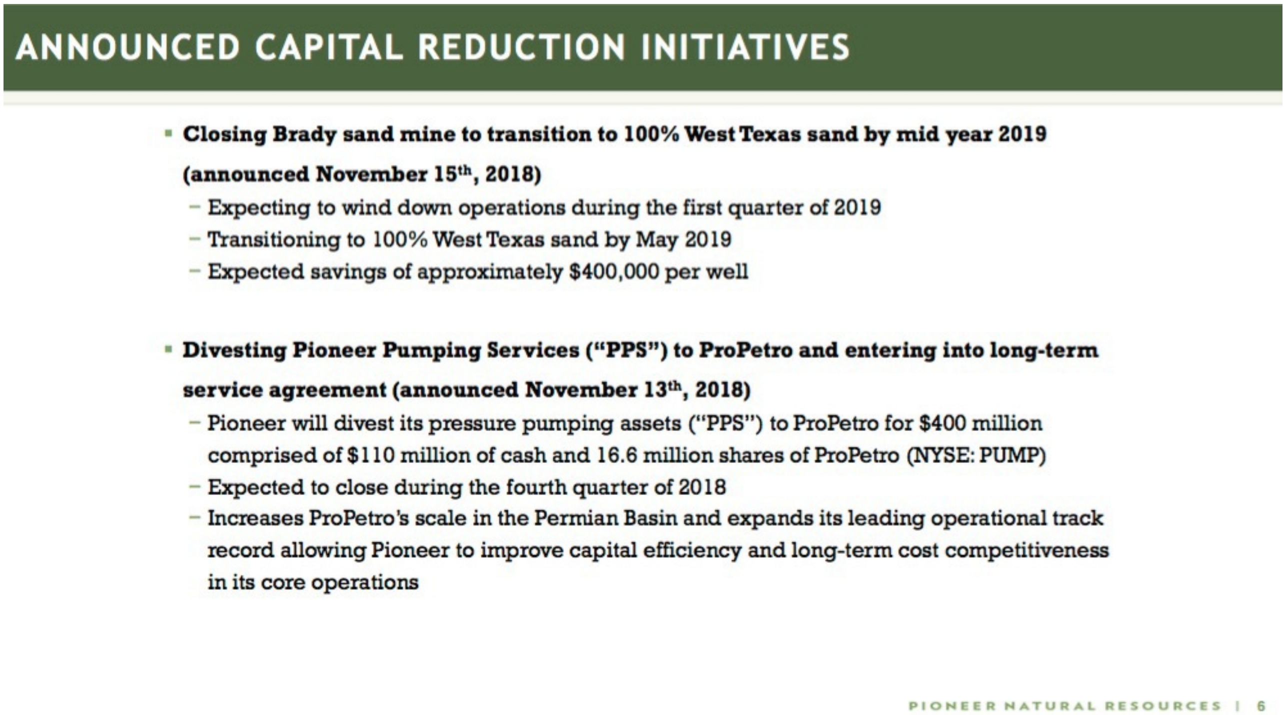
Giraud’s comments echoed ones made by other members of Concho management on the third-quarter call: “Describing to our shareholders how they are going to profit from all this is really a big part of our business,” CEO Timothy Leach said. CFO Jack Harper: “Clearly, our dividend is a priority. And so if the consequence of lower [commodity prices] is lower production growth over a year or two, that's fine.”

For other companies, the near-term goal is still positive free cash flow. Parsley Energy, as noted above, said on its third-quarter call that it had “decided to accelerate our path to free cash flow. Put simply, our job is to allocate capital responsibly.” It outlined its goals for reducing outspend and achieving free cash flow neutrality:

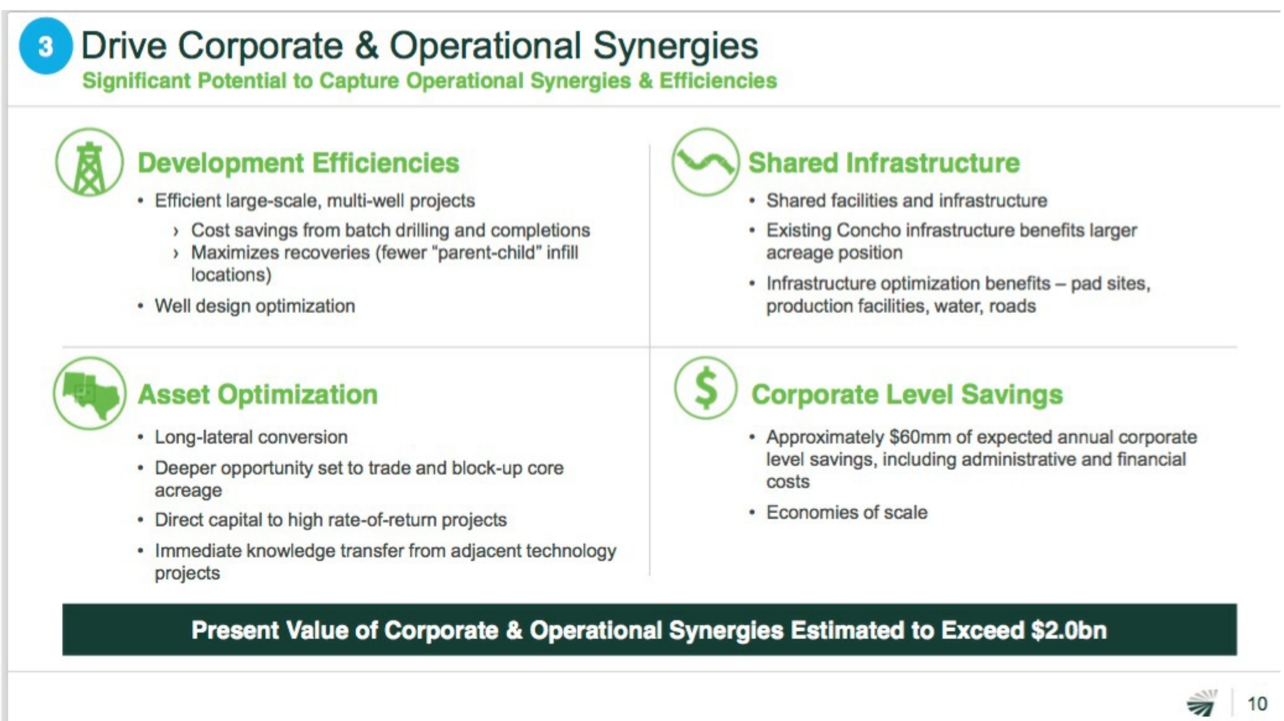


Carrizo Corp.'s CFO David L. Pitts said that the company expects to get to free-cash-flow positive in the middle of next year. The company also noted that its leverage had fallen below 2x and that during the quarter its borrowing was boosted to $1.3 billion with $1.1 billion of elected commitments. In addition, the LIBOR margin was reduced by 25 basis points to a 1.25%-2.25% range, depending on the level of borrowings. It plans to use the increased liquidity to retire its remaining 7.5% notes.

Pioneer Natural Resources said its 2018 capital program was, in the words of CEO Timothy Dove, "spending our operating cash flow." However he said, the company would be "essentially cash flow neutral" by year end, a "great step in the right direction." The 2019 budget, he said, would come in below operating cash flow and the company would "take steps to more meaningfully return cash to shareholders." The company announced the following capex reduction initiatives in November:



Initiatives designed to boost share prices have an additional and over the long term more significant purpose: the creation of a currency that can be deployed in M&A transactions. As Bob Sullivan of AlixPartners told Reorg two years ago, the trend in North American shale plays is toward full-scale industrialization or "manufacturing," which will allow for the greatest efficiencies in terms of scale, cost and technologies. This will require increased consolidation. Concho Energy, which agreed to acquire RSP Permian in an all-stock transaction valued on the announcement date at $9.5 billion, presented the argument as follows:



On Aug. 14, Diamondback announced the acquisition of Energen in an all-stock deal valued at $9.2 billion. The acquisition, according to the release, increased Diamondback's Tier 1 Permian acreage by 57%. Diamondback highlighted drilling, completion and equip well cost savings of up to $200 per lateral foot across over 2,000 net operated locations in the Midland Basin, savings of $50 per lateral foot in the Delaware Basin and other benefits from economies of scale due to overlapping and adjacent acreage in Howard, Martin and Ward counties.

“Our industry has transformed into a manufacturing business, and the operator that converts resource into cash flow at the lowest cost will win in the long run,” CEO Travis Stice said on the call. It would create more efficient operations and lower well costs by more than $200 per lateral foot, and create, Stice said, “a must-own large cap independent that is uniquely positioned to deliver unmatched growth and returns in the Permian basin.”

On the day of the announcement, Diamondback’s shares fell more than 10%. Concho’s shares fell more than 8% when it announced its all-stock RSP acquisition. Cimarex’s $1.6 billion purchase of Resolute Energy, announced in November, offered Resolute shareholders the choice of cash, stock or a combination of the two, subject to proration of 60% stock and 40% cash. Cimarex funded the acquisition with revolver borrowings and cash on hand.

However, Michael Byrd, a partner at Akin Gump who has served as lead counsel on more than 100 upstream acquisitions, divestitures and joint ventures, said he is optimistic on the outlook for M&A. While there may not be blockbusters in the $8 billion to $10 billion range, there will be many in the nine-figure range, according to Byrd. Byrd represented DiamondBack on its Energen purchase; an ad hoc group of EV Energy Partners unsecured noteholders in the formation of a new exploration-and-production company and acquisition of the assets of EVEP arising from EVEP’s restructuring, and an ad hoc group of unsecured noteholders of Breitburn Energy Partners LP in the formation of a new exploration-and-production company and acquisition of the Delaware Basin assets in Breitburn’s $3.6 billion restructuring.

“This has always been a business for risk-takers, so we will continue to see smaller independent and entrepreneurial operators who think they can come in, pick up assets, and do a better job than someone else,” Byrd said in an interview with Reorg. Byrd said the expects to see transactions involving operators in a given basin who are looking to add to existing acreage, or trades and exchanges between operators. Entire companies could also come into play, he said.

“There’s a good deal of talk about some other companies that may be targets, such as Parsley, WPX, Endeavor, Abraxas, Felix and Callon. Generally, these companies can offer prime blocks of acreage and/or cost synergies attractive to potential acquirers. I wouldn’t be surprised to see deals involving those companies next year. And some of the companies that were big acquirers this year will be divesting some of the non-core acreage that came along with the acquisition.”

Karthik Revana, a petroleum engineer with Ralph E. Davis, an Opportune company, says that the premium values for Permian acreage make a good argument for the basin being the world’s premier oil and gas play. The Concho/RSP deal implied an acquisition cost of $75,504/acre, while Diamondback’s purchase of Energen implied an acquisition cost of $54,977/acre for the 89,000 net Tier 1 acres and $1.5 million each for 3,901 net drilling locations.

The Permian is not the only basin that will see M&A activity, according to Akin Gump’s Byrd.

“We’re also seeing some of the gassier plays garner some interest,” Byrd said. “We’re seeing deals in the Utica and Haynesville. The Powder River Basin also has a lot of interest right now. And we’re seeing a lot of activity in the Eagle Ford, more so in the eastern part of the play. A lot of the eastern Eagle Ford is productive for both Eagle Ford targets and the Austin Chalk right above it.”

In its conference call discussing the Resolute acquisition, Cimarex CEO Thomas Jorden, like Diamondback and Concho, cited scale as a rationale for the deal. Resolute had done a “great job” with its assets, Jorden said. “But quite frankly, they're just smaller and haven't had the breadth and scope that we have to test completion styles, to test development styles.”

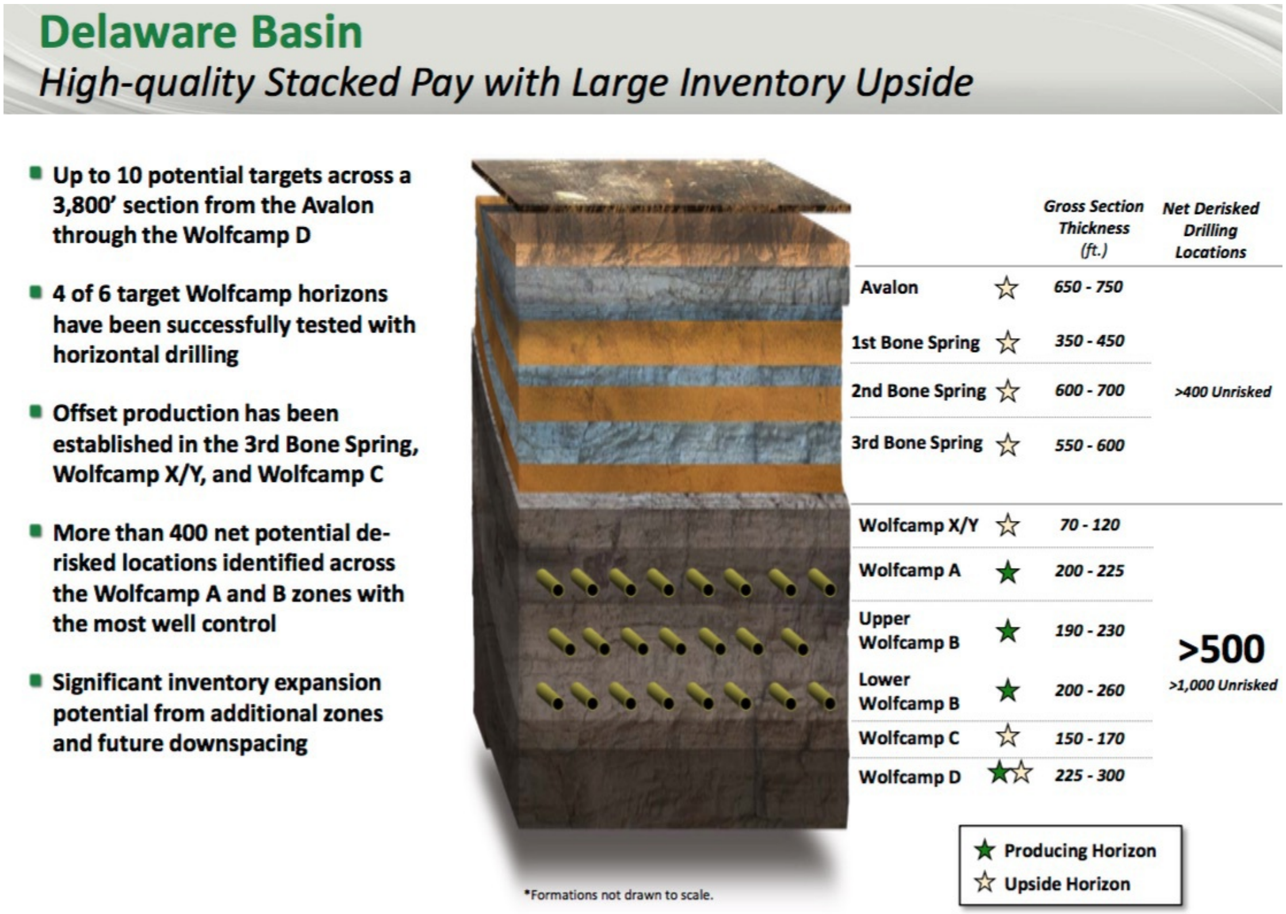
Breadth and scope were also themes on Cimarex’s third-quarter call on Nov. 7. Forecasting year-over-year production growth in the fourth quarter of 29%-38%, Jorden said this was the result of economies of scale that deliver “increasing capital efficiency” and help Cimarex maintain an “industry-leading cost structure.” This trend toward this industrial or manufacturing model would continue across all of the company’s assets, Jorden said, “As our program transitions to one that is dominated by large-scale development and we transition to a more repeatable multiyear development pattern in 2020 and beyond,” Jorden said, “we think establishing a consistent program within cash flow and returning excess cash to shareholders is a prudent approach that fits our business. Our experience tells us that capital programs that expand and contract with rising and falling commodity prices and cash flows leads to inefficiencies. Furthermore, these complex development projects require a long lead time for planning, design, permitting and infrastructure. Effective execution requires a multiyear plan.”

Henceforth, Jorden said, the company would formulate multi-year budgets around a flat Nymex oil price: “We can grow our assets and generate cumulative free cash flow over the next three years at a flat $55 WTI price.” (EOG, similarly, notes that its capital allocation is based on returns measured against a “premium price deck” of $40 flat oil and $2.50 flat natural gas. However, as CEO William R. Thomas said on the company’s third-quarter call, “we’re not really focused on growth. We're really focused on getting better and increasing returns.”)

Apache Corp., which raised its full-year guidance, said on its call that it is moving toward the development phase. In the Midland and Delaware basins, CEO john Christmann said, “a greater percentage of our capital” is moving to full pattern development. And while some testing and delineation would continue in the Alpine High, Christmann said, “we are transitioning now to a multilevel pad development designed to optimize spacing, pattern and completions configurations.”

However, many smaller operators remain in testing mode: Understanding the quality of their assets and determining the optimal well spacing and completion design can create a model for development. Getting this wrong can, as in the case of Sanchez Energy’s experience with the Comanche asset, result in unfortunate outcomes.

Carrizo Oil & Gas, on its third-quarter call, said that after gathering eight months of production history it had determined the “optimal development strategy” for its Eagle Ford position. “By combining the multipad development with lower fluid, hybrid frac designs, we believe we will minimize parent-child impacts and improve stimulation efficiency,” CEO Sylvester Jordan said. The subject of parent-child impacts - also known as frac hits - and well spacing was also a point of discussion. COO J. Bradley Fisher described a configuration that looks “like a five on a dice:” Two wells in Wolfcamp A spaced at 660 feet, a well in Wolfcamp B upper 330 feet between those two, two in Wolfcamp B lower spaced at 660 feet.



EOG Resources, for its part, provided an update on its "remarkable progress" in unlocking how to best develop the "technically complex" Delaware Basin. Six hundred and sixty feet, according to EVP of exploration and production Ezra Yacob, was a "good average" for its Permian position, while noting that in its Combo area the curve was based on 880-foot spacing, and it had tested spacing between 500 and 700 feet in the other parts of the oil window. David Trice, EVP of exploration, noted that the company was planning tests in the Mowry and Niobrara, both of which would be done at 660 feet.

An interesting question was posed to Timothy Dove, CEO of Pioneer Natural Resources. Stifel analyst Derrick Whitfield noted that Pioneer was more conservative than most peers with its spacing in the Permian's Wolfcamp. However, the analyst said, Pioneer also has materially more inventory than its peers. "if your position were a 100,000 acres or less, would your development approach still be biased towards 750-foot spacing or water in the Wolfcamp?"

"This is the best question I've got in a long time because it shows some insight into what's going on in the industry," Dove replied. Operators with limited inventory, he said, "basically drill the hell out of it" - the idea being, one more well will "squeak out" one more dollar of NPV.

"And what that means, the last economics on the last well drilled are lousy. We're taking the opposite view. We want the economics on every single well to be very, very strong," Dove said. Pioneer's "vast inventory" allows it to stop drilling "when we start seeing diminishing returns in a section by drilling it too far down space."

Dove's point indirectly makes the case for further consolidation: Operators with the larger holdings will be able to focus on economic development plans rather than just a grab for the last marginal dollar.