Our Outlook for Energy Stocks

Is the consensus on oil stocks already unraveling?

By Eric Chenoweth, CFA, Associate Director of Stock Analysis

- Last quarter, we challenged the deeply entrenched conventional view that oil stocks should be favored at the expense of natural gas stocks. Cracks in this consensus view have formed much quicker than we anticipated.

- The incredibly bright future of deep-water drilling constituted the primary subplot of the oil consensus view. In the wake of the oil spill, this subplot met with a sharp twist.

- Valuations in the energy sector have become somewhat cheaper in aggregate, though still close to fairly valued as a group. We view XOM, RRC, SE, RIG, and UPL as excellent companies to own over the long term.

For the third consecutive quarter energy stocks failed to move decisively, though there was plenty of volatility from day to day. The energy select sector SPDR XLE was down only about 2.5% year to date as of June 18. However, we did see some larger directional movement in the oil and natural gas futures markets, with gas finally emerging as the victor. So far during the second quarter, the front month contract for crude oil is down more than 5% while the front month natural gas contract is up more than 30%. Perhaps this partially explains the crickets we now hear, where not long ago we heard a roaring chorus praising the outlook for oil producers and condemning the future of gas producers.

The other turning-point event, which appears to be driving some of the herd back to gas (or at least onshore), is the plume of oil growing daily in the Gulf of Mexico. Although we think the connection here is a bit fuzzier (that is, trying to translate the Gulf spill into a bullish gas story), it most certainly gave pause to one of the long-standing secular themes trusted widely throughout the investment community—the undeniable growth potential of deep-water oil production over the next decade.

Despite the bad taste the oil spill may be leaving in the mouths of U.S. commuters' each morning, we view the spill as fundamentally bullish for the commodity's price in the intermediate-term. Thus we've been a bit surprised by investors' decisive reaction to cut positions related to long-term deep-water activity. A large share of non-OPEC oil supply growth was due to come from offshore projects, with deep-water projects leading the charge. Any delay, suspension, or termination of planned deep-water drilling activity could threaten an already-tight supply outlook over the next three to five years, placing more pressure on OPEC to make timely investments and/or relying more on long-shot oil production hopeful Iraq.

Our fundamental view that deep-water production is still a critical component for long-term oil supply, combined with the dramatic market sell-off, triggered our 5-star rating for the world's largest deep-water rig operator, Transocean RIG, a few weeks ago. Transocean remains the first and only company directly involved in the spill to garner a 5-star rating.

We admit that the liability facing the company is an unknown, and clouds any downside analysis. And, even though the early data we're seeing points to BP BP as the company likely to bear the lion's share of the ultimate liabilities (especially if gross negligence is proved on their part), spill liabilities remain a risk for Transocean.

Astute investors are also very concerned about the drilling moratorium in the Gulf—could it be extended beyond six months? And could similar actions spread to other deep-water markets? Some smart people have suggested the moratorium could be extended well beyond six months. But we're still very skeptical of this view, as very few parties outside of a few environmental groups are supportive of such an extension. Plus, several companies have already filed suit to cut the moratorium short—one already meeting with early success, and the backlash against the moratorium among Gulf Coast workers, companies, and politicians appears to increase each day.

We forecast Transocean's revenue rig-by-rig, and see some downward pressure on earnings power emanating from the moratorium, and further downside if it is extended. However, we think weakness in the mid-water and jackup markets is more certain (and was a strong theme even before the spill), as these contracts roll over more frequently and rig oversupply in these markets is a problem. Transocean is best positioned among its peers outside of these weaker markets and its earnings power is most influenced by deep, and ultra-deep-water rig rates.

We still think Transocean's intermediate and long-term (2012 and beyond) earnings power is $10 per share or better, giving it compelling upside potential when it's trading in the $40-$50 per share range. If this spill turns out to have been a preventable mistake, where BP bears more blame than the industry at large, then deep-water activity would likely come roaring back (in our opinion), and Transocean's earnings power would improve and the multiple the market places on that earnings power could improve again. Thus the potential upside, given Transocean's critical role as the largest deep-water rig operator, makes us think the firm is worth the risk for the right kind of investor.

In contrast, we don't see that kind of upside potential in BP's shares, and we see more downside if gross negligence is proven.

Changing gears—like many, we've been surprised to see natural gas prices rise so sharply, even though we've long thought sub-$5 gas was unsustainable longer-term. Some have attributed the rapid runup in gas prices to troubled hedge fund trading, a la Amaranth (which lost about $6 billion in the natural gas futures market in 2006). Another explanation could be the return of utilities and certain industrial companies to the marketplace, where hedging requires going long natural gas futures. For a couple of quarters, we've suspected this group would eventually return to the marketplace and restore some balance to the cadre of E&P companies selling futures to hedge their positions and protect drilling budgets.

Near-term natural gas supply fundamentals are mixed, despite the recent pop in the futures market. E&P CEOs appear decidedly less enthusiastic about gas drilling compared with a few quarters ago, and 2010 gas drilling budgets have been reduced wherever possible. This has led to very little discretionary gas drilling and budget shifts toward oily and liquids-rich prospects. Unfortunately, factors like increased JV activity, other successful fund raising efforts, and drilling to hold leases even where single well economics don't support it all suggest gas drilling will remain more active than it otherwise would, given such low gas prices. And as a result, U.S. natural gas inventories remain near their seasonally adjusted historical high.

On the demand side, we're watching for upticks from industrial gas consumers and electric power generation demand (with summer peaking season soon upon us). Transportation data points have been trending upward in the U.S., helping support better refined oil product demand here. Although a U.S. refined product demand recovery is certainly encouraging for oil prices, the pace at which the emerging economies continue to demand greater and greater quantities of crude (and natural gas) remains the greatest factor to watch. Recent weakness in Europe, and its ultimate impact on trading partner China (and China's demand for raw materials and crude), will likely continue to be a key theme for oil as we move through the rest of 2010.

And though oil's global demand profile has been a distinct positive for oil versus natural gas in recent quarters, it likely played a part in reversing that positive trend during the second quarter. One recent bright spot has been China's apparent willingness to let the yuan appreciate versus the U.S. dollar, which could improve the outlook for oil prices.

Industry-Level Insights

Energy stocks mostly ran in place during the second quarter. For the fifth consecutive quarter, E&P companies' stocks largely matched or outpaced the prices of assets in recent deals (based on comparing companies' enterprise value/reserves versus dollars spent per mcf of reserves in the marketplace). We continue to see relatively modest debt yields, after watching them fall considerably during the past year, but we have recently seen them rise from their lowest levels.

Companies continue to take advantage of healthy debt and equity markets and more recently strong asset markets to improve liquidity, conduct deals or IPOs, and fund budgets. And even though this seems to have slowed a bit in recent months, we continue to view marketplace activities as further evidence that energy stocks remain fairly valued as a group. We'd need to see sustained oil- and gas-price strength or further multiples improvement to justify significant stock-price gains from here, in our opinion.

As a group, energy was close to fairly valued at the end of the second quarter, much like it was toward the end of the first and fourth quarters, with the market-cap-weighted price/fair value ratio for the energy sector at 0.88. The median price/fair value ratio was 1.01, illustrating the disconnect we see between some of the larger- and smaller-cap names in energy. In general, we see larger-cap energy names slightly undervalued and many smaller names more fairly valued, in aggregate. Recent valuations contrast sharply with where we stood a year ago and in late 2008, when market prices appeared much cheaper to us.

Energy Stocks for Your Radar

We've picked five stocks from our 4- and 5-star list to keep on your radar. One of our picks, Spectra SE, is a midstream company focused primarily on transporting natural gas in the U.S. Spectra has an attractive asset footprint to capitalize on rising gas production volumes from new shale gas-producing regions in the U.S. and Canada.

We've also chosen two E&Ps, Range Resources RRC and Ultra Petroleum UPL. Range has a dominant position in the natural gas-producing Marcellus Shale in Appalachia. Ultra has a dominant position in the Pinedale Anticline in Wyoming and a large, emerging position in the north central Pennsylvania Marcellus Shale.

ExxonMobil XOM is our only 5-star rated major integrated energy firm. We think the pullback in Exxon's stock following the announced acquisition of XTO Energy XTO has provided a unique opportunity to acquire a great firm at a reasonable discount to our fair value estimate. That deal is likely to close before the end of the second quarter.

Finally, we've included Transocean RIG, based on the case we made above. For certain risk-tolerant investors, we think its upside potential due to long-term robust deep-water drilling demand is great enough to accept the murkier downside threat of an uncertain liability
Our oil price deck is about 7% below the futures market when considering years 2013 and beyond, while our natural gas price deck is about 20% higher than the futures market for 2013 and beyond.

Top Energy Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Consider Buying
Spectra Energy	★★★★★	27.00	Wide	Low	21.60
Range Resources	★★★★	78 .00	Narrow	High	39.00
Ultra Petroleum	★★★★	63 .00	Narrow	Medium	44.10
ExxonMobil	★★★★★	87 .00	Wide	Low	69.60
Transocean	★★★★★	116 .00	Narrow	High	58.00

Data as of 6-23-10.

Spectra Energy SE

Spectra operates one of the largest diversified midstream footprints in North America, with core long-haul pipelines touching many of the continent's most prolific natural gas plays, including the Haynesville, Marcellus, Horn River, and Montney shales. Spectra's massive pipeline network creates opportunities for low-risk organic growth projects that leverage the entire network, bringing incremental volumes to market at attractive rates of return.
Stable fee-based cash flows from Spectra's pipelines, storage, and distribution operations constitute roughly 80% of cash flows, largely insulating Spectra from commodity price and volume fluctuations. The remaining 20% of cash flows, which stem from commodity-sensitive gathering and processing operations, offer cheap upside potential with rising commodity prices.

Range Resources RRC
Range Resources is a first-mover into the potentially prodigious Marcellus Shale in the Appalachian Basin. With more than 1 million net acres in the play, Range stands to extract significant value from the Marcellus during the next several years. Due to its early entry into the play, Range's lease terms are very favorable, which, coupled with the attractive cost structure and production profile of individual wells, make the play very economical at natural gas prices as low as $4 per mcf. Range's low corporate decline curve and its exposure to the Marcellus Shale reduce reinvestment risk and should translate into strong returns on capital for many years.

Ultra Petroleum UPL
For over five years, Ultra has been one of the lowest cost producers of natural gas in the U.S., thanks to its Pinedale Anticline asset in Wyoming. The company is now in the early innings of developing its second low-cost asset, its Marcellus Shale properties in north central Pennsylvania. Together, these two regions should provide Ultra with plentiful low-cost drilling opportunities that will allow the firm to steadily grow production and reserves while generating high returns on invested capital over the decade ahead.

Transocean RIG
As one of the largest deep-water rig operators, Transocean is ideally positioned to benefit from the secular trend toward more offshore drilling, thanks to attractive well economics and several large discoveries. We believe demand far outstrips supply for the industry's ultra-deep-water rigs, which only numbered around 35-40 in 2009. For example, Brazil has indicated a need for another 60 deep-water rigs. We believe the market currently undervalues Transocean's substantial cash-flow-generating power as well as the relatively stable earnings outlook provided by a backlog of more than $28 billion.

ExxonMobil XOM
Exxon recently entered 5-star territory, a point where we think it offers decent return potential with less risk than many of its peers. Exxon's returns on capital regularly exceed its peers'. Its ability to choose from among some of the best mega-projects around the globe helps it drive these higher returns. Its track record of delivering projects on time and under budget makes it a preferred partner on mega-projects. Exxon's ability to integrate its global network of oil and natural gas production, transportation, refining, and chemicals manufacturing, and ability to drive costs down throughout the system further underpin its high returns and buffer the firm during weaker commodity-price environments.

Eric Chenoweth, CFA, does not own shares in any of the securities mentioned above.