Our Outlook for Energy Stocks

Energy firms take full advantage of market-driven opportunities in the second quarter.

By Eric Chenoweth, CFA, Associate Director of Equity Analysis

The energy industry caught a breather this quarter as one of the biggest short-term rallies in oil prices took hold. Although spot natural gas prices remained very weak, expectations for higher prices in 2010 gripped the market and further supported a rally in oil and gas producers' stocks. Equity and debt markets thawed as well, after a couple very weak quarters. Across the spectrum (upstream, midstream, and downstream), energy companies did not let this market-driven opportunity go untapped. Energy firms issued heaps of equity and debt, and merger and acquisition activity picked up. These deals contributed to some of the more debt-ridden and cash-starved firms undergoing significant healing, especially compared with where they stood a quarter ago.

We spoke with a number of large, independent oil producers this past month, hoping to gauge any emerging opportunities or trends they might be seeing with oil climbing back above $70 per barrel. None of the larger players was anticipating any near-term aggressive drilling activity in response to higher oil prices, but many were considering measured drilling rig additions later in the year should oil prices remain high or hedges get put in place at prices high enough to support additional economic drilling. We found Permian oil drilling appears set to rebound sooner and more aggressively than Bakken oil drilling. Large Permian players planning measured increases in activity include Pioneer PXD and Concho CXO. Large Bakken producers include Continental CLR, EOG EOG, XTO XTO, and Whiting WLL. On the flip side, we still haven't found any evidence that drilling and services costs will rebound anytime soon; in fact they appear likely to fall for at least a couple more quarters (partly due to continued weak spot natural gas prices and light gas drilling activity). This trend is especially encouraging for oil producers, as they can capture higher prices and lower costs. We'd expect to see earnings power increase for oily E&P firms over the next couple quarters.

Last quarter, we discussed the potentially negative impact certain provisions in the president's budget proposal could have on the U.S. energy industry. One of the largest threats we have discussed regularly is the potential repeal of intangible drilling costs (IDCs), which would reduce E&P companies' aftertax cash flows by roughly 20% to 30%. The sense of urgency appears to have calmed down a bit on this front, as industry experts likely made some headway in educating key parties in Washington about the negative effect such an action would have on domestic natural gas drilling and production, and the outsized impact it would have on small energy businesses. We continue to monitor government actions and how they might impact the energy businesses we cover, as it appears likely that higher taxes in some form or another will visit the industry in the future. Since our last quarterly update, it appears that carbon legislation is the one area that has seen the most discussion. If a cap and trade system were put in place, it would likely hit stationary emitters of CO2, such as refiners, the hardest.

We didn't make any changes to our long-term assumptions for oil or natural gas in our valuations this quarter. In the short run, we've been surprised at how quickly and far oil prices have rallied, despite record levels of crude oil inventories and continued weak demand for refined products globally. Our long-run base-case oil price assumption of $80 per barrel remains higher than the futures curve and is supported by our thinking that once oil demand stabilizes it will induce tight supply conditions and expose a higher marginal cost to bring on new production compared with present market prices. We have been impressed with OPEC's discipline thus far to rein in some excess supply and expect weaker (or deferred) non-OPEC investments in new supply will help contribute to another round of tight supplies if and when demand rebounds.

Natural gas prices remain very soft in the short run and our near-term outlook is for more pricing weakness during the remainder of 2009. Continued near-term softness appears almost inevitable as record amounts of gas in storage, still robust supply rates stemming from large investments made in 2008, and weak end-market demand should hang over the natural gas marketplace for the rest of the year. However, our higher long-term base-case price assumption of $7.50 per mcf is supported by our view that the industry's steep decline curve will contribute to a reduction in gas supplies as we enter 2010, and any rebound in demand should expose the higher marginal cost to bring on new production when compared with today's market price.

Valuations by Industry

As a group, energy stocks forged a remarkable rally during the second quarter, led by E&P stocks. For the first time in many years, we saw market valuations of E&P companies' stocks outpacing the prices of assets in recent deals (based on comparing companies' enterprise value/reserves versus dollars spent per mcf of reserves in the marketplace). Perhaps this partly explains the rush for firms to issue equity and debt and the uptick in acquisitions we saw during the second quarter.

As a group, energy was very close to fairly valued at the end of the second quarter, with the overall price/fair value ratio for the energy sector at 0.95. This contrasts dramatically with the past couple quarters when energy looked incredibly undervalued. The remarkable rally in energy stocks that happened in the second quarter appears to be banking on a nice rebound in energy prices, volumes, and credit markets in 2010 and beyond. Our oil and natural gas price decks are still slightly above the futures market when looked at longer term, but they are much more closely aligned than they have been in the past two quarters. Presently within energy, we see the most undervalued industries in pipelines and E&P and the most overvalued companies among drillers and services companies.

Energy Industry Valuations

Segment	Average Star Rating	Price/Fair Value*	P/FV Three Months Prior	Change (%)	Uncertainty** (%)
Oil & Gas - Drillers	2.87	1.07	0.67	60	94.3
Oil & Gas - E&P	3.15	0.92	0.6	53	77.3
Oil & Gas - Integrated	3.31	0.95	0.74	28	11.4
Oil & Gas - Pipelines	3.62	0.81	0.62	31	29.5
Oil & Gas - Refiners	3.23	0.94	0.69	36	70.5
Oil & Gas - Services	2.51	1.18	0.75	57	81.8

Data as of 06-12-09.
*Market-Weighted Harmonic Mean
**Ranks the industry's fair value uncertainty (most uncertain =100) based on the aggregate market-weighted uncertainty ratings of all industries under coverage.

Energy Stocks for Your Radar

We've picked five stocks from our 4- and 5-star list to keep on your radar. Two of our picks, Spectra SE and Energy Transfer Equity ETE, are midstream companies focused primarily on transporting natural gas in the U.S. Both have attractive existing footprints and we think Energy Transfer has especially bright prospects for profitable growth. Also, both hail from our most undervalued industry grouping presently—pipelines. We've chosen two E&Ps, our second most undervalued industry grouping, Range Resources RRC and Cimarex XEC. Range has a dominant position in the natural gas-producing Marcellus Shale in Appalachia, which should be a source of profitable growth and reinvestment for the firm for many, many years. Range's existing development positions in the Barnett Shale and Nora should help fund some of this growth. Cimarex is an E&P with ample present liquidity and an emerging shale play in Oklahoma (Cana Shale) that looks set for additional investment and growth over the next few years. We like Cimarex's strong present financial position and think its patience and returns-driven mentality could present it with some good investment opportunities during the present oil and gas price slump. Finally, we've included our only remaining 5-star major integrated firm in our coverage, ConocoPhillips COP.

Top Energy Sector Picks

Company	Star Rating	Fair Value Estimate (USD)	Economic Moat™	Fair Value Uncertainty	Consider Buying (USD)
Spectra Energy	★★★★★	25	Wide	Medium	17.50
Energy Transfer Equity	★★★★★	54	Narrow	High	27
Range Resources	★★★★★	70	Narrow	High	35
Cimarex Energy	★★★★★	56	Narrow	High	28
ConocoPhillips	★★★★★	70	Narrow	Medium	49

Data as of 06-17-09.

Spectra Energy SE

Spectra operates one of the largest midstream footprints in North America, touching many of the continent's most prolific producing areas. Stable fee-based cash flows from pipelines, storage, and distribution operations comprise roughly 80% of cash flows, largely insulating Spectra from commodity price and volume fluctuations. More specifically, customers pay Spectra reservation fees for the right to use a specified amount of transportation or storage capacity, regardless of actual usage. We think the stock currently trades for less than the value of these fee-based cash flows alone. The remaining 20% of cash flows, which stem from commodity-sensitive gathering and processing operations, offer free upside potential when processing margins are favorable, in our view.

Energy Transfer Equity ETE

We think Energy Transfer is one of the very best pipeline operators in the country, with an unrivaled Texas intrastate system serving as its core asset and recent interstate pipeline acquisitions, joint ventures, and new projects extending its reach from California to Alabama. Energy Transfer's preference for building large-diameter pipe secured by long-term capacity reservation fees guarantees a base level of cash flow from each project, locking in favorable returns while allowing for potential upside. With several significant projects currently under construction we have clear visibility into cash flow growth over the next several years, and as the general partner of Energy Transfer Partners ETP, Energy Transfer Equity will benefit asymmetrically. While we think ETP will be able to increase its distribution by roughly 7% a year over the next five years, we expect ETE's distribution to increase nearly twice as fast. And since the two stocks are currently trading for virtually the same yield, we think ETE is a steal.

Range Resources RRC

Range Resources is a first mover into the potentially prodigious Marcellus Shale in the Appalachian Basin. With over 1 million net acres in the play, the Marcellus stands to be a key value creator for Range over 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 reduces reinvestment risk and should translate into strong returns on capital for many years.

Cimarex Energy XEC

We like management's conservative operating and financing strategy—return on capital is paramount and debt is kept to a minimum. The runup in oil prices is allowing the firm to slowly ramp up activity and hedge commodity price risk, setting the stage for higher cash flows in 2010. Its Cana shale play in western Oklahoma, while still early, appears to hold top-tier economics. Cimarex has a partnership with Devon DVN in the Cana shale that should help aid timely development of the play. If commodity prices cooperate, production growth should be much higher over the next three to five years than it was historically.

ConocoPhillips COP
ConocoPhillips should realize long-term production growth from recent acquisitions. The company parted ways with its larger rivals in recent years by aggressively pursuing acquisitions to secure reserves. Now with the fall in commodity prices, some of these deals appear ill-timed. The acquisitions of past years, however, provide opportunities to grow production in the future. As a result, ConocoPhillips' production gains should outpace its rivals' in the coming years. Additionally, in contrast to its peers, the majority of ConocoPhillips' production is natural gas. We believe the company could benefit from increased global natural gas usage. ConocoPhillips has also dealt successfully with the rise in resource nationalism by securing production deals with national oil companies. Its size, integrated operations, and flexibility appeal to national oil companies looking for development partners.

Eric Chenoweth, CFA, has a position in the following securities mentioned above: ETE