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Connecting Market Leaders with Investors

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THE WALL STREET TRANSCRIPT**

## **ANALYST INTERVIEW**

### **DANIEL KATZENBERG**

Robert W. Baird & Co.

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# E&P Backdrop Provides Higher Confidence for Investors

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**DANIEL KATZENBERG** is Robert W. Baird & Co.'s Senior Analyst covering exploration & production. Prior to joining Robert W. Baird & Co. in 2013, he worked at Oppenheimer & Co. Inc. for eight years, most recently as Senior Equity Research Analyst for coverage of oil & gas E&P companies. He received a B.A. in political science from the University of Rhode Island and an MBA in financial management from Pace University.

## SECTOR — ENERGY

(AGU800) **TWST: Let's start with a snapshot of your coverage universe.**

**Mr. Katzenberg:** I cover the small and midcap E&P group, all onshore domestic U.S. producers, the largest being **EOG** (NYSE:EOG), with some of the smaller producers going down in cap size to **Earthstone Energy** (NYSEMKT:ESTE), **Abraxas Petroleum** (NASDAQ:AXAS) and **Comstock Resources** (NYSE:CRK). So a wide gamut of E&Ps, with exposure to just about every basin, a mix of oil and gas, and that's how we prefer it, so that we can have perspective on all things inclusive on the domestic energy front.

**TWST: 2016 was, I think it's fair to say, a volatile year for the sector. As the year winds down, how would you describe investor sentiment right now?**

**Mr. Katzenberg:** Yes, it certainly was volatile. I would say at this point it's improving. Sentiment is improving, dare I say almost optimistic at this point. We've certainly had a rough two years and a lot of uncertainty during that period, so we are coming off of very low confidence levels at the beginning of this year.

If you look back to just a year ago at Christmas and going into January and February of last year — 2016 — that was really the low point of the cycle when sentiment was at its worst. But now flash forward to today, and between the OPEC decision to finally reach a production cut agreement, and then we've moved past the uncertainty around the election, and now we have what appears to be a relatively pro-oil-and-gas incoming administration, sentiment certainly has significantly improved.

Thinking more specifically about the E&P companies, what really helped out the group was that we saw substantial balance sheet restructurings during 2016. I think for me and probably for many of us out there, that was one of the more surprising events in 2016, just the amount of capital market activity and how successful all of those

deals were. We saw a lot of E&Ps that were probably too aggressive in the past cycle and put themselves in difficult positions, able to tap the markets, issue equity to pay down debt and then ultimately rightsize balance sheets. These moves, which we saw many of throughout the year — starting in 2015, but really picking up in pace and volume through 2016 — helped to provide lifelines to many E&Ps, enabling them to participate in the next cycle. And certainly a year ago, I don't think we would have thought that for many companies, but a lot of them are here, better-positioned and can take advantage of the higher prices we are now seeing today.

**TWST: Do you think there will be more need for that kind of restructuring in 2017?**

**Mr. Katzenberg:** I'm sure we will see more. You're seeing a little bit. I think the switch that we've had as we moved toward the end of this year is that at the beginning of this year it was really focused on swapping equity for debt. That is unusual in itself; that was not something we had seen historically in the space. The fact that you are issuing equity to pay down debt, you wouldn't expect those companies to be rewarded by investors. But just given the mindset of energy investors, anything that companies

could do to clean up balance sheets and prove that they could be around for the next cycle was applauded by investors. Almost across

### Highlights

*Daniel Katzenberg covers the E&P sector and says sentiment is improving. He says for E&P companies, what has helped the group is the balance sheet restructurings during 2016. What he is now seeing are capital market activities and equity offerings used for acreage. Mr. Katzenberg also says what is top of mind is rig count add, which has led to concerns from some investors that that might lead to oil service cost escalation. He thinks that there's still enough excess capacity to continue to keep costs down for a bit longer. After being bearish for the last two years, Mr. Katzenberg is now recommending that investors increase their allocations, especially in oil-exposed equities. Companies discussed: EOG Resources (NYSE:EOG); Earthstone Energy (NYSEMKT:ESTE); Abraxas Petroleum Corp. (NASDAQ:AXAS); Comstock Resources (NYSE:CRK); SM Energy Co (NYSE:SM); Carrizo Oil & Gas (NASDAQ:CRZO); Antero Resources Corp (NYSE:AR) and Exxon Mobil Corporation (NYSE:XOM).*

the board you saw those stocks outperform or at least perform in line with the peer group. So that was very interesting earlier this year.

Now what we are seeing is the capital market activity and equity offerings are for acreage. So you are seeing it now as a means for growth, their expansion, or some of the private equity capital that's out there is looking to cash in, and the public companies are issuing some equity to pick up additional assets so that they can be a larger, more substantial producer going forward. I think that's probably more of the go-forward trend. I think that balance sheets are generally in pretty good shape, to the surprise of many people, so at this point it's more

about if you can get the market to help pay for expanded footprints in core positions, you are going to see management teams continue to attempt that or execute on that next year, I'm sure.

**TWST: What other trends are you focusing on today?**

**Mr. Katzenberg:** Both of these thoughts center around the rig count add. We obviously rebounded substantially off the bottom levels of April and May of this year on the rig count, and that has primarily been seen in the Permian Basin. In the Permian alone we've added almost 150 rigs, so a quicker reaction I think than a lot of people projected. That has led to a lot of conversations and concerns from some investors that that might lead to oil service cost escalation. That's the first theme; that is top of mind for everyone in the industry and a lot of the investors that we speak with today.

After two years of significant efficiency gains and cost reductions that have been nothing short of phenomenal, at some point that will revert, and the oil service companies will get some leverage and start to increase costs again. In our view, that's not happening yet. We think there's still a runway here for a couple of quarters at least and potentially through 2017, where there's still enough excess capacity out there — whether it be equipment, rigs, even people — we think there's enough that we can continue to keep costs down for a bit longer, and that's an advantage obviously for E&Ps going over the near term.

The other theme is on midstream transportation and infrastructure capacity. Again, because of the rig adds that we've seen, as the industry accelerates and starts to drill more, there's a concern that we will have bottlenecks in transport and then widening in price differentials. That's been a pretty heavy theme in the gas sector, especially in the Northeast, for a couple of years, but as we look out to specifically the Permian, where the majority of this activity increase is happening, we need to watch carefully how much capacity there is to get out of that basin and make sure that there isn't going to be widening of differentials that could hurt bottom lines.

And again, right now what we are seeing, similar to what our view is on the service side, is we think there's a runway where there's sufficient capacity for 2017. And because of West Texas being a relatively easier place regulatorywise and the ability to build out infrastructure, we think the industry has a shot of staying ahead of this. However, just given the pace of rig adds, it is likely to become an issue

at some point. It's probably more fourth quarter 2017 or maybe first half of 2018, but it will likely lead to some bottlenecks and some point hampering growth down the road.

**TWST: What's your overall recommendation on the sector right now? Is this a good time to be buying or increasing exposure to E&Ps?**

**Mr. Katzenberg:** Well, after being generally bearish on the sector for really the bulk of the last two years, we are now recommending that investors increase their allocations, especially in oil-exposed equities. We don't believe that substantially higher oil prices — that being maybe north of \$70, \$75 — we don't see that as likely. We do think the momentum that we are seeing in the

sector over the last six weeks or so will continue through year end and into the first half of 2017, so we do think investors should ride that momentum and take advantage of the improved outlook for the sector.

I think the OPEC and non-OPEC curtailments combined with a more accommodative domestic regulatory front — all of these things have led to improved sentiment, and I think that's bringing back a lot of the investors that stayed clear in 2015 and 2016. Many of the investors we've talked to the last couple of years just couldn't get comfortable with a lack of visibility in the space, and I think especially some of the value shops and long-only investors couldn't get comfortable and weren't willing to increase exposure. Today's backdrop really can provide higher confidence for those investors.

And then as I just said, with service cost escalation in our opinion looking like it won't happen for the next several quarters, we see E&Ps as being in a sweet spot right now where they can expand margins and actually return to growth. We had for many companies, outside of the Permian at least, declining production over the last two years, but now we are likely to see expanded margins and a return to growth in 2017. That sets up for a pretty attractive outlook over the next 12 months for the E&P space.

***"After two years of significant efficiency gains and cost reductions that have been nothing short of phenomenal, at some point that will revert, and the oil service companies will get some leverage and start to increase costs again."***

**1-Year Daily Chart of SM Energy Company**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: What are some of your favorite names? What are you focusing on as you evaluate the companies?**

**Mr. Katzenberg:** Something that we spoke about early on in the down cycle, when we were trying to evaluate companies that might be safe havens and be better-protected in a lower commodity price environment, was what we labeled early on as the “haves and the have-nots.” As we come out to what’s hopefully the back end of this down cycle, we think the separation really has become much more pronounced now. It’s much more clear who the haves and the have-nots are.

What we’re looking for are companies that have core contiguous acreage positions in the top shale plays.

So in our mind, we’re looking at the Permian, which everybody is very focused on, but also the Eagle Ford, the Bakken, the Niobrara. We think those are the core oil plays that offer very attractive returns, even at current oil prices. On the gas side, the Marcellus and the Utica would be the tier-1 core plays that we would want exposure to. And then also importantly are clean balance sheets. The companies that have rightsized their balance sheets, that gives them much more flexibility versus others to accelerate drilling when the time is right and prices warrant it, and I think that’s where we’re starting to get to now.

So with that as the backdrop and the mindset of how we pick stocks, I’ll offer up three. We like **SM Energy** (NYSE:SM). They have been aggressive in 2016, and their shift into the Permian we think will offer multiple expansion potential as it begins to trade more in line with the immediate Midland Basin/Permian peers. Right now it’s trading at about a 50% discount to this Permian group on pretty much all of the key metrics that we look get. Given that it has a very core Midland footprint, we think that gap is going to narrow next year as it starts to gain some credibility and a little operational momentum in the basin.

The second one, **Carrizo Oil & Gas** (NASDAQ:CRZO), on our ranking is one of the most correlated to oil prices of the stocks that we cover, and — a rarity for the E&P space — it’s one of the few companies that we forecast to be cash-flow positive next year. We think the combination of those things and then the potential noncore asset sales — they have several assets, including the DJ Basin, the Utica and the Marcellus that we think will likely be divestiture candidates at some point next year — those proceeds could then be used to accelerate activity in their core Eagle Ford and potentially in the Permian. That leads us to be a bit biased on oil growth beating expectations for next year.

And then our favorite natural gas producer is **Antero Resources** (NYSE:AR). We like it not only because of its Marcellus and Utica core acreage position, but more importantly we like that it has peer-leading firm transport capacity contracts, and that’s important because of the bottlenecking that I referenced earlier. One of the issues in the Northeast for all of the natural gas producers is the ability to get it out of the basin and into premium-priced markets, and **Antero** has a real competitive advantage versus its peers in their ability to get it out. We think that that more attractive pricing over the next couple of years — as we do think that the capacity will be constrained for at least another 12, probably 24 months in the

Northeast — puts **Antero** in a very advantageous position. Also, they have the most attractive hedge book going out toward 2020 versus any other natural gas producer, so that can give you some confidence in protecting off of any downside or any falloff in gas prices.

**TWST:** You mentioned earlier the OPEC production-cut agreement. Are there any other big-picture or geopolitical issues that an investor should be cognizant of?

**Mr. Katzenberg:** We did reference a little bit the incoming administration, but clearly — not just in the energy sector, but I think across

the market today — everybody is trying to gauge expectations for this new administration. Our team has written about the various nominations we’ve had in the energy space. We’ve come up with the term “the Oil Dream Team,” because that’s what it feels like right now given the number of pro oil and gas industry nominees that have been announced so far. Between Rex Tillerson, the **Exxon** (NYSE:XOM) CEO and Secretary of State; Rick Perry, the former Texas Governor as the Head of the Department of Energy; also Scott Pruitt, who is the Oklahoma AG, as the EPA head, and there are more, but all of these guys have industry ties and, it seems, are very likely to be accommodative to the sector.

I also think it appears that President-elect Trump is focused on job creation, which is also likely to further expand oil and gas activity in the U.S. So that’s on the domestic front. Obviously, since the election that has helped the group outperform, but also, we do believe that’s a reason to be optimistic for next year for the E&P sector, and the oil and gas group as a whole.

**“What we’re looking for are companies that have core contiguous acreage positions in the top shale plays. So in our mind, we’re looking at the Permian, which everybody is very focused on, but also the Eagle Ford, the Bakken, the Niobrara.”**

**1-Year Daily Chart of Carrizo Oil & Gas, Inc.**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

The global front is really no different than a lot of other years. OPEC and non-OPEC actions are also top of mind, but certainly right now even more so than normal, given the cartel finally for the first time in eight years agreed on a production cut. I think in the near term, certainly the first half of 2017, the ability to execute on these reduced targets will be in focus, and I expect that to

be the most impactful event for how oil prices react in 2017.

Our expectation is that at least in the early stages, as we start to get OPEC output numbers in the first half of 2017, we do think that there will be a high level of execution from OPEC countries on cutting production. And one of the big reasons for that is that with the **Saudi Aramco** IPO coming in 2018, we think the Saudis have an extra incentive to keep production low, and therefore oil prices high, in an effort to help drive up that valuation. This is potentially something that has been overlooked and not discussed as widely, but that motivation for the Saudis, in our view, is significantly different than what we've seen in past cycles or in past cuts and leads to our higher confidence that these cuts will actually be executed on, at least through the first half of 2017. We will see how long that continues through the year.

**TWST: Is there anything else you want to discuss?**

**Mr. Katzenberg:** We focused on the oil front, but I think investors should not overlook the opportunity in natural gas. This commodity is often underappreciated, I think, given all the major headline-grabbing focus on crude oil. But natural gas prices have rebounded, and with prices north of \$3 today — helped by an early start to winter, and demand has been very strong through all of 2016 — we think things are setting up pretty attractively for 2017. Look at LNG exports that are now finally happening after over five years of all of us waiting for that moment. We're over 1 BCF a day of exports today, and that's likely going to climb toward 2 BCF by the end of

2017. Increasing exports to Mexico have also been a big demand pull. And most impactful has been power gen demand that hit record levels throughout all of this year and throughout this summer.

What I like about the gas outlook right now is that we're not focused on supply collapsing, as many hoped through 2014, 2015 and 2016. Now we have a demand story that is very strong for gas, and I think that can lead to gas prices staying near current levels, whether that's \$2.75 or \$3.25. Anything north of \$3 provides really attractive returns for gas producers. And when you think about cash cost being sub-\$1, and in most cases all-in costs being maybe \$1.50 to \$2 or so, \$3 gas is a very attractive level for these producers and offers attractive return potential. That brings us back to **Antero** being one of my favorite names, but other gas-exposed stocks deserve to be evaluated with that, also.

**TWST: Thank you. (MN)**

*Note: Opinions and recommendations are as of 12/20/16.*

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