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ANALYST INTERVIEW

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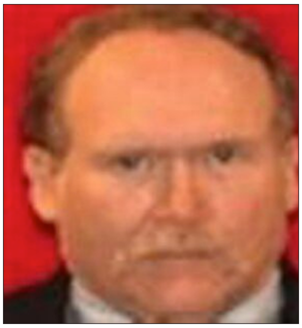
ANALYST INTERVIEW

A Vigilant Stance on U.S. E&Ps in 2017

JOHN P. HERRLIN JR. — SOCIETE GENERALE



JOHN P. HERRLIN JR. is the Head of Oil and Gas Equity Research and Equity Analyst at Societe Generale. He covers integrated oil and E&P companies within the Americas region. Mr. Herrlin joined the firm from AlphaOne Capital Partners, LLC in 2010. Prior to that, he spent 14 years at BofA Merrill Lynch Research Division as an Analyst, where he followed U.S. and Canadian E&P companies, and since 2004, United States integrated energy companies. Mr. Herrlin also followed the E&P sector at Lehman Brothers Holdings Inc. Research Division and before that Smith Barney. He was *Institutional Investor's* top-ranked oil and gas analyst for six years while at BofA Merrill Lynch Research, and was rated since 1994 in the exploration and production category. Mr. Herrlin has an MBA in finance and energy management from the University of Denver, conducted graduate studies in geology from the University of Montana and Colorado School of Mines, and received an undergraduate degree in geology from the University of Montana.

SECTOR — ENERGY

(AGU803) TWST: Let's start with an introduction to your coverage universe.

Mr. Herrlin: I've been on the Street for over two decades. By training I was a geologist before I became a sellside analyst. I follow 15 U.S. E&Ps, two Canadian seniors and four integrateds — two in the U.S., **Exxon** (NYSE:XOM) and **Chevron** (NYSE:CVX); one is Brazilian, **Petrobras** (NYSE:PBR); and the last one is **Cenovus** (NYSE:CVE), which is definitionally an integrated because of its partnership with **Phillips 66** (NYSE:PSX) that gives **CVE** over 200 Mbbls/d of crude refining capacity.

In terms of the E&PS, I follow the following U.S. large caps: **Anadarko** (NYSE:APC), **Apache** (NYSE:APA), **Devon** (NYSE:DVN), **EOG** (NYSE:EOG), **Murphy** (NYSE:MUR), **Hess** (NYSE:HES), **Marathon** (NYSE:MRO), **Murphy Oil** (NYSE:MUR), **Occidental Petroleum** (NYSE:OXY) and **Pioneer** (NYSE:PXD); U.S. midcaps **Newfield** (NYSE:NFX), **California Resources** (NYSE:CRC); and U.S. small-cap E&Ps **Kosmos Energy** (NYSE:KOS) and **Laredo Petroleum** (NYSE:LPI). In Canada, I'm down to two seniors or large caps, given M&A through the years: **Canadian Natural Resources** (NYSE:CNQ) and **Encana** (NYSE:ECA).

TWST: After what was a volatile year in 2016, how would you describe current investor sentiment on the space?

Mr. Herrlin: Prior to the December holidays and year end, I traveled to see institutional clients in the U.K., Continental Europe and the West Coast of the U.S. over a two-week period. At this stage, given the volatile nature of petroleum product and oil and gas stock pricing during 2016, I would say that most clients just want the year to reach an end. And that perspective is understandable.

At the year's start, WTI was thought to be heading to $20/bbl. It recouped during 2016 off the February lows, retrenched, and then rose again when OPEC announced their export cuts which were later followed by some non-OPEC export reductions at their meeting in Vienna. Many E&P stocks during 2016 more than doubled off their 52-week lows and should still post strong annual gains from 2016's start. And IOCs will likely beat broad-based indexes like the S&P 500.

So the big question for investors and the sector near year end isn't how the stocks are going to perform during the last few weeks of 2016, but how will they fare in the New Year? I have been advising clients to expect potential news-headlines-driven downdrafts. Even though OPEC is reducing its exports, the Street really won't see true validated volume reductions until probably February. And depending on how we start the year in terms of weather, the market will have to weigh those seasonal factors plus timing of the balance between existing OPEC export cuts and their member compliance, existing crude and product inventor declines, supply growth from U.S. E&Ps, which will be increasing their upstream budgets, other non-OPEC supply sources like Brazil and also currency effects.

Most E&Ps during 4Q16 opted to take advantage of oilfield cost deflation, better horizontal well designs and completion efficiencies by increasing their capex spending for more drilling and DUC — drilled but uncompleted wells — completions in anticipation of stronger 2017 product pricing. They also added new rigs to spud more wells than they had originally planned, and the U.S. BHI oil rig count is up over 50% from its 2016 low. So U.S. oil production could pop up in the first quarter as a consequence.

For now investors believe in OPEC, but we expect it to remain a news-headlines-driven market and think that the Street will need to be vigilant. If I am correct in terms of product pricing, E&P spending plans and efficiencies, the U.S. could increase output by 500,000 to 600,000 barrels a day from the start to the end of 2017. I am of the opinion that OPEC may have to cut twice next year as "an active supplier manager." So given the oil and gas stock appreciation experienced post the last OPEC Vienna meeting cut announcements, it wouldn't at all be surprising to see some profit taking at the start of the year. But that likelihood will depend upon weather, broader markets and ongoing optimism about a new U.S. presidential administration being "oil-industry friendly."

Longer term, we are concerned about some global factors that could negatively affect oil pricing and demand such as a stronger U.S. dollar and non-OECD factors such as India with their currency control mandates, Brazil's ongoing recession and China needing to post real demand growth rather than having teapots increase crude imports to in turn export more distillate. So there are many factors that could swing oil pricing and the stocks short term.

TWST: You mentioned the incoming administration. What are you expecting in terms of potential impact from new policies and given some of the Cabinet nominees?

Mr. Herrlin: It's assumed that President-elect Trump will be favorably disposed toward the oil and gas industry in terms of a reduction in regulations. But if you look at what's transpired thus far, I think the confirmation process for his Cabinet nominees could be somewhat protracted or contentious. We will see when it starts during the second week of January.

I would imagine that the Democrats will push the EPA nominee on his views regarding global warming and the Department of Energy nominee perhaps on the need of that department to encourage the use of all forms of energy supply, including coal, which might be questioned. Certainly the markets appear to be embracing the concept of lower corporate taxes and regulations, and also stimulus such as a large domestic infrastructure spending, which would be good for oil demand. But I don't see that type of stimulus program occurring until 2018. Therefore one must ask themselves if the oil and gas stocks will have the same group uplift in 2017 as they did during 2016 when the U.S. oil production and the U.S. dollar were lower.

The one thing the oil and gas industry proved this year, in our view, in the wake of weak product prices, was that it could do less with more, and that it was pretty effective at stemming production output declines though better completion and procurement practices. But now E&Ps are going to be back into an acceleration mode in terms of their spending, and investors seemingly to want to participate.

During 2016, E&Ps sold over $40 billion of new stock for E&Ps to fix their balance sheets, buy complementary assets or accelerate E&D activity versus $15 billion during 2015. The shale E&P stories are embraced as technology growth stocks since companies discuss greater technology-based efficiencies brought about by drilling longer horizontal wells with more frac stages. So even though the oil and gas industry is cyclical, the stocks of many of the E&Ps are bought for growth. Shareholder dilution has been overlooked because the stocks simply went up for the companies that issued equity.

What we find perverse is that the industry's strategy is development-driven, which means lower operations risk. Yet no one on the Street seems to be concerned that E&Ps don't generate meaningful earnings or experience self-funded growth — capex equals production cash flow. One might also argue that some of the stocks outperformed in 2016 because investors were E&P underweight, and that concentrated ownership and short interest caused some "short squeezes."

On a valuation basis, I think my E&P stocks are discounting mid-50s, and some others mid-60s. So in order to have another up leg in 2017, there may have to be greater global economic growth certainty and question marks answered regarding potential demand issues as I've implied — India, China, the U.S. and also Europe.

TWST: What are your top stock recommendations right now and why?

Mr. Herrlin: For the most part, I like E&Ps that aren't fully discounting the future or that offer hidden resource or drill-bit option value. Generally, I like the E&Ps to have solid balance sheets — low fiscal leverage and undrawn bank credit lines — so they can maintain their upstream capital programs even when product prices are volatile. And the IOCs, I like to see diverse resource bases with large-scale projects in various stages of completion, solid balance sheets and strong dividend yields which will be earned during normalized pricing environments.

For E&Ps, if one looks at the shale stories, we would argue that the most overvalued basin is the Midland, followed by the Delaware and then probably the Anadarko; Maverick, Eagle Ford; the DJ, Denver-Julesburg; and the Williston, Bakken. So I prefer to see assets that are out of favor if those companies have other attributes to mitigate the holding risks.

Highlights

John Herrlin has been advising clients to expect potential news headlines-driven downdrafts in 2017 for U.S. E&Ps. He thinks the Street will need to be vigilant on the sector, and that OPEC cuts and oil inventory balance will be very critical for 2017.

Companies discussed: Exxon Mobil Corporation (NYSE:XOM); Chevron Corporation (NYSE:CVX); Petroleo Brasileiro SA Petrobras (ADR) (NYSE:PBR); Cenovus Energy (USA) (NYSE:CVE); Phillips 66 (NYSE:PSX); Anadarko Petroleum Corporation (NYSE:APC); Apache Corporation (NYSE:APA); Devon Energy Corp (NYSE:DVN); EOG Resources (NYSE:EOG); Murphy Oil Corporation (NYSE:MUR); Hess Corp. (NYSE:HES); Marathon Oil Corporation (NYSE:MRO); Occidental Petroleum Corporation (NYSE:OXY); Pioneer Natural Resources (NYSE:PXD); Newfield Exploration Co. (NYSE:NFX); California Resources Corp (NYSE:CRC); Kosmos Energy Ltd (NYSE:KOS); Laredo Petroleum (NYSE:LPI); Canadian Natural Resource Ltd (USA) (NYSE:CNQ); Encana Corp (USA) (NYSE:ECA); Noble Energy (NYSE:NBL); Freeport-McMoRan (NYSE:FCX) and BP plc (ADR) (NYSE:BP).

First and foremost, I think that exploration potential matters, but the trick is to not pay for it. In my opinion, successful E&P companies should truly be able to explore and spend 10% or more of their budgets on wells that don't work, if their drilling program delivers reserves to replace production and offset the costs of those dusters. So it isn't like a basins-centered play, like the shales, but it does create value over the long term. The thing about exploration is that not everyone is good at it, and that may also explain why investors have willingly embraced the shales given shorter-cycle-time growth rates and greater well-completion success rates.

> ***"The thing about exploration is that not everyone is good at it, and that may also explain why investors have willingly embraced the shales given shorter-cycle-time growth rates and greater well-completion success rates."***

Most E&Ps that conduct rank wildcat exploration also are globally more diversified and conventional. So our top recommendations are **Anadarko**, **Apache**, **Hess**, **Noble Energy** (NYSE:NBL) and **Occidental Petroleum —** which really doesn't explore but has other businesses, i.e. chemicals — in the U.S. large caps; **Canadian Natural Resources**, a Canadian senior; in the U.S. midcaps, **Newfield Exploration**; and in the U.S. small-cap E&Ps, **Kosmos Energy** and **Laredo Petroleum**. For the IOCs, I have both **ExxonMobil** and **Chevron** "buy" rated.

Looking at that list, what are the commonalities for the large-cap E&Ps? **Anadarko**, **Apache**, **Hess** and **Occidental** all have both shale and conventional operations. In the case of **Anadarko**, **Apache**, **Hess** and **Noble**, they all pursue conventional as well as unconventional exploration and have proven to be proficient at that. Again, these companies don't get the basin-specific shale valuation premiums of a peer such as **Pioneer Natural Resources**, and generally have more global output and cash flow in addition to their own value adding onshore shale programs.

TWST: What will you be paying attention to most when the fourth-quarter and year-end calls and reports start in January?

Mr. Herrlin: Very few companies have disclosed their spending plans for 2017. That is really the place to start. It's my belief that U.S. IOCs will reduce their spending for 2017 versus 2016 drop 10% to 15%, and more of their upstream capital dollars allocated to shorter-cycle-time programs: shales, deepwater satellite tie-ins or other facility efficiency upgrades. E&P capex budgets during 2016 should rise 15% to 25%.

The Street will also focus on 1Q17 production targets versus 4Q16. Many E&Ps are now in a multi-well pad mode, and as such, volume additions tend to be lumpier. Because many E&Ps completed DUCs in 4Q16 and given new well completions, many of the spending increases will bring volumes on during 1Q17. So investors will look at sequential and annual production growth targets. So E&P production volume gains will matter as the investors again look the OPEC cuts and supply new production affecting overall inventories.

TWST: We talked about OPEC; we talked about the incoming administration. Are there any other big-picture, macro or global issues that investors should pay attention to?

Mr. Herrlin: The upstream business is simple in concept of what is needed. To be a successful upstream company, it needs, one, petroleum resource access; two, skilled people; three, cost-effective extractive technologies for reserve conversion; and four, production cash flow or other funding mechanisms to fuel production replacement and reserve and production growth.

It's generally easier in concept than practice. At the start of the year, I believe that the generalists, at the margin, are slightly underweight the sector. So they look at oil and gas stocks with the understanding that the stock market's at all-time highs, and this sector is still rebounding off its lows, and they know for a few quarters they should have positive YOY — year-over-year — comparisons. The oil and gas stocks may not be as inexpensive on a share-price basis as last year, but on relative benchmarks may be less expensive than the markets or have other attributes such as production growth that they are willing to pay for. In essence, investors are making a relative beginning-of-year trade that has the potential to be longer term in nature. This is why OPEC cuts and oil inventory balance will be so critical for 2017.

Thus far, no one on the Street is discussing the potential for weaker demand growth — less than 1.2 mbbls/d — given potential non-OECD GDP issues, geopolitical events such as Brexit, Korean presidential impeachment, India's currency regulations, etc. So this is why expectations about oil supply versus demand are so important. Right now, as I said earlier, I think the stocks are discounting WTI in the mid-$50s and HH natural gas at $3/Mcf. But in order for the stocks to move higher, global oil inventories will need to shrink. Unfortunately given the nature of these markets it will be Dr. Seuss-like: Push me and pull you, especially given high institutional, HF — hedge fund — and ETF representation.

1-Year Daily Chart of Anadarko Petroleum Corporation

Chart provided by www.BigCharts.com

Before the OPEC meeting, I published a report on short interest levels for the oil and gas sector. I demonstrated that short interest levels for the select oil and gas subsector stocks had 30%, 40%, 50% of share outstanding short by 3Q16 and could be subject to a squeeze, given the fact that institutions typically control 80% to 90% of a company's public stock flow. And that's exactly what happened in the wake of the OPEC announcements. Fiscally leveraged E&Ps and other subsectors rose dramatically. Going forward, if there is any sign of above-average supply increases which lead to lower inventory rebalancing and weaker prices, the oil and gas stocks could retrench.

I don't believe that many institutional investors who are new to the sector are focused on other factors which would affect product pricing and demand such as global GDP, the "move to the right" in Italy, U.K. — Brexit — U.S. and perhaps Germany. And given a new U.S. presidential administration with a congressional majority, the markets will be concerned with what legislation passes and how quick the administration moves during the first 100 days.

"Going forward, if there is any sign of above-average supply increases which lead to lower inventory rebalancing and weaker prices, the oil and gas stocks could retrench."

In addition to the prior factors discussed, weather can always swing demand. The past two years have been relatively warm in the Northern Hemisphere, but early in the New Year it has been cold, which helps consumption. If it's a warm start of the year, the opposite could take effect and again affect psychology at the margin. This is very much a sentiment-driven market.

TWST: What else did you want to discuss?

Mr. Herrlin: Many investors and sellside analysts believe the oil and gas sector will see public company M&A. I would say that's still unlikely. If fiscally leveraged companies are able to issue equity or sell assets and not be penalized, why would senior executives give up the perch if they can maintain their business model? So from a public-company-merger perspective, I don't think that you'll have that many sellers. Also, from an accounting perspective, most of these shale companies have large proved undeveloped reserve bases, or high PUD counts. Typically when such companies are purchased, their assets get capitalized since the shale leases aren't producing, and that avoids earnings and cash flow dilution while putting more nonproductive capital on company balance sheets.

So to purchasing company to pay a premium for an E&P that has a lot of PUDs or unamortized properties, the acquirer's balance sheet might incur record unamortized asset basis or will need to book goodwill. So we expect there to be plenty of acreage M&A, but not outright company purchases. In the past this sector experienced significant public company mergers. Most occurred during the conventional era and not in the era of basin-centered resource plays.

What could happen, which did occur a few times during 2016, is that private equity-funded companies on the verge of going public will get bought at IPO purchase levels. Regarding the IOCs, I don't see them being aggressive public company acquirers as in the past. We think they will look at $3 billion to $5 billion value purchases.

Ultimately, E&P investors will have to come to terms with the concept of profitability and growth via cash-flow neutrality — cash flow equals capex. Given the land-grab nature of the shale plays and need for infrastructure, it hasn't happened, but we believe that it will have to since we don't expect development-based growth to sell if, as we believe, there won't be a meaningful public company M&A consolidation. Ultimately, what investors want to see is the integrateds earn their dividends, and they maybe restart their common stock repurchase programs when product prices stabilize. And for the E&Ps, they should want to see cash-flow-neutral spending and growth and minimal dilution.

Over these last few years, even before product prices dropped, E&P companies were delivering high production growth because they were outspending their cash flow materially. Other than public and private financings, public companies and private equity companies have also facilitated the industry's profligate ways. We believe they will continue to fund it for as long as projected economics work.

So if I consider the portfolio of stocks I'm recommending, **Anadarko** and **Noble Energy** have meaningful Denver-Julesburg Basin exposure onshore. That basin has been discounted, in our view, too much by the market. They also both have Delaware Basin exposure, but only **NBL** has Eagle Ford since **APC** just sold theirs, and **NBL** has Marcellus, which **APC** also just sold. Both pursue deepwater optionality. **Anadarko** in 2H16 bought **Freeport McMoRan's** (NYSE:FCX) deepwater assets, whose cash flow they will use to fund its Delaware basin development, and **NBL** will sell down assets in Israel to fund Leviathan. So both have a self-funding mechanism for volume growth.

1-Year Daily Chart of Noble Energy, Inc.

Chart provided by www.BigCharts.com

Apache, via the U.K. North Sea and Egypt, has free-cash-flow-generating assets whose proceeds can be repatriated to pursue their own 300,000-plus acre Alpine High play, and will have more operating news in the 2H17 when their gas pipeline gets installed. And they have deepwater potential in offshore Suriname.**HES** is involved with **Exxon** in offshore Guyana at a new deepwater discovery called Liza, which has 1 Bbbls of oil potential that **HES** has a 30% working interest in. **HES** is also developing its own deepwater plays — Stampede — and has captive Bakken assets and infrastructure, which they could MLP, and overall are discounted versus other shale basins.

Occidental has a 4% dividend yield, which I view as more of a bond-yield substitute, and is finishing a chemical plant which will generate free cash flow. Given its size, it trades at a premium multiple, but it has a very solid balance sheet. **CNQ** is a Canadian senior or large cap. During 2017, they plan to grow their output 6% and generate C$1.7 billion in free cash flow, which makes them one of the few E&Ps to generate free cash flow during 2017. This comes as a consequence of their capital budgeting plan and completion of Phase IIb at Horizon, their oil sands upgrader.

Newfield Exploration is slowly morphing into a STACK pure play. They have sold their Eagle Ford assets to fund the growth there; they have over 300,000 acres, and would consider monetizing their Bakken or Uinta assets. With the smaller caps, **KOS** is a differentiated conventional deepwater story. They just farmed out about half their interest in Mauritania and Senegal to **BP** (NYSE:BP) for $916 million for cash, a drilling and development carry. Granted, it isn't a shale story, but the company is creating deepwater value.

Lastly, we're recommending **Laredo**, a Midland-Permian Basin player. The stock isn't valued as high as many of the peers on the basis of cash flow, but unlike them, **LPI** has a large GTP infrastructure — gathering, transmission and processing — that they own directly or in partnership that is undervalued by $3 to $4 per share. So that's a quick thumbnail of companies that we are recommending and our outlook on the sector.

TWST: Thank you. (MN)

Note: Opinions and recommendations are as of 12/21/16.

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