Kimmeridge

Now or Never: Testing the Resolve of the E&P Industry

Summary

As the new year begins, there is a renewed sense of hope for the US E&P industry. From the depths of the pandemic, the industry evolved its messaging and embraced a new business model that prioritized reinvestment rates, capital returns and sustainability. The early success of the model is evident in the financial results and energy was the best performing sector in 2021.

Despite the progress to date, investors question the permanence of change. Interest in the sector has largely been driven by the sharp recovery in oil demand back to pre-pandemic levels and the recognition that a rapid transition away from fossil fuels could prove inflationary. We have yet to see valuations reflect the improvements to the underlying business. Notably, the energy sector weighting in the S&P 500 is less than a third of what it was the last time WTI prices were over $80, and valuation metrics remain dislocated from both the broader market and historical trading ranges.[1]

Skepticism is largely justified. The fabric of the newfound industry discipline appears tenuously stitched together by a reluctance to separate from the pack. We believe that as oil prices rise, so too will the temptation to revert to a more pro-cyclical business model and abandon financial restraint in the face of attractive half-cycle economics. Sustaining discipline through an upcycle will require management teams and boards to make difficult and unpopular decisions.

This paper argues that the path to higher valuation multiples lies in reducing the cyclicality of the business and prioritizing consistency in strategy over responding to the ever-changing winds of investor sentiment. While establishing credibility takes time, we offer four recommendations to help accelerate the process:

1. **Enhance transparency around future development plans**
2. **Communicate capital allocation frameworks as a percentage of cash flow**
3. **De-emphasize relative TSR in executive compensation**
4. **Pursue consolidation based on industrial logic (over management incentives)**

Valuation alone will not bring the generalist investor back to the sector. However, we believe a more consolidated industry with lower downside volatility, increased transparency, greater shareholder alignment and firmer commitments around use of cash flow will prove increasingly difficult to ignore.

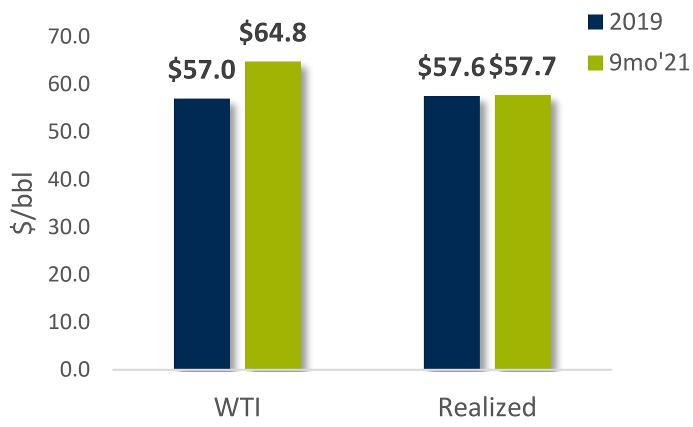
Early Evidence of Success

We are seeing the early results from the industry's adoption of a business model that aligns with the principles we advocated for in our February 2020 white paper, *Preparing the E&P Sector for the Energy Transition: A New Business Model*, and they are impressive. We screened for public US E&P companies with at least 30kb/d of oil production and comparable financial results to 2019, including an ability to

[1] Source: Bloomberg. The Energy sector was 3.2% of the S&P 500 on 1/14/22 compared to 9.2% on 10/31/14, the last time WTI was over $80. As of 12/31/21 the S&P 500 E&P sub-sector was trading at 4.5x NTM EBITDA compared to 14.5x for the S&P 500, over twice the historical discount (10-year average of 6.7x vs 10.7x for the S&P 500)

adjust for historical M&A activity. 2019 provides a useful baseline for comparison, as despite the WTI price being $7 lower, the realized price after hedges is almost identical:

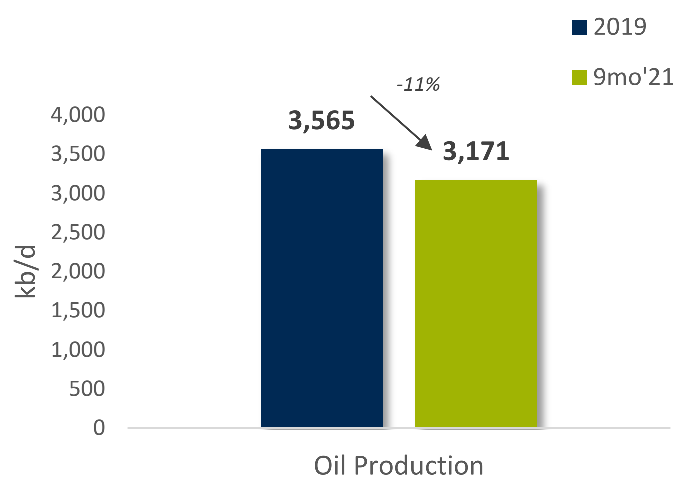
Figure 1: WTI vs. Realized Oil Prices



Source: Bloomberg Data and Company Reports

We analyzed the results of twenty-two companies[2] with aggregate oil production of over 3.5 million barrels per day in 2019. Through the first nine months of 2021 their oil production was 11% lower than 2019, representative of the broader industry where total US production was 10% lower than 2019:

Figure 2: Aggregate Oil Production

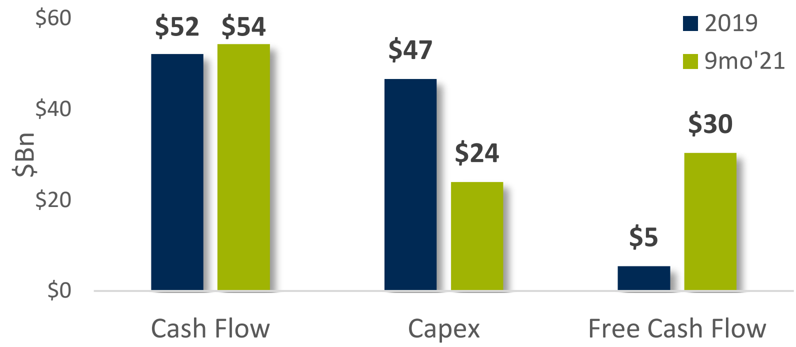


Source: Bloomberg Data and Company Reports

Despite lower oil production, annualized cash flow was marginally higher due to improved gas and NGL pricing. What was most notable, however, was the fact that **annualized free cash flow was six times higher** as capex fell by almost 50%:

[2] Companies included were APA, CHK, CLR, COP, CRC, CRZO, CPE, CXO, DVN, EOG, FANG, HES, MRO, MTDR, MUR, OAS, OVV, PDCE, QEP, SM, WLL and WPX

Figure 3: Annualized Cash Flow

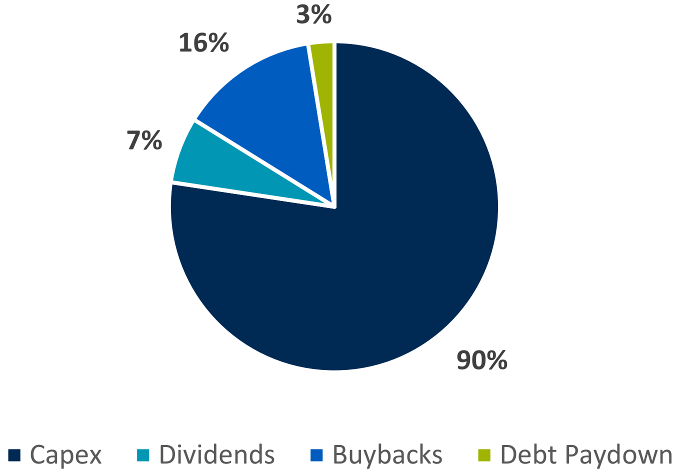


Source: Bloomberg Data and Company Reports

If the value of any business is the discounted present value of its future free cash flow, hopefully we can finally put to rest the fallacy that production growth is a relevant measure of value creation. And the combined market cap of these companies at year-end was roughly $300Bn, so the $30Bn of annualized free cash flow represents a trailing yield of 10% at a WTI price of $57, nowhere close to the $80 on the screen today. To put that in perspective, the same annualized FCF yield for the S&P 500 through the first nine months of 2021 was 3.4%. Therefore, the sector has demonstrated that it can deliver a yield that is 3x higher than the market at relatively conservative oil prices. Now it must demonstrate the free cash flow generation is sustainable.

Just as important is how the industry reprioritized the use of free cash flow. In 2019, with a 90% reinvestment rate, the next call on capital was pro-cyclical buybacks, which represented 16% of cash flow and were largely funded by asset sales. Debt paydown in 2019 represented only 3% of cash flow:

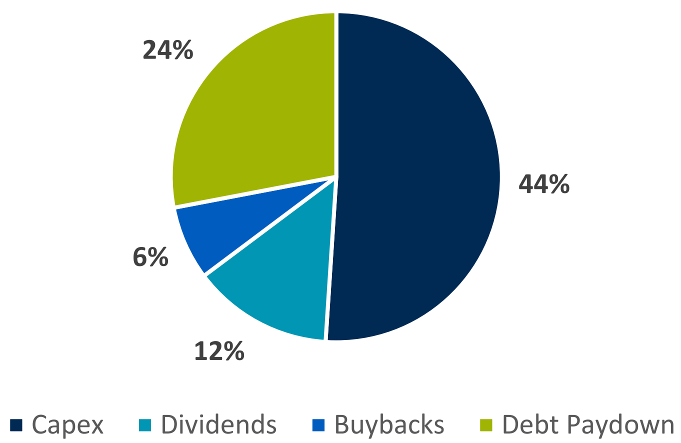
Figure 4: Percentage of Cash Flow (2019)



Source: Company Finanicals. Represents % of operating cash flow and does not sum to 100% due to asset sales and change in cash balances

Conversely, through the first nine months of 2021 the same companies reinvested 44% of their cash flow into capex with 24% directed to debt paydown, four times the amount of money allocated to buybacks:

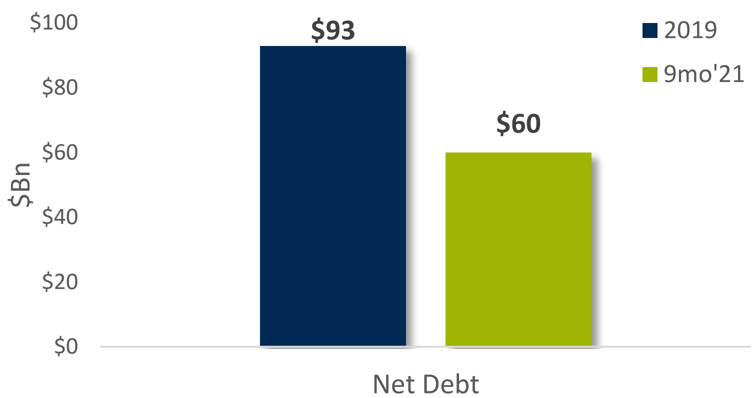
Figure 5: Percentage of Cash Flow (9mo'21)



Source: Company Finanicals. Represents % of operating cash flow and does not sum to 100% due to asset sales and change in cash balances

The rigorous focus on debt paydown, combined with a handful of companies going through bankruptcy, led to a meaningful reduction in net debt by 35%:

Figure 6: Balance Sheet



Source: Company Finanicals

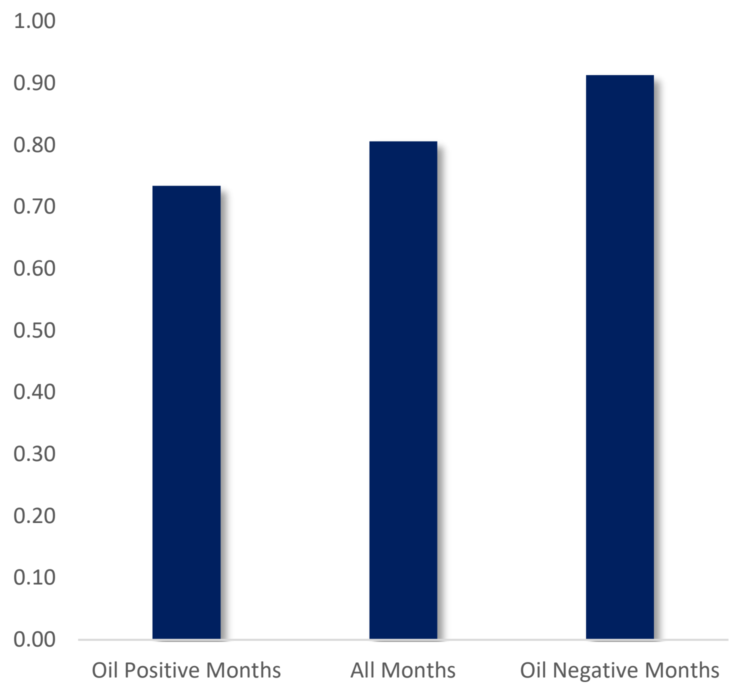
This is important progress on the path to reducing the cyclicality of the business, which we believe is the ultimate key to expanding valuation multiples. However, we worry that investor preferences are already shifting as companies get penalized for continuing to pay down debt. In our view, the first call on free cash flow should continue to be a **reduction in leverage below 1x debt/EBITDA at $50 WTI**.

Unsuprisingly, shareholder pressure to pay down debt has been replaced by an emphasis on maximizing sharehare buybacks. Buybacks should certainly play a role in capital allocation over time, but companies should be focused on how they can accelerate debt paydown at higher commodity prices so that they are able to repurchase shares at lower prices. Share buybacks in a rising commodity price environment when stocks are at 52-week highs are like a sugar high…it feels great in the moment but what are the lasting effects? Building a sustainable business through the cycle should continue to be the priority.

Reduce the Cyclicality

The reason why reducing the cyclicality of the business is so important is because it is the downside volatility of the sector that keeps so many investors away. The chart below looks at the monthly beta of the S&P 500 E&P sub-sector relative to the 12-month WTI strip since 2017:

Figure 7: Equity Beta vs. Oil Price (2017-2021)



Source: Bloomberg Data

In the months where the WTI strip declined, the volatility of the equities was elevated. It was notable, therefore, in November 2021 when the WTI strip was down almost 15% and the E&P sector was down less than 5%. While clearly not yet statistically significant, more muted downside volatility to the commodity price is going to be a key leading indicator of attracting generalist investors back to the sector. Importantly, there was only one month in 2021 where the E&P sector declined by over 5%, compared to an average frequency of three months since 2014:

Figure 8: Frequency of >5% Drawdowns for S&P 500 E&P Sub-Index

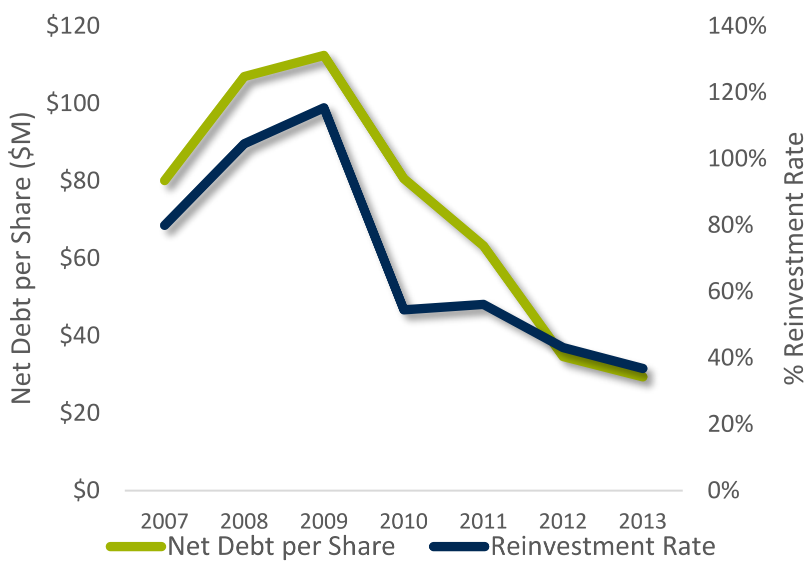
Source: Bloomberg Data

In an investment industry increasingly allergic to volatility, the consistency and severity of these drawdowns was unacceptable. Furthermore, these are the largest and most resilient companies which made it into the S&P 500 index. Downside volatility is a critical issue for the industry and must be addressed through a concerted effort to reduce the cyclicality of the business model.

Refining Analogy

Our conviction in the importance of the drawdown metric extends back to the analogy we have made to the refining industry. After years of excessively high reinvestment levels and collapsing returns, refining companies pivoted to a new business model in 2010 coming out of the financial crisis. As illustrated on the chart below, the reinvestment rate and net debt per share collapsed from 2009 to 2013:

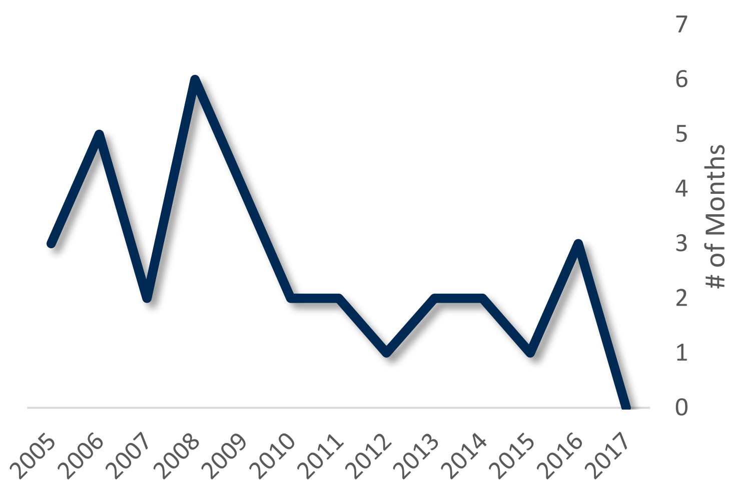
Figure 9: Reinvestment Rate & Net Debt for S&P 500 R&M Sub-Sector



Source: Bloomberg data

Historically, refining was a sector that would experience three to five monthly drawdowns a year of over 5%, but starting in 2010 that fell dramatically to only one to two:

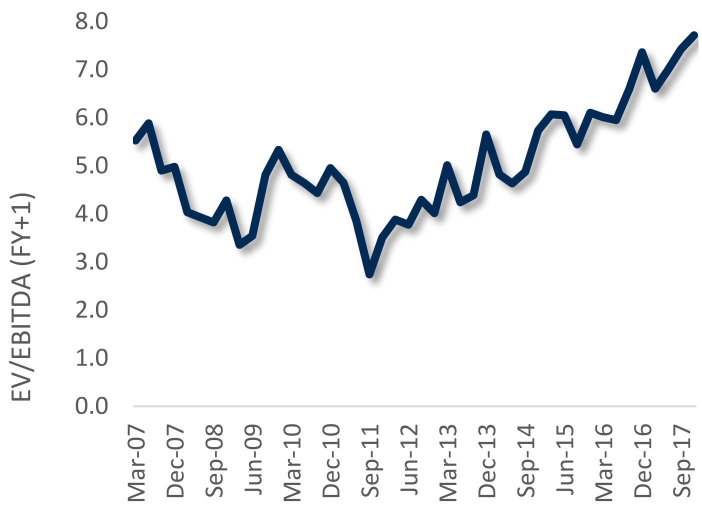
Figure 10: Frequency of >5% Drawdowns for S&P 500 R&M Sub-Index



Source: Bloomberg data

Additionally, when you reduce the downside volatility through a more resilient business model, you materially increase the number of investors who can own the stocks. This is evident in the valuation multiple re-rating that occurred in the refining sector over that period, where EBITDA multiples expanded from 3-5x to over 7x:

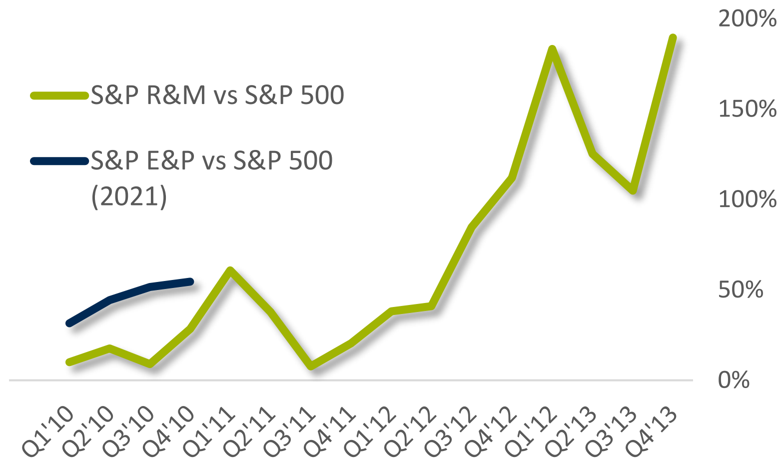
Figure 11: EV/EBITDA (FY+1) for S&P 500 R&M Sub-Index



Source: Bloomberg data

Expanded ownership is also evident in the relative performance against the broader market. It took roughly two years, but by the start of 2012 there was general recognition that the refining industry had fully embraced a more shareholder-friendly business model. As a result, the relative performance took off. Today, we believe we are one year into the transition for the E&P sector and while the future performance of the sector is highly uncertain, we think the trajectory of the refining sector provides a potential roadmap for success:

Figure 12: Relative Performance vs. S&P 500



Source: Bloomberg data

Accelerating the Recognition

In a world that increasingly seeks instant validation, we sense a mounting frustration from E&P executives that the sector remains in the penalty box. However, given the historical track record of this industry, it was never going to be rewarded for the right messaging. It is all about the consistent execution of a through-cycle return of capital model. Moreover, we believe investors are questioning which management teams they can trust; dependable delivery will be key to ownership. That means no curve balls, and no diverting the flight path in 2022 – restrain the reinvestment rate, pay down debt, return most of the excess cash via dividends and attack scope 1 & 2 emissions. It is not a very complicated formula and boring is good. While there is no 'silver bullet' for addressing the high degree of investor skepticism, we'll finish with four recommendations for accelerating the recognition that the industry has structurally changed:

1. **Enhance Transparency**
   As the industry successfully transitions to a return of capital model, investors will inevitably question the sustainability of the business. We previously argued for providing ten-year visibility into future free cash flow generation. Credibility would be further enhanced with a detailed analysis of the drilling inventory and cost of supply associated with future development plans. Asset level guidance has diminished at a time when investors are increasingly questioning the maturity of resource bases. Without confidence in the depth and quality of the remaining inventory, investors may be reluctant to underwrite current levels of free cash flow.

2. **Transition to Percentage of Cash Flow**
   Companies consistently refer to their commitments to debt paydown and capital returns as a percentage of free cash flow. Ultimately, that still allows companies full discretion to raise capex, as free cash flow is merely the output in the equation. This is especially relevant when oil prices are above mid-cycle levels that are used in reinvestment rate frameworks. We would advocate for transitioning guidance around capital allocation to include percentage of cash flow, as companies like Conoco, Coterra and Marathon have.

3. **De-Emphasize Relative TSR in Executive Compensation**
   We are going to sound like a broken record on this issue, but long-term incentives remain overly dependent on time-based compensation and relative shareholder returns. It's no wonder investors are paranoid that companies will shift to accommodate changes in market sentiment given the consistent focus on short-term relative performance. It is essentially the tail wagging the dog. As we outlined in *Bringing Alignment and Accountability to the E&P Sector*, companies should introduce financial metrics into their long-term incentives that correspond to their stated long-term financial objectives (debt reduction, reinvestment rates, free cash flow generation) to enhance credibility.

4. **Pursue Consolidation Based on Industrial Logic (Over Management Incentives)**
   As we progress through the energy transition, the oil and gas industry is fighting for investor relevance. It starts with the historically low weighting in the indexes and carries through to the prevalence of companies with market caps under $5 billion. To remain relevant and show up on the radar for most investors, we think companies need to be at least $10 billion in market cap. The most logical solution is consolidation, but to date most of the consolidation has been illogical. Companies are merely acquiring who is for sale – and who is for sale is often dictated by the financial incentives of the management team. This is a perverse path to deal selection and serves as an impediment to further consolidation as it is not economically rational for most executives to relinquish their role, as we previously argued in *US Upstream M&A: Like Turkeys Voting for Christmas*. While we continue to believe friendly, low-premium mergers of equals are the most desirable option, companies should be willing to publicize a rebuffed approach and ultimately let the shareholders decide.

Conclusion

The sector has come so far over the past year. The long-absent generalist investor is just starting to take notice but has yet to fully engage. There remains a high degree of skepticism that anything structural has changed. This is a critical moment where companies must double down on their commitments to a business model that is fully aligned with the energy transition: one that prioritizes capital discipline, lower leverage, capital returns, consolidation and environmental stewardship. This may be the only shot the industry gets to demonstrate that the evolution of the business model is a lasting change, and not just a desperate pledge at the bottom of the cycle.