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## Anadarko Petroleum Corp. APC

### Analyst Report

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by Justin Perucki, CFA

**Thesis** 05-21-2009

After its 2004 restructuring failed to spur sufficient growth, Anadarko Petroleum purchased Kerr-McGee and Western Gas Resources in separate transactions for a combined \$23.3 billion in June 2006. It was a bold move, as debt increased to 67% of total capital. But numerous asset sales, along with internally generated cash flow, has reduced debt to much more manageable levels.

The move was arguably well-timed. Kerr-McGee's and Western Gas' stocks were slightly depressed after a warm winter, and an abundance of relatively cheap credit was available. Cheap capital not only benefited Anadarko on the acquisitions, it also helped when it was overhauling its portfolio--buyers were willing and able to pay attractive prices for Anadarko's unwanted properties. However, given what Anadarko paid for Kerr-McGee and Western Gas, and the price Anadarko received for its numerous asset sales, we wonder why Anadarko did not sell itself instead.

The key difference between the old and new Anadarko is that the firm is now significantly more leveraged to offshore production and the Rocky Mountain region. The firm also believes the upside potential (such as the amount of probable and possible reserves) is much greater.

Anadarko has had great success in its offshore drilling program as of late. In the Gulf of Mexico, the firm drilled two successful exploratory wells in the first quarter--Heidelberg and Shenandoah. The firm is also in the process of developing a number of past discoveries. Of probably greater interest is the firm's projects in Ghana. Anadarko and its partner's first success there was the Jubilee field, widely considered to be one of the largest oil discoveries this decade. Appraisal and exploratory work continues, but first production is expected sometime in 2010. Anadarko also had a discovery (Tweneboa) during the first quarter in another area offshore Ghana, about 16 miles west of Jubilee. This project is still in its early stages, but it is the same geological concept that is being targeted in Jubilee. Key exploratory wells to watch for over the next several quarters include wells in Sierra Leone, Cote d'Ivoire, Mozambique, and China.

Anadarko is also becoming very active in North American shale-gas plays. Preliminary results from the Eagle Ford and Pearshall Shales in the Maverick Basin look promising, but the firm still needs sufficient well control data before releasing per-well reserve estimates. Management also stated they still need to drive down well costs and delineate the play. Anadarko is adding another rig to drill additional wells in the play. In the Marcellus Shale, the firm is partnering with Chesapeake [CHK](#) and through their partnership hold rights to 600,000 gross acres in the play. Drilling has been slow, but early results compare favorably with some of the best wells drilled in the play to date and the company plans to commit additional rigs throughout 2009.

**Morningstar Rating** 

**Stock Price**

 As of 05-21-2009  
\$43.31

**Fair Value Estimate**

\$79.00

**Consider Buying** 

\$39.50

**Consider Selling** 

\$158.00

**Fair Value Uncertainty** 

High

**Economic Moat** 

Narrow

**Stewardship Grade** 

C

**Bulls Say**

- Anadarko has a number of deep-water exploratory prospects internationally and in the Gulf of Mexico, which could prove to be a boon.
- Recent production tests confirm further exploration success in Ghana.
- Anadarko has a number of nascent shale plays--Eagle Ford, Marcellus, and Haynesville.
- Anadarko owns the mineral rights on 8.3 million acres stemming from the Land Grant. This helps insure that most of Anadarko's Rockies natural gas production is economical at almost any price.

**Bears Say**

- Unique environmental and regulatory challenges in the Rocky Mountains could slow or limit Anadarko's development in the area.
- While initial results from Anadarko's offshore projects are good, questions surrounding development costs and ultimate estimated recoverable reserves remain.

Finally, the company is performing some preliminary drilling on the East Texas side of the Haynesville shale play. It's still very early in all three plays and key hurdles remain--among other things, infrastructure--but we're cautiously optimistic that one or all three of these plays will be key contributors to future production growth.

#### **Valuation**

We are raising our fair value estimate to \$79 per share from \$69. The change stems from a decrease in our long-run production tax assumption and higher income from the midstream segment, offset by lower near-term natural gas prices and the recent equity issuance. In our discounted cash-flow model, our benchmark commodity prices are based on Nymex futures contracts for 2009-11. For oil, we use \$55 per barrel in 2009, \$66 in 2010, and \$71 in 2011. For natural gas, we use \$4.60 per thousand cubic feet in 2009, \$6.60 in 2010, and \$7.10 in 2011. We assume long-run oil and natural gas prices of \$80 and \$7.50, respectively. As a result of the drop in commodity prices, Anadarko has cut its 2009 budget by about 15% in 2009. As a result of the reduced spending, we forecast only low-single-digit production growth in 2009. In the longer term we believe Anadarko can grow production in the mid-single digits. Given the uncertainty surrounding the timing of first production and expected volume from Anadarko's many nascent offshore projects, our production forecast could change materially as we get greater clarity on these issues. We weigh our low, base, and high scenarios as follows: 40%, 40%, and 20%. In our low scenario, we change our long-run price assumptions for natural gas to \$5 and for oil to \$50. We also believe growth slows and costs moderate. Under this scenario, we believe Anadarko is worth around \$25. We believe Anadarko is worth around \$60 in our base case. In a high scenario of \$15 natural gas and \$150 for oil over the long run, we believe Anadarko is worth around \$190. We assume higher production growth rates in our high case but higher operating and capital costs, as well.

#### **Risk**

As with all oil and gas companies, Anadarko faces environmental and terrorist risk. Infrastructure constraints could limit production growth in some of Anadarko's more nascent plays. Anadarko's long-term transportation agreements and basis hedges help alleviate this problem. But the potential for weak regional natural gas prices should be an issue for the foreseeable future.

<b>Close Competitors</b>	TTM Sales \$Mil	Market Cap \$Mil
<b>Anadarko Petroleum Corp.</b>	<b>14,340</b>	<b>22,919</b>
* <a href="#">Apache Corporation</a>	10,836	28,826
* <a href="#">Devon Energy Corporation</a>	14,264	28,072
* <a href="#">Chevron Corporation</a>	243,189	138,743

\* Morningstar Analyst Report Available

Data as of 03-31-09

#### **Strategy**

Natural gas makes up the majority of Anadarko's domestic reserves. Onshore, the firm focuses on unconventional gas plays with minimal reinvestment needs that produce a strong, steady, free cash-flow stream. Anadarko uses the cash to fuel its successful deep-water programs, which are expected to be a key growth driver during the next few years.

#### **Management & Stewardship**

- Despite its large midstream position, Anadarko could still face energy infrastructure bottlenecks.
- Anadarko could be subject to changing regulation internationally and the U.S. In the near term, what is most at risk of changing are lease terms in the Gulf of Mexico.

CEO Jim Hackett has been at the helm since 2003. His second overhaul of the company appears to be working out better than the first. However, the company's stock price sits well below valuations that might have been generated through a sale of the company outright at the time of the Kerr-McGee and Western Gas transactions. Performance metrics include finding and development costs, operating costs per barrel, production growth, corporate overhead, and safety goals. We aren't big fans of the company's staggered elections for board members, but we're happy to see that restricted stock and stock options represent two thirds of total director compensation.

**Profile**

After several acquisitions and aggressive internal expansion, Anadarko is one of the largest independent exploration and production companies in North America. In 2006, the firm acquired Kerr-McGee and Western Gas in separate transactions for a combined \$23.3 billion. The deals solidify Anadarko's position in the deep-water Gulf of Mexico and the Rockies.

**Growth**

Growth is largely dictated by oil and gas prices. When commodity prices rise, Anadarko makes more money, enabling it to invest more, boosting production. The opposite happens when commodity prices fall. Anadarko's offshore properties and the Rocky Mountain region will be the primary production growth drivers for the next several years.

**Profitability**

Operating margins typically hover between 30% and 40%, making Anadarko one of the more profitable independent oil companies we cover. Although Anadarko's returns on invested capital should be weak during the next few years, we believe they will expand over time as production increases.

**Financial Health**

At first quarter end, debt/total capital stood at 36% (excluding cash and the subsequent equity offering). Anadarko's large offshore programs require a sizeable amount of up-front capital before production actually starts flowing. Free cash flow should be thin the next few years as a result of this spending and lower commodity prices. Anadarko has an estimated \$3.9 billion in offshore drilling rig commitments over the next four years. The company ended the quarter with \$2.1 billion in cash, its revolver sits untapped, and in May the firm issued an additional 30 million shares. Before accounting for the over-allotment and fees, Anadarko received \$1.3 billion in proceeds. The company, however has about \$1.4 billion in floating-rate notes that mature in September. In 2011 and 2012, Anadarko has maturing notes of \$1.6 billion and \$2 billion, respectively.

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