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Chesapeake Energy Corp. CHK

Analyst Report

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Top Rated Stocks in Sector



by Justin Perucki, CFA

Thesis 05-27-2009

In the summer of 2008, Chesapeake Energy's shale acreage position in terms of size and scope was arguably second to none. However, an aggressive operating and financing strategy coupled with a precipitous drop in natural gas prices has forced the firm to sell assets and find partners to support the drilling capital needed to develop its acreage and shore up its balance sheet. Although its net acreage base is smaller today, its expertise in shale-based natural gas remains.

Chesapeake's foray into shale deposits began with the Barnett Shale in the Fort Worth Basin several years ago, but its shale-based plays now extend from West Texas to Appalachia. In addition to the Barnett, Chesapeake also holds positions in the Haynesville, Fayetteville, and Marcellus shales. The firm's concentrated focus on shale gas should provide it the expertise to monetize these assets more effectively and efficiently, boosting returns.

When building up its acreage base, Chesapeake moved aggressively and quickly, often paying top dollar for leases in order to lock up what it felt were the best acreage plots. The company felt the combination of its shale knowledge base and the best rock would offset the higher lease bonuses and royalties it was paying. But its growth plans exceed its internally generated cash flow, forcing the firm to rely on secondary offerings, convertible debt, asset sales, joint ventures, and other funding methods to execute its drilling and leasing programs. In hindsight, management bit off more than it could chew. But by moving quickly to monetize assets we think management preserved a lot of value by avoiding any truly distressed asset sales. Also, its large, attractive acreage positions and the opportunity for knowledge-transfer probably enabled Chesapeake to receive a better price for its assets.

Of all its financing maneuvers, its various drilling partnerships are of particular note. Chesapeake is partnering with Plains Exploration [PXP](#) in the Haynesville, [BP](#) [BP](#) in the Fayetteville, and StatoilHydro [STQ](#) in the Marcellus. In addition to the up-front fee paid by all three partners, the deal terms also included a drilling capital carry, which will allow Chesapeake to increase production and reserves during the next couple years with lower levels of capital spending than it would have otherwise. Furthermore, the partnerships should help ensure that Chesapeake avoids losing large blocks of acreage because of lease expirations in the next couple of years. The Plains partnership gives us the greatest concern, but Plains should have sufficient capital to meet its drilling obligations in the Haynesville after the recent equity issuance and the monetization of a number of its "deep in the money" oil hedges. Chesapeake's financially driven moves are nearing completion, but a monetization of its midstream assets and a possible partnership in the Barnett may still be on the horizon.

Morningstar Rating 

★★★★

Stock Price

As of 05-27-2009
\$20.83

Fair Value Estimate

\$46.00

Consider Buying 

\$18.40

Consider Selling 

\$115.00

Fair Value Uncertainty 

Very High

Economic Moat 

Narrow

Stewardship Grade 

B

Bulls Say

- Given the structure of its asset sales, Chesapeake should be able to increase production at a lower capital outlay during the next few years.
- Chesapeake's ownership interest in drilling rigs and drilling companies will help the firm hedge against an uptick in daily rig rates.
- A slowdown in industrywide drilling activity should result in lower service costs.
- Chesapeake is still in the early stages of development in key plays such as the Fayetteville, Haynesville, and Marcellus shales. We could see lower well costs and higher reserve estimates from management.

Bears Say

- Chesapeake employs more leverage than most of its competitors.
- The conversion of the firm's numerous convertible issues will dilute common shareholders' ownership interests.

In contrast to other large producers, Chesapeake takes an active stance on service costs by investing directly in drilling and service firms. These investments will allow Chesapeake to capture some of the economic rents that the service providers command when demand is strong and service capacity is tight. Even though we expect these investments to be value-generating propositions, Chesapeake's returns on invested capital from its upstream operations could be diluted.

Valuation

We are lowering our fair value estimate to \$46 per share from \$48 to reflect lower Nymex natural gas futures prices and lower production growth. In our discounted cash-flow model, our benchmark commodity prices are based on Nymex futures contracts for 2009-11. For natural gas, we use \$4.60 per thousand cubic feet in 2009, \$6.60 in 2010, and \$7.10 in 2011. Over the long run, we assume base-case natural gas prices of \$7.50. The reduced spending outlook during 2009-10 should translate into mid-single-digit production growth on average during the next two years, even after factoring in asset sales. We still think the company, given its asset base, could kick production growth up to the high teens in the right commodity price environment. One of the biggest risks to our valuation is a prolonged drop in natural gas prices, but we don't believe this is a high-probability event. In the event of a one- to two-year drop in natural gas prices, Chesapeake's hedge book should help protect its drilling program through 2009, but the company is significantly less hedged in 2010. We expect cost inflation to moderate in the near term, given the slowdown in activity industrywide. Under a low scenario of long-term natural gas prices of \$5, we believe Chesapeake is worth around \$11. In this hypothetical low case, we expect production growth and capital spending to drop considerably and costs to moderate. We also think that the firm's projects in Appalachia, Fayetteville, and Haynesville would become top priority, given their superior economics. In a high case of long-run natural gas prices of \$15, we anticipate that growth would kick into high gear, with cost inflation to follow. Under this scenario, Chesapeake is worth around \$130. Our base case falls out at \$39. To derive our fair value estimate we weigh the low and base scenarios at 40% each and the high scenario at 20%.

Risk

Chesapeake has moved from being an acquisitive company with many emerging plays to a company that is more development-focused with many core plays. Keeping operating costs low is of greater importance than managing geologic risk especially given Chesapeake's focus on shale gas. Like all oil and gas producers, Chesapeake is subject to volatile commodity prices and an ever-changing regulatory environment. However, Chesapeake hedges a large amount of its production. For 2009, more than 40% of anticipated natural gas production is swapped at \$7.70 per thousand cubic feet. The company also has more than 40% of its natural gas production hedged via collars at an average floor price of around \$7.32. The company has unwound most of its knockout swaps for 2009. However, the company has sold some put options with an simple average strike price of about \$5.50. The company is lightly hedged for 2010. Changing tax legislation in the U.S. could have a negative effect on future cash flows.

- The firm announced two secondary offerings in 2008, diluting existing equity owners' ownership interests.
- Chesapeake could become a victim of its own success. The recent host of new shale plays could put a damper on domestic natural gas prices.

Close Competitors	TTM Sales \$Mil	Market Cap \$Mil
Chesapeake Energy Corp.	12,013	15,354
* EOG Resources	7,151	19,201

* <u>Devon Energy Corporation</u>	14,264	28,072
* <u>XTO Energy, Inc.</u>	8,183	25,553

* Morningstar Analyst Report Available

Data as of 03-31-09

Strategy

Chesapeake is focused on North American natural gas. Management believes that by concentrating its assets, it can enjoy scale advantages and build expertise that can be applied across different plays. Most of Chesapeake's efforts will be directed toward developing drilling in the coming years.

Management & Stewardship

Executive commentary at Chesapeake is among the best in the industry: Management is very forthcoming about its strategy and how it runs the business. We like that the company primarily relies on variable compensation to reward its executives. However, we don't like some of the executive perks, which includes personal accountants, among other things. CEO Aubrey McClendon has been a very active buyer of Chesapeake stock during the last couple of years. In October, however, he was forced to liquidate essentially all of his holdings to meet margin calls. As a potential consequence of this forced liquidation, McClendon was awarded a one-time \$75 million incentive award in January. The award will be a credit against the costs associated with his well-participation plan, and he must reimburse the company for this award if he resigns or is terminated for cause during the next five years. The \$75 million incentive payment seems like a big number on the surface, but restrictions on the payment will serve to enforce McClendon's retention.

Profile

Chesapeake Energy is an independent oil and natural gas producer. CEO Aubrey McClendon cofounded Chesapeake in 1989 and took it public in 1993. The firm's proven reserves of 12 trillion cubic feet of natural gas equivalent are located primarily in the Mid-Continent and Appalachian basins and are weighted 90% to natural gas. Chesapeake also owns natural gas gathering and processing assets and several drilling rigs.

Growth

Since its turnaround in 1999, Chesapeake has grown by leaps and bounds. However, it will become increasingly difficult for the firm to expand at its historical rate. Commodity prices are a large determinant of sales and profit growth.

Profitability

Profits will fluctuate with oil and gas prices. Given Chesapeake's operating and financial leverage, profits will expand and contract more than the change in commodity prices. Returns on invested capital are around the industry average but should improve as the firm increases production from its host assets.

Financial Health

Despite a host of opportunities, disruption in the financial markets has forced management to sell down its ownership stakes in a handful of plays rather than relying on debt or equity to fund its growth. Private market transactions continue to occur at price levels greater than what is reflected in the public equity markets. However, if interest wanes, Chesapeake may be forced to tap the equity markets at an inopportune time. The firm has no immediate refinancing needs, and its hedge book provides a layer of

protection.

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