EOG Resources EOG

by Justin Perucki, CFA

Thesis 05-08-2009

With the help of its low-cost asset base, clean balance sheet, and strong 2009 hedge book, EOG stands to strengthen its competitive position during the next few years as it competitors struggle with high leverage and weak commodity prices. We anticipate EOG will accomplish this by acquiring acreage on the cheap in existing plays and in new ones. Moreover, EOG is shifting the balance of its portfolio--oil and natural gas liquids are expected to represent 50% of production by early next decade.

EOG has historically shunned acquisitions, preferring to find and develop reserves on its own. Although its production growth hasn't been as impressive as some of its competitors', EOG operates one of the lowest-cost asset bases in the industry. The firm's low-cost structure helps improve its odds of remaining profitable even during the bottom of the industry cycle. Moreover, by minimizing capital costs and operational costs, EOG enjoys solid returns on capital.

EOG is one of the largest leaseholders in the prodigious Barnett Shale near Fort Worth, Texas. EOG's results in the Barnett have been impressive, and performance continues to exceed expectations. In 2008, Barnett production grew more than 50% year over year. However, we are more impressed by the firm's ability to keep costs in check in the escalating cost environment that persisted through most of 2008. One way EOG has been able to minimize costs has been by cutting the time it takes to drill a well in half. More recently, the firm acquired a sand mine south of Fort Worth, as well as built its own gathering and processing in western Johnson County. This willingness to vertically integrate exemplifies what sets EOG's management team apart, in our opinion.

One of the more exciting plays, EOG is involved in, is the Bakken Shale within the Williston Basin, which spreads across North Dakota and Montana. It appears EOG has found the sweet spot of the play, holding an enviable position within the Parshall field. The play is economical down to around $50 per barrel. Expected recovery rates are still relatively low, but they could increase over time through tighter well spacing and secondary and tertiary recovery techniques. However, minimal work has been done on this front. The company is curtailing production in the early part of 2009 because of weak regional oil prices and a transportation issue. The main oil pipeline is full, and current prices don't justify trucking oil to market. The infrastructure situation should improve throughout the course of 2009 and into 2010 as new pipelines and rail capacity is added.

In the hope of leveraging the knowledge gained in the Barnett Shale, EOG has been working on several emerging shale plays during the last year. The most promising appear to be what EOG calls the Barnett Shale Combo play and the Horn River Basin, a shale gas play in British Columbia. The

Morningstar Rating
★★★★

Stock Price
As of 05-08-2009
$76.87

Fair Value Estimate
$112.00

Consider Buying
$56.00

Consider Selling
$224.00

Fair Value Uncertainty
High

Economic Moat
Narrow

Stewardship Grade
B

Bulls Say

- EOG stands to fortify its competitive position in the current environment.
- Management is holding back growth--waiting for lower service costs and higher commodity prices.
- Hedges and a conservative balance sheet will allow EOG to weather the current storm in North American natural gas.
- The firm's new Barnett Shale Combo play holds some of best economics in the company.
- Although its 100,000-plus acreage position in Haynesville Shale is not as large as some of its competitors, it still holds great potential.

Bears Say

- Despite being a low-cost producer, profitability and production growth would suffer under our low-commodity-price scenario.
- Although exploration risk is significantly lower for unconventional deposits, EOG still faces engineering risk.

Barnett Shale Combo play produces a mix of oil, natural gas, and natural gas liquids (NGLs) and sits north of EOG's main producing properties in the Barnett Shale. With gathering and processing infrastructure now in place, the Combo play should see material growth in 2009. Even at lower commodity prices, this play should produce nice returns.

EOG still has a lot of work ahead of it on the Horn River Basin. While geologically Horn River appears attractive with characteristics on par with many of the best shales in the lower 48 states, the remote location of the play and the harsh operating environment present a formidable, but surmountable, challenge. Our biggest concern is the lack of infrastructure in the region, which will defer the timing of future development and cause weak pricing differentials. However, increasing demand from the Alberta oil sands and a potential LNG export terminal on Canada's west coast should improve pricing differentials and economics of the play. The play should be economical at our long-run natural gas price assumption of $7.50/mcf.

Valuation

We are maintaining our fair value estimate of $112 for EOG. In our discounted cash-flow model, our benchmark commodity prices are based off of NYMEX futures contracts for 2009-11. For oil, we are currently using $50 per barrel in 2009, $62 in 2010, and $67 in 2011. For natural gas, we are currently using $4.10 per thousand cubic feet (mcf) in 2009, $6.20 in 2010, and $6.90 in 2011. Natural gas growth will slow considerably in 2009 and maybe longer as the company has expressed a desire to keep drilling in check in the current price environment. However, the company should still experience robust oil and NGL production growth because of growth from the Bakken, the Barnett Shale Combo play, and other emerging oil plays. Given its strong balance sheet, we would expect EOG to take advantage of lower asset prices by acquiring acreage on the cheap--strengthening its competitive position in existing plays and potentially establishing new ones. We would expect EOG to turn the growth engine back on once service costs fall and/or commodity prices rebound. In our base case described above, we believe EOG is worth $97 per share, and we weigh this scenario at 40%. If we assume long-run natural gas and oil prices of $5 and $50, respectively, our fair value estimate would fall to $50 per share. If that were to happen, we would expect growth to slow further, but expenses to drop, as well. We assign a 40% weighting to our low-side scenario. We also looked at a high case based on long-run natural gas prices of $15 and oil prices of $150. In this scenario we would expect activity to kick into high gear. However, we also assume higher operating and capital cost inflation. Under this scenario, we believe EOG is worth around $270 per share, and we place a 20% probability on this scenario. The company recently monetized some hedges in the latter half of 2010 and boosted its hedge position from June to October of this year. About 38% of EOG's expected natural gas production is hedged next year at a price around $9.40.

Risk

A protracted decline in natural gas prices is EOG's primary risk. Such a decline could be caused by an anemic economy, mild weather, or oversupply. However, we think EOG would be able to weather the storm better than others. Fires, explosions, and changing regulations are ever-present risks as well. Because unconventional deposits are well defined, exploration risk is relatively low. However, engineering risk still remains. Poor management of the development process can reduce the amount of reserves that can ultimately be recovered from a specific field.

- Weak industrial demand and strong supply growth in 2008 should keep a lid on natural gas prices in 2009.

Close Competitors	TTM Sales $Mil	Market Cap $Mil
EOG Resources	**7,151**	**17,600**
* Devon Energy Corporation	14,264	27,624
* Chesapeake Energy Corp.	11,629	12,771
* Anadarko Petroleum Corp.	15,723	20,005

* Morningstar Analyst Report Available

Data as of 03-31-09

Strategy

EOG says its strategy is to maximize the rate of return of investment on capital by controlling operating and capital costs. We think that the firm's solid long-term performance is representative of this strategy. One of the key components of EOG's strategy is to increase reserves and production internally, avoiding pricey acquisitions. As part of its decision to slow drilling, we expect management to redirect capital toward acquiring acreage on the cheap from distressed sellers.

Management & Stewardship

Although EOG can trace its lineage to Enron, its current management does not appear to have had anything to do with the funny business that brought Enron down. Mark Papa has been at EOG and its predecessor companies for more than 20 years; he became chairman and CEO at the time of EOG's independence from Enron in 1999. We like that the firm relies on a mix of cash bonuses, restricted stock, and stock options to compensate its executives. Executive bonuses are based on reinvestment rate of return, production growth, reserve replacement, finding costs, and stock price performance in relation to the firm's peer group. The firm earns kudos for its minimum stock ownership requirement for senior managers, which ranges from 1 times base salary for vice presidents to 5 times base salary for the CEO. We believe EOG has good stewardship practices.

Profile

EOG Resources is one of the largest independent natural gas producers in the United States. About 85% of its gas production and 85% of its total production comes from North America. At year-end 2008, the company had total reserves of 8.7 trillion cubic feet of gas equivalent, weighted 80% toward natural gas. EOG Resources is one of the biggest players in North American unconventional natural gas.

Growth

Management is slowing growth in the near term due to low commodity prices. But the company could turn on the growth engines should commodity prices rebound from their existing levels thanks to its strong asset base and financial situation.

Profitability

EOG's low-cost mentality helps the firm generate above-average margins and returns. Like sales, profitability moves with commodity prices.

Financial Health

Peak cyclical conditions have provided significant free cash flow, allowing the firm to reduce net debt/total capital to 18%. Management wants to keep its balance sheet pristine; it would cut its budget before taking on significant amounts of debt in the current environment. EOG's first material debt maturity ($220 million) is 2011, with no other maturities until 2013. The firm's $1 billion revolver is completely undrawn; however, it did have $191 million outstanding in commercial paper as of March 31 offset by $85 million in cash.

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