

[Snapshot](#)[Quote](#)[Analyst Research](#)[Morningstar Rating](#)[Options](#)[Data Interpreter](#)[Valuation Ratios](#)[Financial Statements](#)[Key Ratios](#)[Charts](#)[Dividends & Returns](#)[Company Filings **new**](#)[Insider Trading](#)[Formatted Report](#)[Print](#)**EXCO Resources, Inc. XCO****Analyst Report**[Analyst Report Archive](#)[Top Rated Stocks in Sector](#)by [Eric Chenoweth, CFA](#)**Analyst Note** 06-30-2009

On Tuesday, EXCO Resources XCO announced a definitive agreement with BG Group BRGGY for a joint venture to develop its North Louisiana and East Texas gas properties 50/50; EXCO will remain the operator. This deal comes on the heels of EXCO's sale of some of its Mid-Continent and East Texas oil and gas properties a day earlier to Encore Acquisition EAC for \$375 million in cash. Both of these deals will accelerate EXCO's ability to reduce debt, a key goal for the company. We're lowering our fair value uncertainty rating for EXCO to very high from extreme, thanks to these deal announcements that are very good for the firm, in our opinion.

The EXCO deal has greater significance for the U.S. gas industry in that it continues the long-running trend of large, integrated European oil and gas companies partnering with U.S. independent producers to develop their shale gas reserves. The larger European players have teamed up with debt-ridden and cash-hungry U.S. players with shale-rich portfolios, trading liquidity for exposure to shale gas resource potential. We think EXCO also emerges from this deal much stronger, receiving \$655 million in cash up front and a \$400 million commitment on BG's part to carry 75% of EXCO's Haynesville Shale drilling and completion costs going forward (providing further room for EXCO to set aside excess cash flow for debt reduction versus plowing it back into the drilling budget). Additionally, EXCO plans to sell BG 50% of its midstream assets for \$249 million in cash. BG gains a 50% stake in 84,000 Haynesville acres (most of which is in the core play) for about \$15,000 per acre, by our estimates, after adjusting for the value of the shallower, producing properties. This price tag appears a bit rich by today's standards but well below the high prices we saw last year.

EXCO could still have more deals up its sleeve that would help reduce debt and enable it to prove up its Marcellus and Haynesville resources more quickly. During its conference call Tuesday, EXCO said it is marketing some shallow Appalachian reserves and production for a sale and is beginning to consider joint-venture talks for its large Marcellus Shale acreage position.

Thesis 02-06-2009

EXCO Resources follows a strategy not uncommon in the oil and gas industry: acquire and exploit. Since present management took the helm in 1998, it has closed about 150 acquisitions, rapidly expanding production and reserves.

In our opinion, a disciplined deal-making team is an essential component of the acquire-and-exploit model. We see some encouraging signs at EXCO in this regard. During the last three years, the firm has kept its finding and development costs below many of its peers'. If EXCO can continue to acquire and develop reserves more cheaply than the industry

Morningstar Rating 

★ ★ ★

Stock PriceAs of 06-30-2009
\$12.92**Fair Value Estimate**

\$12.00

Consider Buying 

\$4.80

Consider Selling 

\$30.00

Fair Value Uncertainty 

Very High

Economic Moat 

None

Stewardship Grade 

C

Bulls Say

- Untapped resource potential, like the Haynesville and Marcellus shales, rests under some of EXCO's mature properties and may add significant value for shareholders in the future.
- Unlike oil, natural gas is a stranded resource. Until liquefied natural gas becomes more prevalent, domestic producers like EXCO should have an advantage over foreign competitors.
- EXCO's natural gas assets are in the United States, where political risk is low.

Bears Say

- Costly exploratory failures, mechanical problems, and environmental disasters are constant concerns for E&P companies.
- EXCO's ability to boost production is limited by its access to external capital, transportation infrastructure, and manpower.
- Like other acquisition-driven companies, EXCO faces integration risk when it acquires new properties and

as a whole can, it should contribute positively to the firm's long-term results.

personnel.

After going public in February 2006, EXCO hit the ground running on the deal front. It acquired Winchester Energy from Progress Energy [PGN](#) for roughly \$1.2 billion, as well as Anadarko's APC North Louisiana properties for \$1.6 billion and its Mid-Continent and South Texas properties for \$860 million. However, EXCO's decision to withdraw its master limited partnership (MLP) offering earlier this year was a small setback to the firm's aggressive acquisition and development plans. Had the MLP gone forward, it would have given EXCO a vehicle through which to wage an aggressive acquisition campaign.

Saddled with a higher debt load following these large deals, as well as a scuttled MLP offering, EXCO's deal machine has been quiet during the last year. Due to a midyear rally in its shares, EXCO announced that nearly \$2 billion in convertible bonds would convert to equity, improving the firm's financial flexibility at a crucial time. However, the firm's debt levels are still high relative to peers, and the rapid decline in oil and natural gas prices has made this debt load more onerous in recent quarters.

We expect EXCO will be more active on its exploratory acreage in the Marcellus Shale and Haynesville Shale, currently two very bright spots in the company's portfolio. During the last year, both of these plays have become more active areas for natural gas producers, with acreage prices rising considerably before the recent decline in oil and gas prices. If EXCO meets with commercial success in the Marcellus and Haynesville shales (a prospect that seems more likely today than it did earlier in 2008), then this could translate into higher valuations of the shares.

Despite its focus on natural gas (we expect natural gas will make up about 90% of total 2008 production), EXCO's extensive hedging program should reduce the firm's exposure to gas prices during the next couple of years. By our measure, EXCO has hedged more than 75% of its 2008 production and more than 60% of its 2009 production. Of course, over the long term, natural-gas prices play a big role in determining EXCO shareholders' returns. Besides natural gas prices, EXCO's success in overcoming integration challenges and finding ways to reduce costs will largely determine the firm's ability to add long-term value for shareholders.

Valuation

We're lowering our fair value estimate to \$12 per share from \$15 to account for our lower long-term, base-case natural gas price assumption. In our discounted cash-flow model, our benchmark oil and gas prices are based on NYMEX futures contracts for 2009-11. For natural gas, we are currently using \$5.40 per thousand cubic feet (mcf) in 2009, \$6.80 in 2010, and \$7.20 in 2011. For oil, we are currently using \$48 per barrel in 2009, \$57 in 2010, and \$61 in 2011. In our base scenario, we assume long-run perpetual oil prices of \$80 per barrel and natural gas prices of \$7.50 per mcf. This scenario values EXCO at \$7 per share. Our low case scenario assumes long-run perpetual oil prices of \$50 and \$5 natural gas. In our low scenario, we assume EXCO's drilling and acquisition activity slows considerably. Given the dramatically lower activity and pricing assumptions and the higher prices EXCO paid for recent large acquisitions, EXCO's shareholders would struggle to realize much value in our low case. Our high case assumes long-run perpetual oil prices of \$150 and \$15 natural gas. In this scenario, EXCO ramps up drilling and acquisitions and its Haynesville and Marcellus Shale acreage adds considerable value for shareholders, and our valuation is \$45 per share. We assume a cost of equity of 13% in all scenarios. In our base case, we project average

daily production of roughly 400 million cubic feet of natural gas equivalent in 2008 and roughly 420 million cubic feet in 2009. Our 2009 forecast for earnings before interest, taxes, depreciation, amortization, and exploration expenses is just under \$750 million.

Risk

EXCO's biggest risk is a substantial and prolonged drop in the price of oil and natural gas. This could depress profits, slow development plans, and reduce the value of its properties. Like other acquire-and-exploit firms, EXCO relies on a combination of cash flow and external financing to fund its acquisitions. Lower gas prices could reduce cash flow and increase the cost of external financing, thus reducing EXCO's ability to do deals. Additionally, EXCO faces geological, mechanical, and regulatory risks.

Close Competitors	TTM Sales \$Mil	Market Cap \$Mil
EXCO Resources, Inc.	1,347	2,374
* XTO Energy, Inc.	8,183	19,785
* Chesapeake Energy Corp.	12,013	11,227
* Encore Acquisition Company	977	1,467

* Morningstar Analyst Report Available

Data as of 03-31-09

Strategy

EXCO acquires and develops oil and natural-gas properties, focusing on deals in its core operating regions of Appalachia, East Texas, and West Texas. It targets onshore properties with established production records and long reserve lives. Through investing in drilling and more efficiently spreading costs by integrating acquired properties into its existing property base, EXCO hopes to wring profits from its acquisitions. To achieve this, the company must identify and close deals where it can add value.

Management & Stewardship

Chairman and CEO Doug Miller has a long history of deal-making and leading oil and gas companies. Miller's first time at the helm of a public oil and gas company came after restructuring Chapman Energy in 1987. Chapman was later renamed Coda Energy, where Miller was chairman and CEO for most of the 1990s. At Coda, Miller applied an acquire-and-exploit strategy. After selling Coda, Miller acquired a majority stake in EXCO Resources, where he's employing a similar strategy. As of early March, executives and board members owned about 20% of EXCO's outstanding shares. We like to see management and board members with a lot of skin in the game. Management compensation levels are not unusual for a company of this size in the oil and gas industry. EXCO's stewardship is fair, overall.

Profile

Dallas-based EXCO Resources engages in the exploration and production of oil and natural gas in Appalachia, the Mid-Continent, East Texas, the Permian Basin, and the Rockies. At the end of 2007, EXCO reported proven reserves of 1.87 trillion cubic feet of natural-gas equivalent. Daily production averaged 332 million cubic feet in 2007. EXCO's production is about 92% natural gas.

Growth

EXCO made a number of large acquisitions in 2006 and 2007; production gains from these deals should propel the company's top line in 2008. Natural-gas and oil prices, the other key driver of EXCO's growth, are out of the firm's hands.

Profitability

Profitability at EXCO has been weak and volatile during the last few years, largely because of poor economies of scale, commodity price hedges, and large interest payments. Profitability should improve as EXCO builds scale, but its ultimate level remains unclear.

Financial Health

EXCO's financial health has improved as a result of the recent conversion of almost \$2 billion worth of debt into equity, though it still carries more debt than most of its peers. The firm's aggressive acquisition strategy makes it heavily reliant on external sources of capital and likely to sport a significant debt burden in the future.

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