Range Resources Corporation RRC

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Analyst Note 07-23-2009

Range Resources RRC reported second-quarter results on July 22 after the close. As previously reported, production averaged 433.5 million cubic feet of natural gas equivalent (mmcfe) per day during the quarter, a 14% increase year over year. Although Range is one of the lowest-cost producers in the industry, operating costs dropped $0.08/mcfe year over year before accounting for the reduction in workover activity. However, SGA increased slightly as a result of higher personnel expense related to the build-out of the Appalachian division. Although Range turned in a net loss of $40 million for the quarter, the firm incurred about $103 million in non-cash hedging and asset impairment charges.

The biggest news of the day was the disclosure of a Marcellus production type curve based on production history from the 24 wells that have been producing for greater than 120 days and Range's internal estimates. Based on the graphical presentation, it appears production declines are around 75% in year 1, 35% in year 2, 25% in year 3, 12.5% in year 4, and 10% in year 5. Range is also assuming a 40-year average well life and a 6% terminal decline. Other data points include: initial production rates of around 5 mmcfe/d; gross recoverable reserves of 4.4 bcfe; well costs of $3.5 million, and an average royalty of 15%.

Range performed no additional drilling on its northern Marcellus acreage during the quarter. However, the company plans to drill its first two horizontal wells in the next several months in the area. Well results are expected by year-end. Marcellus production is expected to exit the year at around 90-100 mmcfe/d and 180-200 mmcfe/d by year-end 2010.

In the past week, Range continued to bulk up its hedge book for 2010. The company now has about 50% of estimated production hedged for the first half of 2010 at an average floor price of $5.50/mcf and ceiling price of $7.50/mcf. About 24% of expected second-half production is hedged at the same price levels. As we have stated previously, the added hedges ensure a minimal level of cash flows should natural gas prices remain weak.

Thesis 04-15-2009

For most of its history, Range Resources' strategy involved acquiring legacy-producing properties on the cheap and boosting production rapidly. This served the firm well, but over time, Range has devoted more resources to finding and developing its own reserves. The shift in strategy has been a success and the company has a vast leasehold position that should generate impressive internal production growth during the next several years.

Range's drilling opportunities consist primarily of unconventional (shale, tight sands, and coal bed methane)

Morningstar Rating
★★★★

Stock Price
As of 07-23-2009
$44.78

Fair Value Estimate
$70.00

Consider Buying
$35.00

Consider Selling
$140.00

Fair Value Uncertainty
High

Economic Moat
Narrow

Stewardship Grade
NA

Bulls Say

- The firm has built up a substantial asset base in the last few years, which should provide it with plenty of drilling opportunities. Its reserves/production ratio stands at 19 years.
- Range's assets in southwest Pennsylvania hold some of the best economics in the entire industry.
- Lower industrywide activity should result in lower operating and capital costs in the near term.
- It's appears Range's Marcellus acreage could keep the entire company growing for years to come.
- Natural gas produced in the Appalachian Basin usually sells at a premium to Henry Hub, the industry benchmark.

Bears Say

- Proposed changes to the tax code, if enacted, could reduce Range's operating cash flow 20%-30%, all else equal.
- Production growth may be constrained by infrastructure and regulatory constraints.

natural gas deposits in Texas and Appalachia. Unconventional reserves have low geological risk; the amount and location is largely known, which leaves extracting the natural gas as the real challenge. Once an effective drilling and well completion technique is found, producers can often drill thousands of wells with near-100% success rates in the same area. The biggest challenge that Range faces during the next several years is finding the most effective drilling and completion technique, and development plan to exploit its nascent projects.

The firm is in the preliminary stages of evaluating and developing its acreage base. If there is sufficient gas in place and Range can develop an effective extraction method, then production and reserve growth should remain robust during the next several years. Some of Range's premier assets are its properties in the Fort Worth Basin (the Barnett Shale). Most of Range's acreage lies just outside the core area of the play, but initial well results from Range and some of its competitors nearby look promising.

Another one of Range's emerging plays is the Marcellus Shale in Appalachia. Range is one of the first movers in the play, and it recently announced that it is shifting from testing mode into development mode after drilling more than 100 wells across the play. Most of the Range's acreage is in southwest Pennsylvania, which appears to hold some of the best acreage. While Range has released some preliminary initial production, reserves, and cost estimates for the play, competitors have been relatively tight-lipped as they scramble to buy more acreage. Some near-term challenges remain, but we think that Range will be able to overcome them in due time.

The ability to quickly boost production from its acquired properties has enabled Range to maintain a very attractive unit operating cost profile. All-in lifting costs have averaged around $1 per thousand cubic feet equivalent of production during the last three years. But Range, like its competitors, has experienced some cost creep in recent years because of rising drilling, equipment, service, and land costs. Range has done a commendable job reinvesting capital, which has led to a three-year average finding-and-development cost of $1.93 per thousand cubic feet. Management's target cost of $1.50 to $2 per thousand cubic feet (mcf) seems ambitious but attainable, if the unconventional resources prove to be prolific.

We believe Range has a narrow economic moat. The firm benefits from the stranded nature of natural gas, which limits imports, and OPEC's influence on oil prices. Range's relatively low-cost asset base and its ability to extract oil and gas from its fields in an efficient and cost-effective manner are the other key reasons the firm has been able to generate excess economic returns. During the last five years, Range has earned an average return on invested capital of 17%, substantially above its cost of capital, despite having its average selling prices severely hampered by hedging. We believe Range will be able to continue generating excess returns for the foreseeable future.

Valuation

We are raising our fair value estimate for Range to $70 per share from $66. The change stems primarily from an increase in our natural gas liquids forecast and some cost savings from the recent slowdown in industrywide drilling activity. Range's assets in southwest Pennsylvania appear to hold some of the best economics in the entire industry and its acreage in north Pennsylvania could be even better. We expect production growth to fall to around 11% this year, but it should kick back up north of 20% after that as Marcellus production comes on line in a big way, assuming natural gas prices closer to $7 per thousand cubic feet (mcf). While

- Range may have to issue equity to fund its robust growth plans.
- Lower industrial demand, coupled with strong supply growth in 2008, could keep natural gas prices suppressed over the next couple of years.
- Even though Range has a substantial acreage base, it is still in the evaluation phase in many of its plays.

regulatory and infrastructure hurdles could limit the pace of growth at times, we feel that Range has its books in order over the next couple years. 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 $4.30 per mcf in 2008, $6.20 in 2009, and $6.80 in 2010. In our base scenario, we assume long-run perpetual oil prices of $80 per barrel and natural gas prices of $7.50 per mcf. We value Range at $66 in this scenario. Range is one of the lowest-cost producers in the industry; even if we assume NYMEX futures are 20% lower for 2009-11, the firm could still generate strong margins. However, growth will likely slow as a result of lower capital spending. Range's natural gas hedges cover about 50% of estimated production for 2010 but is unhedged for 2011. Even in our low-case scenario, growth should remain pretty strong, but dramatically reduced pricing assumptions results in a value of around $20 per share. Our high case assumes long-run perpetual oil prices of $150 and $15 natural gas. In this scenario, growth accelerates, but cost inflation increases as well; our valuation is around $180 per share in this scenario. We weight our base and low cases at 40% and our high case at 20%.

Risk

Range operates with above-average leverage, but its hedge book and low-cost asset base mitigates a liquidity crisis should commodity prices drop precipitously. Of estimated 2009 production, 50% of production is hedged at an average floor price of $8.30. Like other oil and gas producers, Range is subject to dry holes, changing regulations, labor shortages, and environmental concerns.

Close Competitors	TTM Sales $Mil	Market Cap $Mil
Range Resources Corporation	**1,423**	**7,312**
* Chesapeake Energy Corp.	12,013	13,481
* EOG Resources	7,151	18,596
* EQT Corp.	1,510	4,917

* Morningstar Analyst Report Available

Data as of 03-31-09

Strategy

Range likes to focus its efforts on a couple of core areas to develop expertise and cost synergies. This strategy should serve it well, especially in developing its shale acreage across the Southwest and Appalachia.

Management & Stewardship

CEO John Pinkerton has led Range Resources since 1992. We like that the chairman and CEO roles are split. The chairman position is held by Charles Blackburn, a 40-year industry veteran. Blackburn spent most of his career with Royal Dutch Shell RDS.A and was chairman and CEO of Maxus Energy before it was acquired in 1995. Range's engineering and management team consists of several ex-Mitchell Energy employees. Mitchell was one of the leaders in unconventional natural gas before it was acquired in 2001 by Devon Energy DVN. At that time, Mitchell was the largest acreage holder and producer in the Barnett Shale. This experience with shale gas should prove beneficial to Range. Directors and executives beneficially own a fair amount of the firm's outstanding shares.

Profile

Range Resources is a North American exploration and production company that focuses on unconventional natural gas. At the end of 2008, the firm had 2.7 trillion cubic feet of natural gas equivalent in reserves weighted 84% toward natural gas. The firm's properties are primarily located in Texas and Appalachia.

Growth

During the last four years, Range has generated healthy production growth through a mix of internal projects and acquisitions. The next several years should be characterized by strong internal production growth, but top-line growth will be largely dictated by commodity prices.

Profitability

Range is one of the lowest-cost producers in the industry. The firm's cost profile should improve following the divestiture of its higher-cost offshore assets.

Financial Health

While debt/capital at over 40% is higher than the industry average, we think the company is sufficiently financed for the foreseeable future. At year-end, the firm was about 50% drawn on its revolver with about $690 million in availability based on the current commitment. Furthermore, its $1.5 billion borrowing base exceeds the current commitment by $250 million. Range also has about $1 billion in senior subordinated notes, which mature relatively uniformly between 2013 and 2018. The firm is also about 50% hedged for 2009 at a price of around $8.30/mcf. Should natural gas prices and Range's stock price rebound we wouldn't be surprised if the company issues equity down the road to fuel growth.

Authors can be reached at analyst feedback.