



INVESTMENT  
RESEARCH CENTER

Provided by James Brown Library of  
Williamsport

Thursday, May. 14, 2009

Contact

End Session

- Home
- Stocks
- Funds
- ETFs
- Industries
- Portfolio X-Ray
- Help & Education

Print

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

## Talisman Energy, Inc. TLM

- Analyst Report
- Analyst Report Archive
- Top Rated Stocks in Sector



by Morningstar Analysts

**Analyst Note** 04-30-2009 | by Jennifer O'Connor

Talisman Energy [TLM](#) announced positive first-quarter results April 29. The firm generated production volumes of 436,000 barrels of oil equivalent per day from continuing operations, bolstered by ongoing success in the U.K. North Sea, first gas from Rev Field in Norway, and first oil from the Northern Fields in Southeast Asia.

Development is humming along across the board. Following the first two successful wells at Rev Field, a third well is expected on stream later this year. Development at the Northern Fields in offshore Malaysia and Vietnam is on track, with plans to drill more wells throughout the rest of 2009 and 2010. Despite strong production growth in these regions, second- and third-quarter production is expected to be typically lower because of routine maintenance shutdowns.

Talisman is also progressing its shale play development. The firm drilled four Marcellus wells this quarter, and management expects to complete the 2009 program with two to three rigs instead of the five it had originally planned, as a result of improvements in drilling efficiency. Well results from the region are encouraging, topping management's initial expectations. Meanwhile, the Montney shale and Quebec projects remain in piloting phases. Talisman completed its first horizontal well in the Montney shale, though results fell short of expectations because of operational challenges. The firm desires to prove up the Montney shale by year-end. We will be watching for more detailed results as the play moves forward.

Talisman continued to divest unwanted assets. The firm garnered \$720 million for its Saskatchewan Bakken acreage, \$380 million for its Trinidad and Tobago assets, and \$300 million for its midstream assets in Cutbank Ridge. We were pleased to see the firm pay down all of its bank lines. This added liquidity should help ensure that Talisman has the necessary capital to ramp up its shale play developments.

**Thesis** 04-17-2009 | by Jennifer O'Connor

Talisman Energy, an international oil and gas exploration and production company, is in the midst of a strategic shift toward unconventional natural gas deposits and away from conventional ones. Since the new game plan was unveiled early last year, Talisman has shed \$1.7 billion in unwanted assets, exceeding its initial target of \$1.5 billion. The firm has also established positions in two of North America's emerging shale plays, the Marcellus and the Montney, and now holds 1.1 million net acres total across the two plays.

Talisman is relying on its assets in Canada and the United Kingdom North Sea to generate the necessary cash flow to help fund the hefty up-front investment needed to effectively enter these shale plays. Management contends that the Marcellus and Montney shales will not only give Talisman more drilling opportunities and more stable growth, but will

**Morningstar Rating**



**Stock Price**

As of 04-30-2009  
\$14.95

**Fair Value Estimate**

\$17.00

**Consider Buying**

\$8.50

**Consider Selling**

\$34.00

**Fair Value Uncertainty**

High

**Economic Moat**

Narrow

**Stewardship Grade**

**B**

**Bulls Say**

- Talisman has a sizeable North American land position, which it is now testing for unconventional natural gas potential.
- The company has built an exciting suite of development projects and exploration opportunities in Southeast Asia.
- Development drilling should maintain steady North Sea production for years to come.
- Talisman operates the majority of its projects, giving it better control over the timing of costs and development.
- The company has a culture of applying technical expertise across various parts of its portfolio.

**Bears Say**

- Talisman may have a tough time extracting value from tricky new plays. Its Bakken play is an example of an emerging play that didn't quite make the grade.
- 2008 year-end proved reserves declined 27% from 2007 levels, primarily attributable to price-related revisions for the U.K. North

also yield more attractive returns on invested capital in the long run.

While these prospects look promising, we question how quickly and effectively Talisman can unlock the plays' potential with its scant shale experience. Further, the large majority of the firm's Marcellus acreage is located in New York, where horizontal drilling is not currently allowed, due to ongoing regulatory and environmental discussions. Without key regulatory changes in New York, full-scale development will have to wait. While Talisman's Montney acreage straddles British Columbia and Alberta, the Montney shale play is located entirely in British Columbia, where the royalty rates are more favorable. However, new, higher royalty rates in Alberta could mute returns on Talisman's conventional drilling program there. Despite these obstacles, Talisman has already contracted significant future incremental firm-transport takeaway capacity from both shales, indicating to us the firm's determination to ramp up production rapidly in the plays.

One piece of Talisman's strategy that remains is its commitment to its offshore international projects. The Rev and Yme projects in the Norwegian Sea and the Northern Fields in Malaysia and Vietnam are poised to deliver substantial near-term growth. However, success hinges on the firm's ability to deliver these projects on time and at cost--things Talisman has struggled with in the past. Talisman's international projects could provide a nice uplift, if the firm can continue its history of exploration success.

Due in part to strong commodity prices last year and the aforementioned asset sales, Talisman is on sound financial footing, with over \$2 billion of undrawn capacity on its revolving line of credit at year-end and more expected proceeds from the remainder of its asset sales. With the facility fully committed until 2012 and the large majority of the firm's term debt maturing at least five years out, the firm is afforded some financial flexibility. The firm intends to fund 2009 capital spending solely with operating cash flows. As Talisman continues to implement its strategy, we would not be surprised to see the firm take advantage of industry turmoil and snap up some assets on the cheap that would complement its new strategic direction. All told, Talisman is pursuing a challenging endeavor, and it remains to be seen whether the path the firm is forging will lead to future outsize returns.

#### **Valuation**

We're lowering our fair value estimate for Talisman to \$17 per share from \$18 to reflect our lower long-term natural gas price forecast. As the firm shifts its strategy in North America from conventional to unconventional drilling, we anticipate that substantial up-front capital investment will be required. Development has recently begun in the Montney and will not begin in the Marcellus until later this year. In the meantime, we expect the firm to continue to generate steady cash flows through its conventional Canadian base and its remaining U.K. assets, and to deliver growth through several projects in Norway and Southeast Asia expected onstream this year. These assets should help provide the necessary near-term stability and growth necessary to allow for Talisman to ramp up unconventional production in North America. However, we expect 2009 production to stay flat to 2008 levels, with mid-single-digit growth occurring thereafter. We think the firm has quite a bit of running room, but it could be a couple years until the benefits are fully realized.

Our valuation is weighted 40% to the base case, 40% to the low case, and 20% to the high case. Our base fair value of \$20 per share uses projected benchmark oil prices of \$51 per

Sea reserves.

- The company has a history of failing to meet project timelines and production expectations.
- It could be years before Talisman realizes the full benefit of its unconventional programs.

barrel in 2009, \$64 in 2010, \$69 in 2011, and \$80 in 2012 and beyond, and natural gas prices of \$4.30 per thousand cubic feet in 2009, \$6.20 in 2010, \$6.80 in 2011, and \$7.50 in 2012 and beyond. Under a high long-term scenario of \$150 oil and \$15 natural gas in 2012 and beyond, our fair value estimate would be \$37 per share. Under a low long-term scenario of \$50 oil and \$5 natural gas in 2012 and beyond, our fair value estimate would be \$5.50 per share. Our valuation is modeled in Canadian dollars and converted back to a U.S. dollar fair value estimate at the spot exchange rate of CAD 1.21 per U.S. dollar as of April 15, 2009.

#### **Risk**

The most significant risk facing Talisman is a sustained downturn in commodity prices. The company also faces risks in securing adequate resources to execute its plans. In a busy environment for oil and natural gas, costs may be subject to considerable inflationary pressure. Talisman also faces the risk of changes to regulations, whether related to royalties, taxes, or the environment.

<b>Close Competitors</b>	TTM Sales \$Mil	Market Cap \$Mil
<b>Talisman Energy, Inc.</b>	<b>10,815</b>	<b>13,922</b>
* <a href="#">Canadian Natural Resources, Ltd.</a>	14,703	26,909

\* Morningstar Analyst Report Available

Data as of 12-31-08

#### **Strategy**

Talisman's strategy is focused around its three core areas: North America, the North Sea, and Southeast Asia.

Near-term testing of unconventional natural gas in North America should help define future growth opportunities to supplement ongoing development projects in the North Sea and Southeast Asia. The company continually invests in exploration to replenish its long-term opportunity set.

#### **Management & Stewardship**

Former BP BP refining and marketing executive John Manzoni has taken over the helm from Jim Buckee, who retired after 14 years as Talisman's president and CEO. Before heading up refining and marketing at BP, Manzoni worked in various roles on the exploration and production side of the business. At Talisman, he joins a team of experienced senior managers who have 10 to 20-plus years of industry experience. We applaud the company's efforts to tie compensation to performance measures, with a high proportion of variable pay tied to goals and outcomes that are clearly disclosed. We also like that Talisman sets minimum levels of share ownership for its directors and its executives, so that the stewards of the company behave in its best interests.

#### **Profile**

Calgary-based Talisman Energy engages in oil and gas exploration and production, with operations in North America, the North Sea, Southeast Asia, and many other places. In 2008, the firm reported gross proven reserves of 1.43 billion barrels of oil equivalent, weighted 62% to natural gas. Talisman's 2008 production was weighted 48% to natural gas.

#### **Growth**

We expect production growth from continuing operations to increase at a steady clip through 2009 because of development projects such as Rev and Yme in the North Sea and the Corridor and Northern Fields projects in Southeast Asia. Our long-term expectations are for roughly 5% to 7% of annual production growth.

**Profitability**

We expect weak commodity prices to compress operating margins in 2009, but we anticipate margin expansion back into the high teens to low 20s beginning in 2010, and ramping up from there. Over the long run, we anticipate that Talisman will be able to generate excess returns on capital.

**Financial Health**

Talisman has a reasonable amount of leverage on its balance sheet, with net debt around 27% of capitalization. We expect Talisman to be able to use its free cash flows to fund its exploration and development activities during the next several years. We would not be surprised to see the firm use either some of the \$2 billion in borrowing capacity on its revolving line of credit or proceeds from asset sales to fund an acquisition.

Authors can be reached at [analyst feedback](#).

Morningstar's editorial policies prohibit analysts from owning stocks they cover. Find out more about Morningstar's editorial policies [here](#).

Morningstar Ratings and Morningstar Risk are updated daily.

[Show Data Definitions](#) | [Ticker Lookup](#)