Fadel Gheit: The Bullish Case for Large-Cap Oil Stocks

The Energy Report www.TheEnergyReport.com 03/20/2012

COMPANIES MENTIONED

- Anadarko Petroleum Corp.
- Apache Corporation
- Chesapeake Energy Corp.
- ConocoPhillips
- Devon Energy Corp.
- EOG Resources, Inc.
- Exxon Mobil Corp.
- Hess Corp.
- HollyFrontier Corp.
- Marathon Oil Corp.
- Marathon Petroleum Corp.
- Murphy Oil Corp.
- Noble Corp.
- Occidental Petroleum Corp.
- **Royal Dutch Shell Plc**
- Southwestern Energy Co.

Streetwise Reports LLC
101 Second St., Suite 110
Petaluma, CA 94952
Tel.: (707) 981-8107
Fax: (707) 981-8998
bfung@streetwisereports.com

THE ENERGY REPORT
THE GOLD REPORT
THE CRITICAL METALS REPORT

With oil prices near record highs, who are the big winners in this energy bull market? Fadel Gheit, managing director and senior analyst of Oppenheimer & Co. has large-cap explorers and producers on his radar. In this exclusive interview with *The Energy Report*, Wall Street veteran Gheit shares his top picks for diversification, income and even growth.

Source: George Mack of *The Energy Report*

The Energy Report: What is your current investment theme?

Fadel Gheit: I think oil prices are inflated by about 30%, an estimate I've arrived at using the replacement cost of the marginal barrel coming from Canada, which would be profitable in the $70–75 range. I see no real reason for oil prices to be significantly above $80, let alone above $100. That said, I expect oil prices to remain inflated because of global tension arising from the situation in the Middle East. As we speak, Brent Crude is around $122/barrel (bbl). A lot of people do not realize that this is the highest level of global crude prices for this time of the year, higher than March of 2008.

TER: What price of Brent are you building into your models through the end of 2012?

FG: The New York Mercantile Exchange (NYMEX) suggests that crude oil prices will probably ease going forward. We are estimating 2012 Brent crude oil prices at close to $120/bbl, with West Texas Intermediate (WTI) close to $107/bbl. WTI will rise slightly whereas Brent will decline from current levels, with the discount between the two remaining in the double digits. Hopefully, there will be no further threats of war in the Middle East.

TER: What are you hearing from institutional investors? Are they bullish on energy? Are they receiving flows of funds from investors?

FG: It's really a mixed bag. Surprisingly, a lot of investors are not throwing in the towel on natural gas. They still believe that gas prices will rebound; the only question is when and by how much. They see the disparity between oil and gas prices and expect the two to level out to a degree. However, that will take time. In my view, natural gas prices will probably be depressed for a lot longer than many people hope. Nonetheless, at current prices, long-term upside potential in natural gas is much higher than the upside potential in crude oil prices.

TER: What is your time horizon for natural gas prices to appreciate?

FG: I would say three to five years, possibly a couple of years longer. The current low price and abundance of supply will entice utilities and other major users to make the switch.

TER: What about the use of natural gas in vehicles?

FG: Natural gas is likely to figure into transportation infrastructure, namely through compressed natural gas vehicles and trucks. If new technology and catalysts can be developed and improved, I think gas-to-liquid is a very strong possibility. Royal Dutch Shell Plc (RDS.A:NYSE; RDS.B:NYSE) has completed the largest gas-to-liquid facility in Qatar. It is a very expensive but improved technology; efficiency and catalysts can bring this cost down. At $100/bbl for oil, I think gas for transportation may be competitive if we can reduce capital costs.

TER: In terms of energy efficiency, natural gas is about one-third to one-fourth the cost of oil. Current research suggests that we have a 100-year supply of natural gas in North American shales. Is this myth or fact?

FG: You are probably only scratching the tip of the iceberg. I truly believe that we probably have four- or even fivefold of what people think of as the high end of the reserve estimate. Technology is going to improve recovery rates, which currently remain very low. If we double or triple the recovery rate over the next 20 years, that would give us 200 or 300 years of supply.

TER: What price for natural gas would make it economical for companies to operate?

FG: Right now, most of the supply sources are not exploited because they are not economic at $2.40 per thousand cubic feet (/Mcf) in a market that is already oversupplied. When natural gas prices exceed $4/Mcf, most of these reserves will be very attractive and will justify an enormous amount of capital spending. I think that $4–4.50/Mcf-natural gas will open a lot of new gas reserves to the market.

TER: What does your universe of coverage include?

FG: We cover the large companies, including the majors. We also cover independent refining and marketing companies and large-cap exploration and production (E&P) companies such as Anadarko Petroleum Corp. (APC:NYSE), Apache Corporation (APA:NYSE), Chesapeake Energy Corp. (CHK:NYSE), Devon Energy Corp. (DVN:NYSE), EOG Resources Inc. (EOG:NYSE), Hess Corp. (HES:NYSE), Marathon Oil Corp. (MRO:NYSE), Murphy Oil Corp. (MUR:NYSE), Noble Corp. (NE:NYSE), Occidental Petroleum Corp. (OXY:NYSE) and Southwestern Energy Co. (SWN:NYSE). In the next few months, we are going to have a new arrival with the split of ConocoPhillips (COP:NYSE) into two separate companies. One will be added to the refining companies universe and the other will be added to the large-cap E&P companies.

TER: Conventional wisdom says that the majors are tied to the commodity price, meaning their stock values rise when the energy commodity price increases. How much truth is there to that premise?

FG: A rising tide lifts all ships. When oil prices rise, oil stocks usually will move up, and when oil prices go down energy stocks usually drift lower. The smaller the company, the greater the reaction to the price movement. Percentage-wise, Exxon Mobil Corp. (XOM:NYSE) would not move as much as, say, Hess or Murphy or Apache. There is an inverse correlation between the market cap of the company and the percentage movement in the stock price in relation to the commodity price.

TER: Investors often look to juniors for explosive growth. What should they look for in the fully integrated players, the large E&Ps and downstream players?

FG: A lot of people say they are investing in energy, but we look at companies differently. Nobody expects Exxon to grow production by 5%, 10% or 15%. For a very large company, that's unrealistic and unsustainable, and it does not happen this way. Investors who are buying the large integrated companies are seeking dividends, less volatility and efficiency because these companies' growth comes through improved efficiency and share buyback. Most of the large companies, especially a company like Exxon, have found a formula. Because management knows they cannot grow the company by 5%, 6% or 7%, they buy back their stock at the rate of 2%, 3%, 4% or 5% annually. It's a way of increasing the valuation per share. At the end of the day, we don't buy the company, we buy the shares. So if Exxon buys back 5% of its stock, it hopes that the market will reward the shares by lifting the share price up by at least 5%. Otherwise, the share buyback would not be successful.

TER: Investors sometimes ask a company if buying back shares is the best investment it can make with its cash. Do you think that way when you see a company buying back shares?

FG: Absolutely, but companies have different strategies. For Exxon, the buyback is part of its business formula. It buys back its stock consistently. It is not in the business of predicting where stock prices will be a year from now or five years from now, and it doesn't look at the stock price. One thing we know for sure is that by reducing the number of shares, a company improves its valuation per share, and this is something that nobody can take away from it.

TER: Fadel, you have already mentioned the threat of war. If tensions escalate between Israel and Iran, we all know that energy prices will rise, and that could shock the global economy. How serious is this threat?

FG: As I mentioned earlier, there is no question in my mind that oil prices are already inflated by at least 30%. But there is some justification for this inflation due to fears of potential supply disruption should war break out between Israel and Iran. Unfortunately, we might get dragged into a war not of our choice, because the president is going to be under pressure from the Republican candidate to act assertively in the situation. This is just pure politics. But as commander-in-chief, he doesn't want a third war under his watch when he's trying to wind down one and the other. Any miscalculation, and the conflict could spread throughout this region.

A physical supply disruption in any shape or form, whether a closing of the Straits of Hormuz or a bombing or launching of missiles from Iran on Saudi Arabia's Ras Tanura terminal, could result in oil prices like we have never seen before. We could see $200/bbl oil and gasoline prices of $5–6 per gallon (/gal). It would destroy any hope of economic rebound and send the global economy into a deep recession, even bigger than the one we saw in 2008. This is the nightmare scenario that nobody would wish for. I hope cool heads prevail, and I hope that the president stands his ground and does not let his detractors push him into another war.

TER: If oil escalates rapidly, will this hurt energy companies? They may be getting a higher price per barrel, but consumers will be buying less. How will this affect them?

FG: Higher oil prices are bad for our economy and bad for the oil companies themselves, because although they might enjoy a spike in oil prices momentarily, that would be followed by a very bad economic situation that in my view would

probably take the financial markets down by 10–15% in a very short period of time. That would also affect energy stocks, which will go down as much as the rest of the financial markets.

TER: How can investors diversify against these global macroeconomic uncertainties?

FG: Unfortunately, as in 2008 when we had the market meltdown, there is no safe place to hide, so it becomes a case of choosing the lesser of two evils. There could be a flight to quality, as energy funds find fewer and fewer safe places to hide. That would normally benefit, relatively speaking, the stocks of major integrated companies. Basically, investors will seek higher ground, but everybody will get hurt. I'm better off down 20–30% than somebody down 50–60%.

TER: Earlier you mentioned your focus on refining stocks. What is their unique appeal?

FG: We are bullish on the refining and marketing stocks because although this business will remain volatile, these companies are in much better shape operationally and financially than at any time in the last 5 or 10 years. While demand for refined product continues to decline in developed countries and in the U.S. in particular, it is growing elsewhere. So even if the demand growth increases only slightly, we will see accelerated capacity utilization, especially in the U.S. The market is more balanced.

Most of the refining companies in the U.S. have significant competitive advantages. They have crude oil flexibility, and they can buy crude cheaper than their competitors outside of the U.S. because most of their competitors are buying crude at a price indexed on Brent, which is $20 higher than WTI.

In addition, most U.S. refineries use natural gas to operate, compared to their competitors outside the U.S., who are using fuel oil or other more expensive sources. Also, these companies either increase their dividends, buy back their stock, or do both.

TER: What refining stocks are on your radar?

FG: We actually like all of them, particularly HollyFrontier Corp. (FTO:NYSE), Marathon Petroleum Corp. (MPC:NYSE), Tesoro Corporation (TSO:NYSE) and Valero Energy Corp. (VLO:NYSE).

TER: Which large-cap E&Ps do you favor?

FG: We like Anadarko. It's a premier exploration company with a tremendous track record. Also Apache, one of the fastest-growing companies, is one of the largest oil producers outside of the major oils in the U.S. It has a balanced operation between oil and gas. It is very conservative, and it focuses on costs. It is opportunistic on acquisitions, and these continue to be very profitable investments. That's very positive.

We specifically like Hess, Marathon and Murphy. These are former small integrated companies. They were basically lost in the crowd when they were compared to BP Plc. (BP:NYSE; BP:LSE), Chevron Corporation (CVX:NYSE) or ConocoPhillips. They are either spinning off their refining and marketing businesses to be pure E&Ps or selling their refineries, as in the case of Hess and Murphy. Now they have

relatively lower valuations and increased upside potential. Two-thirds or more of their production is oil, and one-third is natural gas. They have decent dividend yields and good balance sheets. In fact, Murphy has more cash than debt, and although it has had its share of disappointing drilling results, it will turn the corner. Once it is successful again, I think the stock is going to rally significantly—it's only a question of how much.

TER: You mentioned HollyFrontier earlier, another refinery company. You calculated your $35 target based on a 6.6x 2012 earnings estimate. That is about half of its peer group multiple of 11.8x. Why so low?

FG: Actually, we are reviewing our target price because it is very close to it now. Again, this is a company that continues to buy back stock, continues to increase dividends and pays special dividends. It's locked into the midcontinent, where it has access to much more discounted crude than anybody else. It's an area that I think is going to be advantaged by the increased supply from all the unconventional oil plays and its ability to access all kinds of crude oil. The stock has done very well. It has been the best-performing stock in the last couple of years. I think the trend will continue.

It's doing everything, literally. When a stock is moving fast like HollyFrontier, your dividend yield obviously goes down. That's not because it is cutting the dividend. But there is a speed limit: How high can you go, and how fast can you grow the dividend? Obviously, you cannot just keep growing the dividend every time something happens. There is nothing worse than companies cutting their dividends. It is also not good if you leave the dividend unchanged for a long period of time, because you then lose the lure of dividend growth. It's not the yield that moves the stock, but the growing dividend. When a company increases its dividend, it is basically sending a message to investors that management is confident in the financial outlook of the company.

TER: Staying on yield for a moment, there are two companies in your coverage with nice yields, Royal Dutch Shell and BP. Shell's dividend is about 4.7%, and you have a target price of $85 on the stock, which represents a very nice implied upside of 20%. You have written that new investment and enhancements are expected to dramatically increase cash flow by 50% between 2012 and 2015 compared to the previous three-year period. Why such an increase?

FG: Many companies, especially Shell, have a very large number of projects spread over the next three or four years. These are multibillion-dollar projects that have been in the works for many years but have not yet contributed production, cash flow or earnings. However, once they hit their stride, these projects will boost cash flow by almost 50%. At that point, the company and shareholders are basically collecting the fruit.

TER: BP has a nice yield of around 4%, and it is actually up 27% over the past six months. After the announced settlement of $7.8 billion (B) for economic damages on March 2, the stock reacted positively for a day, but nothing to write home about. Would you have expected a bigger jump after that agreement?

FG: It's not time for the cigar yet because it's not over. There is potential liability, as high as $20B with regard to the Clean Water Act. I think most investors cheered the news on March 2 but exaggerated the impact because the bigger liability is still yet to come. It is a step in the right direction. It shows clearly that BP is making progress. It reduced its risk and that in itself is positive. But that doesn't mean it's home free. It is far from it.

TER: You have a $55 target price on BP, which represents very good upside from current levels.

FG: Correct, but it also has the largest risk, to tell you the truth. The $55 price target assumes that BP is not going to be found to have committed gross negligence. The difference between no gross negligence vs. gross negligence could be as much as $17B, equivalent to more than $5 in the stock price. That's substantial. We are building a case based on three government investigations around the BP well blowout in the Gulf and settlements with other partner companies like Anadarko, Mitsui & Co. Ltd. (MITSY:NASDAQ), Weatherford International Ltd. (WFT:NYSE) and Cameron International Corp. (CAM:NYSE). Federal investigators found no gross negligence. It was the most unfortunate accident but it was multiple breakdowns in communications that resulted in the accident. Now, if BP loses its court battle with the Department of Justice and the state and local governments, then obviously all bets are off. But, again, I'd say there's a very high probability that BP will probably get this dark cloud removed and settle all outstanding lawsuits at or within the current budget estimate of $37B.

TER: You just increased your target price on Devon Energy Corp. from $80 to $90, but your valuation multiple is still below its peer group averages. What is your investment theory here?

FG: This is a company that is very well run. It sold most or all of its interests offshore to focus on onshore plays. The rise in the target price basically reflects its recent joint venture, which in my view is going to be the beginning of an accelerating trend.

TER: You raised your target price on EOG from $120 to $140 to reflect generous reserves in the Eagle Ford. When might we see production growth materialize from these assets?

FG: Companies are accelerating their drilling activities and development in all these plays because it's very profitable relative to natural gas. EOG is growing its oil production and liquids by 30% this year. Next year most of its revenue is going to be coming from the oil and the liquids, and less and less from natural gas. But what really triggered the target price increase was the expansion in the Eagle Ford's potential reserve. That is a significant development, and it is the largest play in terms of increased production and reserves. It was the biggest in the Bakken, but now it is making the Eagle Ford its biggest play. It's much oilier and has much larger reserves than ever before, yet the stock is still trading 20% beneath its price five years ago. I'm very positive.

TER: EOG is up 30% over the last six months. Do you think of this as a value or a growth play?

FG: It's a combination. It's a very interesting question because when you come to think of it, the gas companies that are becoming oil-focused really should be ranked on liquids growth, not gas growth. By putting their emphasis on oil, they are creating value. So I think this is a profitable growth story, and over the next two or three years, you are going to easily see double-digit production growth in a very profitable environment if oil prices remain even in the $80–$90/barrel range.

TER: Southwestern Energy is a pure U.S. onshore gas play, and clearly it has suffered because of that. Does the company have to wait for gas prices to recover, or is there another avenue for the company?

FG: It's a very well-run company. Even given low natural gas prices, it still maintains a very decent balance sheet. It pays no dividend. Breakneck speed growth production of 20–30% per year for the last 10 years when gas prices were positive is obviously not sustainable. The company is definitely looking at other opportunities and other options.

TER: Fadel, thank you for taking this time. It's been very valuable and enjoyable.

FG: Excellent, thank you.

Fadel Gheit is a managing director and senior analyst covering the oil and gas sector. He spent six years with Mobil Oil and five years with Stone & Webster. He has been an energy analyst since 1986 with Mabon Nugent and JP Morgan and has been with Oppenheimer & Co. Inc. since 1994. He has been named to The Wall Street Journal's *All-Star Annual Analyst Survey four times and was the top-ranked energy analyst in the* Bloomberg *Annual Analyst survey for four years. He is one of the most quoted analysts on energy issues and has testified before the U.S. Senate and the U.S. House of Representatives about oil price speculation, and is a frequent guest on TV and radio business programs. Gheit holds a Bachelor of Science degree in chemical engineering from Cairo University and a Master of Business Administration degree in finance from New York University.*

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