The 19th Annual Energy Conference

Recap

SIMMONS ENERGY

A DIVISION OF PIPER JAFFRAY[SM]

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Conclusion

1) Growing divergence between improving oil market balances and investor sentiment. While markedly reduced Saudi/GCC imports and VZ dislocations are propelling a market rebalancing, Street sentiment for energy remains jaundiced. The key intellectual hurdle confronting investors is the sustainability of the improvement in YTD crude price strength due to 1) rapidly improving L-48 well economics and cash flow generation driven by markedly improved YTD oil prices and ongoing, non-trivial well cost deflation which, collectively, are seemingly leading to growing optionality for propulsive L-48 production growth, and 2) the growing Saudi/GCC spare production capacity overhang – how long will Saudi/GCC willingly cede market share?

The key emotional hurdle confronting investors is the unhealed scar-tissue from years of sustained underperformance and the exquisite timing required to generate relative outperformance in energy. The cyclical duration witnessed over the 2004-1H'14 period, which resulted in a sustained SPX energy weighting of ~7-15% (currently closer to 5%), has been elusive due to the disruption of L-48 unconventional oil. Energy stocks have been underperformers vs. the broader market since 2010 and vs. crude over the past three years. Notwithstanding the compelling YTD outperformance, investors are skeptical about the durability of this year's outperformance. Further, there is an awareness of growing policy risk (2020 anyone?) due to the growing demands for decarbonization.

Thus, energy stocks, for the moment, continue to climb a very steep wall of worry. Juxtaposed against intractable investor incredulity, however, is a profound, unfolding shift in capital allocation comprising ~80-85% of the rig count due to: 1) a new-found objective of generating sustainable FCF (public E&Ps), and 2) a meaningfully escalated cost of capital due to considerably less generous exit avenues (private E&Ps). Collectively, this has the potential of moderating the rate of L-48 production growth. To what extent the secular growth agenda of the majors (15-20% of the rig count, and growing – majors have generated the most cathartic expansion in activity since 2017 as their rig count has doubled) offsets the diminished rate of reinvestment on the part of E&Ps remains to be seen.

Further, increasing evidence of parent/child vulnerabilities point to the potential for diminishing breadth and depth of resource and increasing capital intensity. How these potentially consequential shifts in upstream capital allocation and reservoir quality and performance play out is a key unknown. This is a reminder that industrial transformations of the scale we have witnessed with L-48 unconventional oil and nat gas are never seamless and are often, if not always, surprising.

What will it take for greater public equity investor credulity and commitment? A redefinition of forward supply, a higher than envisioned call on L-48 production and greater than foreseen cyclical duration.

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INDUSTRY RISKS

Oil prices are influenced by a wide array of variables including: 1) Global GDP and demand prospects, 2) Central bank influences impacting F/X, 3) OPEC supply, 4) Non-OPEC supply, and 5) Geopolitical risks.

Jeff Alvarez, VP, IR, Occidental Petroleum Corp. (OXY)

2) E&P shift in focus from growth to efficiency. The capital budgeting austerity extolled for 2019 was the singular revelation of the Q4 earnings season. This was reaffirmed by leading industry protagonists at our conference. The objective isn't simply to live within cash flow but to generate FCF on full cycle basis - OXY professes that at $40/bbl it can now sustain a dividend and hold production flat. For the panelists participating within the panel, larger scale corporate M&A isn't and likely won't be a focus for the foreseeable future. Most importantly, will the downshift lead to a more suppressed rate of L-48 production growth? It should with respect to public E&Ps but they comprise only ~40-45% of the rig count.

3) Scale - increasingly important. As developments become larger and concurrent development of multiple zones unfold and development cycle times extend, scale is becoming a key competitive advantage with respect to balance sheet, cash flows, operational and procurement efficiency. Some companies have it, many do not. Although the law of economics mandate that a wave of consolidation needs to unfold given the exceedingly fragmented state of the E&P industry and the number of sub-scale players, many of the logical, best-of-breed consolidators are unwilling to do so given current extensive economic inventory depth, a slowing cadence in forward drilling and completions activity, and the unwillingness of the market to reward industry consolidators. Further, in spite of the industrial logic, "no/low premium" mergers remain highly unlikely.

4) Parent/Child relationships garnering more scrutiny. Last year at our conference, the refrain on the part of E&P protagonists was centered on the discussion of new zones/benches, leading edge completion designs, and ever expansive well results and production growth. This year, the narrative was focused on reformed capital allocation as well as parent/child issues. There is increasing evidence of parent/child well vulnerability (at least vs. market expectations) as manifested by high profile misses on forward guidance, reserve write-downs and up spacing development plans. In theory, this represents a potential winnowing of the breadth and depth of resource potential and eventual degradation in capital efficiencies going forward. The potential impact at the corporate level, however, is likely to vary significantly across the sector.

5) Cost of Capital for Private upstream protagonists has risen considerably. Given the pivot to austerity on the part of public industry protagonists as well as the disaffection on the part of public equity investors for energy stocks, exit strategies for PE sponsored companies are considerably less generous and/or favorable (for example, leading PE E&P sponsor citing they expect more payments in stock). Hold periods have become longer (one panelist said average hold period had extended from 3-5 years to 4-7 years). Accordingly, what was a "gun-it" capital allocation strategy on the part of many private E&Ps, as recently as last year, has now become more restrained. The central question from a macro point of view is whether private E&Ps will be

Jim Benson, Founding & Managing Partner, Energy Spectrum Capital

Source: Macro - Energy: Energy Ruminations - Top-10 Takeaways from Simmons Energy Conference - March 1, 2019

Scott Bender, President & CEO, Cactus, Inc. (WHD)

as responsive to oil prices and cash flow generation prospects as they have been historically. Lastly, there is some growing concern about environmental policy risk given feedback from limited partners and investors. Nevertheless, the congruence of rapidly improved in-basin pricing and a deflationary environment increases the wherewithal to deliver production growth within CF.

6) Growing debate on the capital allocation evolution of public/private E&Ps and impact on L-48 production. On the one hand, the primary concern on the part of investors is the L-48 production growth optionality associated with markedly improving well economics due to the convergence of oil price reflation and well cost deflation. On the other hand, public E&Ps (~40-45% of the L-48 rig count) are meaningfully lowering their reinvestment ratios, the privates (~40-45% of the L-48 rig count) are in an evolutionary state given a higher cost of capital and less generous exit opportunities, and the majors (~15-20% of the L-48 rig count) are engaged in a prodigious secular expansion. How will the various capital allocation agendas of a fragmented industry impact the trajectory of L-48 production growth? We'll find out in due course, although taking the "under" on Permian growth was a seemingly popular opinion at our conference.

7) Differentials likely to remain volatile. Current Permian takeaway capacity approximates ~4 MBD and there are ~5 MBD of projects on the drawing board - doubtful that the entirety gets built but a substantial amount will. Lack of seamless alignment between Permian takeaway and GC connectivity/storage/export capacity will likely lead to volatility in differentials Q4/Q1.

8) Frac pricing continues to normalize to lower levels. According to leading industry protagonists, frac pricing is down ~10-20% from peak 2018 levels. Pricing is continuing to bleed lower but rate of descent is slowing. Pricing is reaching levels where leading frac providers are prepared to idle capacity. Rate of service intensity isn't diminishing and there is evidence that the industry rate of R&M investment is slowing as manifested by increased rate of catastrophic failure at the well-site. Net frac capacity expansion has ground to a halt and there will likely be less effective capacity by YE.

9) Electric frac pumps - wide range of opinions. Within the world of frac, electrification has garnered ample attention due to the sponsorship of a best-of-breed SMID frac company. The attraction to electric pumps, is markedly reduced diesel consumption (E&P), expected lower R&M expense (frac services company) and increased economic life, notwithstanding a considerably higher capital cost (1.5-2x higher). The refrain on the part of some leading industry protagonists, however, is that while the markedly increased capital cost is a known, the reduced maintenance cost and increased economic life are unproven aspirations. This concern, however, is refuted by existing frac service companies who are adopting electric fleets. Further, while the capital costs are markedly higher, some E&Ps are willing to underwrite the hike in the capital cost, and those operating electric fleets

Taylor Reid, President & COO, Oasis Petroleum (OAS)

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today have garnered term contracts with terms ranging from two-to-four years, in some cases with best-of-breed E&Ps. And while the rate of electric adoption could well be lethargic given the significant industry-wide frac price concessions and ample available spot market capacity, several large E&Ps acknowledge they are evaluating the technology – thus, over time, it seems likely that the industry will see further market penetration. At the same time, a number of OEMs and potential new electric frac companies have "visions of grandeur" on this front – thus, the market is likely to become more competitive over time.

10) Refining in Q1 will be challenging - the critical unknown is how well this is understood by the street. We still see downside versus Street estimates (risk into late March with EPS revisions). Coking economics are challenged through a combination of heavy production off the market (VZ, Canada, OPEC, Mexico) and reduced utilization rates in heavy resid producing regions (Trinidad closure, VZ and Mexico). This will improve with IMO but we still need help from macro variables to drive heavy discounts in order to meet outer year FC estimates.

Source: Macro - Energy: Energy Ruminations - Top-10 Takeaways from Simmons Energy Conference - March 1, 2019


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