# Cabot Oil & Gas Corporation COG



by Catharina Milostan

**Analyst Note** 07-27-2009

Cabot Oil & Gas' COG 2009 second-quarter results were in line with our expectations of continued drilling success at Pennsylvania's Marcellus Shale and East Texas growth areas, warranting no change in our fair value estimate. Not surprisingly, lower oil and gas prices were behind the fall in adjusted second-quarter earnings to $39 million in 2009 from $70 million a year ago. We were encouraged by lower unit-of-production costs and production growth, which was up 13% over year-ago levels. We look for this dynamic of higher production, but lower year-over-year pricing (even after hedges) to continue through this year. However, more evidence of better-than-expected drilling success or lower well costs could prompt us to reconsider our fair value estimate.

Cabot continues to shine at its Marcellus Shale wells in Appalachia with more operating efficiencies and lower drilling costs. The firm plans to shift to more efficient fit-for-purpose rigs as drilling contracts expire with a year-end goal of all horizontal wells to be drilled by these rigs. At three consecutive horizontal wells drilled in March, Cabot Oil reduced drill times by 50% and drilling costs by 35%. Drilling success also gave managers greater reason to believe potential drilling sites extend through the firm's large acreage positions in the Marcellus Shale, supporting several years of drilling. We'd like to see the firm realize additional operating-cost savings as it develops its Marcellus acreage. In East Texas, early horizontal drilling in the Taylor sand layer at Minden properties gave Cabot Oil confidence for more horizontal drilling in the field. Additional testing will determine the potential of Haynesville lime and Haynesville Shale prospects. However, these wells remain at an early-stage testing level, prompting us to hold off from adjusting our model assumptions until further data is available.

**Thesis** 02-06-2009

Cabot Oil & Gas' ample supply of new Appalachian and Gulf Coast drilling sites on lower-cost oil and gas properties gives it a leg up over competitors trying to buy their way into new fields. However, we look for Cabot Oil & Gas to scale back 2009 drilling plans in response to lower oil and gas prices, lower demand amid a weakened economy, and limited funding options caused by current financial market turmoil

Cabot Oil & Gas is more seasoned than many oil and gas producers, having produced natural gas since the late 1800s as part of its old parent, Cabot Corporation CBT. The firm gained its independence after its 1990 IPO and soon expanded from its Appalachian base into the Rockies, Mid-continent, and Gulf Coast. Cabot Oil & Gas' asset base is now among the most diverse of the small- to midsize independent oil and gas firms we cover. This puts the company at an advantage over other independents that are

**Morningstar Rating**
★★★

**Stock Price**
As of 07-27-2009
$35.62

**Fair Value Estimate**
$28.00

**Consider Buying**
$14.00

**Consider Selling**
$56.00

**Fair Value Uncertainty**
High

**Economic Moat**
Narrow

**Stewardship Grade**
**C**

**Bulls Say**

- Cabot Oil & Gas' large base of undeveloped properties can support several years of lower-risk oil and gas drilling in longer-lived fields in Appalachia and east Texas.
- Cabot Oil & Gas has large acreage holdings to support drilling in fast-growing fields including Marcellus Shale sites in Appalachia and Haynesville Shale sites in east Texas.
- With a diverse base of onshore oil and gas properties in Appalachia, Texas, midcontinent, the Rockies, and Canada, Cabot Oil & Gas has multiple avenues for production growth.
- The company's properties are all in North America, reducing exposure to political risk.

**Bears Say**

- Cabot Oil & Gas remains susceptible to a sustained fall in gas prices, causing a potential drop in cash flow and scaled-back drilling plans.

now scrambling--and paying up--for comparable U.S. onshore properties.

Cabot Oil & Gas' renewed focus on developing longer-lived gas basins is a welcome sight after a few discouraging years of production declines from 2003 to 2005. The firm shifted to more onshore drilling in 2004 and sold offshore Louisiana properties in late 2006. It now has several years' worth of lower-risk developmental drilling sites to drive production growth. Cabot Oil & Gas has made solid progress via the drill bit, with healthy reserve additions that replaced 273% in 2006 and another 334% in 2007.

A clear advantage is Cabot Oil & Gas' long operating history and ample acreage in Appalachia and the Gulf Coast. Recent drilling success in deeper gas-rich shale zones in Appalachia, including Marcellus Shale deposits, has sparked industry interest. Cabot Oil & Gas' long presence in the region and low-cost drilling leases gives the firm a leg up over new entrants acquiring higher-priced leases. The firm's prowess in horizontal drilling plus familiarity with the region has netted promising discoveries. Cabot Oil & Gas also has an early-entrant advantage in the Gulf Coast, where drilling success in Haynesville Shale deposits has caused another industry stir. We like how Cabot Oil & Gas has several years worth of drilling sites to drive production growth without the need for costly, large acquisitions.

Cabot Oil & Gas is more leveraged to natural gas prices with gas accounting for 95% of its production and more than 95% of reserves. Over the long-term, the firm stands to benefit rising gas demand for heating and power generation. However, like its peers, Cabot Oil & Gas is scaling back its drilling program in response to lower gas prices plus lower demand caused by a weakened economy. The firm plans to keep capital spending within internal cash generation, focusing on promising east Texas and Marcellus Shale wells and scaling back Rockies drilling.

**Valuation**

We're lowering our fair value estimate for Cabot Oil & Gas to $28 per share from $47 to reflect our lower long-run gas price and outlook for more drilling cutbacks near term. In our discounted cash-flow model, our benchmark oil and gas prices are based on NYMEX futures contracts for 2008-10. For natural gas, we use $5.40 per thousand cubic feet (mcf) in 2009, $6.80 in 2010, and $7.20 in 2011. For oil, we use $49 per barrel in 2009, $57 in 2010, and $61 in 2011. We adjust our benchmark pricing to reflect the quality, location, and hedging of the firm's production. In our base scenario, we assume long-run perpetual oil prices of $80 per barrel and natural gas prices of $7.50 per mcf. Our base scenario assumes Cabot Oil & Gas forges ahead with its focus on developing its east Texas and Pennsylvania properties, particularly the promising Marcellus Shale and Bossier prospects. Management continues to keep capital spending within internal cash-flow generation. We expect this discipline to continue to drive 8% average annual production growth. In our low-case scenario where perpetual prices drop to $50 per barrel for oil and $5 per mcf for gas, we look for a scale back in drilling, causing lower production growth and a fair value estimate of $3 per share. Our high case assumes long-run oil prices of $150, gas prices of $15 and a resurgence in drilling and production gains to drive up our fair value estimate to $79 per share.

**Risk**

Like its exploration and production peers, Cabot Oil & Gas' greatest risk is a prolonged fall in gas and oil prices that would lead to lower operating cash flow and earnings. With 95% of production and more than 95% of reserves in natural gas, the company is more sensitive to gas price fluctuations

- Cabot Oil & Gas lacks the much larger financial resources of industry giants, forcing it to keep spending within internal cash generation during the current financial market turmoil.
- Like many of its peers, Cabot Oil & Gas is subject to costly exploratory failures, environmental constraints, and production delays, especially in the hurricane-prone Gulf Coast.

than more-diversified independents with higher oil production. The company also faces cost inflation risk and operating risks such as mechanical failures and regulatory or environmental constraints that could delay startup of growth projects.

| Close Competitors | TTM Sales $Mil | Market Cap $Mil |
|---|---|---|
| **Cabot Oil & Gas Corporation** | **960** | **3,692** |
| * Cimarex Energy Company | 1,702 | 2,980 |
| * Forest Oil Corporation | 1,465 | 1,671 |
| * Whiting Petroleum Corporation | 1,122 | 2,275 |
| * Southwestern Energy Company | 2,328 | 14,343 |

* Morningstar Analyst Report Available

Data as of 03-31-09

**Strategy**

Cabot Oil & Gas is focusing more of its capital spending on drilling in longer-lived producing basins in the Rockies, Gulf Coast, and Appalachia to offset declining production at mature basins. This shift in focus, plus accelerated drilling, was designed to return production to a targeted 5%-10% annual growth rate.

**Management & Stewardship**

Dan Dinges has been chairman, president, and CEO of Cabot Oil & Gas since 2002; he joined the company as president and COO in 2001. Dinges has more than 25 years of energy industry experience with several firms, including Mobil Oil and Samedan. Most of the senior managers have been with the company since the mid-1980s and 1990s and have long histories in the energy sector with other firms. Dinges' 2007 annual compensation, including salary, bonus, and restricted-stock awards, totaled $3.8 million, which is not unusual. We're encouraged that more than 85% of Dinges' compensation was discretionary and tied to incentives. Managers and directors own about 2.5% of outstanding stock, which is below average for similar-size firms in the sector. Overall, Cabot Oil & Gas' stewardship is fair.

**Profile**

Houston-based Cabot Oil & Gas is an independent oil and gas producer with operations in the U.S. Gulf Coast, Appalachia, Mid-continent, and Rockies. About 95% of production and more than 95% reserves are natural gas. The firm estimates year-end 2008 proven reserves of 2 trillion-2.1 trillion cubic feet of gas equivalent and 2008 production of 97 billion to 100 billion cubic feet of gas equivalent.

**Growth**

High oil and gas prices have been driving sales growth and masked 2003-05 production declines. Accelerated drilling brought a return to oil and gas production growth in 2006 and is expected to drive production over several years. However, volatile oil and gas prices may make sales fluctuate during the next few years.

**Profitability**

With natural gas accounting for about 95% of production, gas prices have a direct effect on Cabot Oil & Gas' profitability. High gas prices were the primary driver behind high operating margins averaging 30% during the last five years. We look for operating margins to decline during the next few years as oil and gas prices remain low, but we look for capital spending cutbacks and lower oil service costs to gradually help boost margins longer term.

**Financial Health**

Cabot Oil & Gas' financial health has been in-line with its peers with debt (net of cash)/capitalization levels at 31% at Sept. 30, 2008. The firm plans to cut capital spending to within internal cash generation in 2009, limiting the need for access to financial markets during the current turmoil.

Authors can be reached at analyst feedback.