Devon Energy Corporation DVN

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Analyst Note 05-06-2009

Devon Energy DVN announced first-quarter results today, and production was better than expected--topping expectations by 2%. But the bigger news, in our opinion, is the company's desire to find a partner for its Lower Tertiary projects in the deep-water Gulf of Mexico. This is a tad surprising given that the firm a year ago boosted its stake in the Kaskida unit by purchasing an additional 6.67% working interest from operator BP BP. However, the rationale seems prudent.

With the Lower Tertiary finally moving closer to full-out development, the amount of capital expected to be devoted to longer-term projects was expected to take up a greater portion of annual budget for the next several years. While it's important to build the company for the future, there's an additional element of risk when devoting a large chunk of capital to only a handful of projects with payouts way out in the future. If commodity prices stayed lower for a significant length of time, the company risks impairing capital and possibly damaging its balance sheet. The company ideally wants long-term projects to represent about 10%-15% of its annual budget. We believe the most likely partner for these assets would be a major or publicly traded national oil company.

The Cana play continues to look promising. Expected first-year decline rates of 50% compare very favorably to decline rates in other shale plays. Further, Devon believes estimated ultimate recoverable reserves per well are between 5.5 billion and 9.0 billion cubic feet equivalent per well. Current completed well costs are around $8 million-$10 million, but these should fall over time. The company is also increasing the capacity of the processing plant it is building to service the play from 100 million cubic feet per day (mmcf/d) to 200 mmcf/d.

In the Haynesville Shale, Devon is not facing the leasehold expiration challenges that some of its competitors are due to the fact that it owns some of the mineral rights in Louisiana and that it has producing wells on a large chunk of its properties. The firm, however, has drilled five wells across its acreage base to understand the prospectivity of its acreage. While early results were mixed due to poor initial well design, we're cautiously optimistic that this play will be key growth driver for Devon in the future.

Thesis 04-15-2009

The firm's U.S. properties are headlined by its holdings in the deep-water Gulf of Mexico and the Barnett Shale. Devon is one of the largest leaseholders of promising deep-water Gulf of Mexico properties. It's successful production test in the lower tertiary during 2006 was a landmark event for deep-water Gulf of Mexico exploration. However, the timing of first production from this area keeps getting pushed back

Morningstar Rating
★★★★

Stock Price
As of 05-06-2009
$61.01

Fair Value Estimate
$106.00

Consider Buying
$53.00

Consider Selling
$212.00

Fair Value Uncertainty
High

Economic Moat
Narrow

Stewardship Grade
C

Bulls Say

- Devon's sizable reserves in Texas' Barnett Shale give the company a relatively cheap and long-lasting source of natural gas within easy reach of major North American gas markets.
- Legacy positions in east Texas and north Louisiana provide the company with a significant amount of acreage with Haynesville Shale prospects.
- Devon has a host of new projects slated to come on line during the next few years, which should meaningfully boost production.
- Among independent exploration and production companies, Devon is one of the largest leaseholders in the promising deep-water Gulf of Mexico market.

Bears Say

- Proposed changes to the tax code, if enacted, could reduce Devon's operating cash flow more than 20%, all else equal.
- Devon's deep-water properties may be promising, but they take years to exploit and are

with current estimates in the 2013-2015 time frame. If it is developed successfully and if oil prices remain strong, this project should be a key future value driver for the firm. Devon is also leveraging its offshore expertise in Azerbaijan, China, and Brazil.

Devon is also the largest leaseholder and producer in the prodigious Barnett Shale deposit around Fort Worth, Texas. The firm benefits from its concentrated position in the core area of the play and below-average royalty rates, which enhances the already-robust economics of the play to Devon. Although the core is more developed than some of the surrounding areas, technological advances, attractive geology, and the acquisition of privately owned Chief Holdings in 2006 provide ample opportunities for Devon to improve recovery and production rates. For example, Devon and other producers are currently engaging in 10-acre spacing tests, and initial results look promising.

Devon's international operations are primarily concentrated in Canada. After taking into account cost inflation, the rise in oil prices, and higher royalties Devon believes that Jackfish, a steam-assisted gravity drilling project, is still economic at oil prices around $60 per barrel. However, the company wrote down all the reserves tied to this project at the end of 2008 because of lower oil price realizations in the region. The company is pushing ahead with Jackfish 2, an expansion of Jackfish; it has an initial startup date of year-end 2011. We expect the economics for this expansion to be pretty resilient, given the initial infrastructure already in place, the drop in engineering and construction costs, and the decline in equipment and steel costs.

Unlike many of its peers, Devon has a fairly large midstream segment. Although the company does not consider this segment core to its strategy, the segment still represented about 15% of sales and 11% of adjusted profits in 2008. The firm has looked to monetize this division in the past, and we would expect the company to do so again in the future if midstream valuations are favorable.

Valuation

We are maintaining our fair value estimate of $106 per share. Total production should remain relatively flat in 2010; low-single-digit natural gas production declines will be offset by strong oil-production gains. The increase in oil production is driven by the continued ramp-up of Jackfish and Polvo, which got on track faster than we expected. In our discounted cash-flow model, our benchmark commodity prices are based on Nymex futures contracts for 2009-11. For oil, we use $51 per barrel in 2009, $64 in 2010, and $69 in 2011. For natural gas, we use $4.30 per thousand cubic feet in 2009, $6.15 in 2010, and $6.80 in 2011. In our base-case scenario, which is based on long-term oil of $80 per barrel and natural gas of $7.50 per mcf, we believe Devon is worth $94 per share. In our low-side scenario, we assume that growth and spending slow and profitability shrinks considerably because of the high fixed cost structure of its offshore and oil sands operations. The low side is based on long-term oil prices of $50 and long-term natural gas prices of $5. We believe Devon is worth around $45 in this scenario. Our high case is driven by long-term oil prices of $150 and natural gas prices of $15. Devon's large offshore projects will be very attractive in this scenario, assuming cost inflation does not become excessive. We believe Devon is worth around $255 in this scenario. We weigh our low and base scenarios at 40% each and our high scenario at 20%.

Risk

Like all oil and gas companies, Devon is exposed to fluctuating commodity prices, political risk, terrorist attacks, rising service costs, and natural disasters. Devon's onshore

much more challenging technologically than the reserves the firm has historically tapped.

- The high-impact portion of Devon's portfolio depends largely on strong oil and gas prices. Even then, returns may be inadequate because of cost inflation.

properties carry minimal exploration risk, but they have a fair amount of engineering risk. While its offshore properties carry significant amounts of both risk types, potential returns are much greater.

Close Competitors	TTM Sales $Mil	Market Cap $Mil
Devon Energy Corporation	**14,264**	**27,624**
* Anadarko Petroleum Corp.	15,723	20,005
* Chevron Corporation	243,189	136,518
* EOG Resources	7,151	17,600

* Morningstar Analyst Report Available

Data as of 12-31-08

Strategy

During the last two years, Devon has followed a disciplined strategy. The company allocates around 85% of its capital expenditures to low-risk projects in well-known oil and gas fields, mostly in North America, that provide a solid base of stable, reliable production. The rest of the firm's capital spending goes to so-called high-impact projects that are riskier but offer the potential for substantial reserves additions. Many of the high-impact fields are located internationally.

Management & Stewardship

CEO and chairman J. Larry Nichols and his father cofounded Devon in 1971. Nichols has presided over the company's growth from a small, regional firm into America's largest independent exploration and production company. We were happy to see that the majority of Nichols' compensation is variable. However, we wish the board would explicitly disclose its executive compensation criteria rather than provide a host of possible metrics. We also dislike that the CEO and chairman roles are not split and that director elections are staggered. Directors and executives beneficially own a respectable amount of Devon's outstanding stock. Devon is one of the few firms in the industry to have the majority of its reserve reports audited by a third party.

Profile

Devon Energy as we know it today was formed in 2003 from the merger of Devon and Ocean Energy. It is now one of the largest independent exploration and production companies based in the United States. In 2008, the firm produced 940 billion cubic feet of natural gas and 53 million barrels of oil. Devon's reserves are 60% natural gas and almost entirely in North America. Midstream and marketing operations accounted for about 15% of total revenue in 2008.

Growth

Revenue growth depends largely on natural gas and oil prices. A large revenue decline in 2009 is in order, but growth should be fairly strong thereafter based on the current Nymex futures strip and our current production growth outlook. After a flat year-over-year production growth in 2009, we expect mid- to high-single-digit growth thereafter.

Profitability

Profitability fluctuates with gas and oil prices. High prices helped Devon generate strong margins in each of the past three years. We believe the firm's returns on invested capital will slightly outpace its cost of capital over the industry cycle.

Financial Health

Devon is one of the more well-financed companies we follow. At year-end, the debt/capital ratio stood at 26% after accounting for the $7.1 billion impairment charge in the fourth quarter. Given the long-lived nature of its projects, the company could outspend cash flow in 2009 if we experience commodity prices lower than $50 oil and $5 natural gas. The firm has $3.3 billion in aggregate unsecured revolving credit facilities. The lines were undrawn at year-end; however, Devon did have $1 billion outstanding in commercial paper (CP) which counts against its borrowing availability. The CP was subsequently paid off in mid-January following the firm's $1.2 billion debt offering. Devon also had $379 million in cash on hand at year-end, plus whatever remains from the debt offering after the CP is paid off. In 2011, Devon has debt maturities totaling $2.1 billion.

Authors can be reached at analyst feedback.

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