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## EQT Corp. EQT

Analyst Report

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Top Rated Stocks in Sector



by Catharina Milostan

## Analyst Note 06-10-2009

We're lowering our fair value uncertainty ratings for some exploration and production companies to reflect greater visibility for cash flow generation after the firms have scaled back 2009 capital spending to conserve cash and found ways to lower costs. Production gains at selected fields plus higher oil prices have helped. Also, earlier concerns over potential energy tax credit cuts have abated as initial proposals have not gained momentum among U.S. legislators. We are lowering the fair value uncertainty ratings for Pioneer Natural Resources [PXD](#) and Approach Resources [AREX](#) to very high from extreme and are lowering our fair value uncertainty ratings for Noble Energy [NBL](#), Questar [STR](#), and EQT Corp. [EQT](#) to high from very high.

## Thesis 03-20-2009

EQT's integrated gas approach is bearing fruit with ample Appalachian-based drilling prospects, and pipeline and midstream networks to drive growth well into the next decade. However, in response to financial market turmoil, managers are cutting back 2009 capital spending and drilling plans to drive more modest growth.

EQT's mix of natural gas businesses in the heart of Appalachia gives it several advantages. With over 100 years of operating experience as a gas utility and gas producer, EQT has a solid base of experience and well-placed assets to benefit from renewed interest in drilling Appalachian wells. In contrast to exploration-and-production-only peers, EQT can use cash flows from its utility to fund E&P and midstream expansion projects.

As a long-time natural gas producer in Appalachia, EQT has a head start over new entrants because it was able to secure drilling leases long ago at low costs. EQT's very long 30-year reserve life bodes well, implying several years of drilling opportunities to sustain production without the need for costly exploratory wells. EQT's experience drilling Appalachian wells puts its ahead of other firms now just testing horizontal drilling methods in the region. The firm moved ahead with a successful horizontal drilling program in Kentucky using complex "air drilling" methods to minimize the use of water for drilling.

EQT can take advantage of its Appalachian gas gathering network to transport gas from new wells and build new pipelines to debottleneck gas transportation to markets east. EQT's midstream business stepped up with three major infrastructure projects completed in 2008 that will help to drive growth in gathering and transportation volumes over the next few years.

On the utility side, EQT returned its attentions back to its original business after it ended plans to acquire two businesses from Dominion in January 2008. The firm plans to grow the gas utilities in line with the local economy. EQT's

Morningstar Rating 

★ ★ ★

## Stock Price

As of 06-10-2009  
\$37.08

## Fair Value Estimate

\$38.00

Consider Buying 

\$19.00

Consider Selling 

\$76.00

Fair Value Uncertainty 

High

Economic Moat 

Narrow

Stewardship Grade 

B

## Bulls Say

- EQT's large, low-cost drilling leases and properties in Appalachia with a sizable undeveloped portion gives it several years of drilling sites to support production growth.
- EQT's accelerated horizontal drilling plans in 2008 is netting production gains and successful test wells in emerging Marcellus Shale and Berea Sandstone plays.
- EQT is planning more midstream projects to add and expand gas gathering and processing facilities in emerging Appalachian fields.
- EQT's regulated utility and pipelines earn a steady return regardless of gas price volatility, making the firm less sensitive to gas price swings than many pure E&P companies.

## Bears Say

- Delays in infrastructure investments and low oil and gas prices could narrow EQT's profit margins.
- Troubled financial markets and greater funding constraints could limit growth options for EQT.

ownership of gas utilities still makes sense, as steady utility cash flows can be used to drive growth on the E&P side.

However, financial market concerns prompted managers to scale back capital spending and drilling plans in 2009. EQT plans to focus on more horizontal air drilling in the Huron and Marcellus Shale plays in Appalachia, but will cut back drilling in other regions. While utility cash flow helps to bolster EQT's internal cash generation, more of its earnings and cash flow comes from more-volatile E&P and midstream units. EQT's concentration in Appalachia and proximity to Northeast consumers is a plus in favorable energy markets, but it also makes it vulnerable to regional pricing or infrastructure bottlenecks. These factors add up to greater uncertainty for our fair value estimate.

#### **Valuation**

We're lowering our fair value estimate for EQT to \$38 per share from \$42 per share to reflect lower oil and gas prices, including a lower perpetual long-run gas price. We also took a more conservative stance with our base scenario to reflect the impact of lower drilling activity planned in 2009. In our discounted cash-flow model, our benchmark oil and gas prices are based on NYMEX futures contracts for 2009-11. For natural gas, we use \$4.70 per thousand cubic feet (mcf) in 2009, \$5.90 in 2010, and \$6.40 in 2011. For oil, we use \$48 per barrel in 2009, \$56 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. We're encouraged by EQT's success using horizontal air drilling in Appalachia in 2008 and look for increasing application of these techniques in 2009. The firm plans to focus its drilling on Huron and Marcellus Shale wells with more testing of multilateral drilling. Test wells in emerging plays netted producing wells in deeper Berea sandstone and Marcellus Shale deposits that are already connected to pipelines. However, in response to financial market turmoil, managers elected to curb 2009 capital spending. Luckily for EQT, the timely startups of three major infrastructure projects in 2008 (Big Sandy Pipeline, Langley gas processing plant, and Mayking pipeline corridor) should allow the flow of more gas produced in 2009 from its fields without the need for major infrastructure spending. This is how management can cut capital spending while planning to boost production in 2009. In our low-case scenario, where perpetual prices are \$50 per barrel for oil and \$5 per mcf for gas, we look for a further pullback in production and margin pressure to reduce our fair value estimate to \$11 per share. Our high case assumes long-run oil prices of \$150 and gas prices of \$15 to drive up oil and gas production, and midstream earnings to boost our fair value estimate to \$92 per share.

#### **Risk**

EQT's E&P operations are subject to a prolonged drop in U.S. natural gas prices that could reduce profits, slow development plans, and lower property values. Hedging may limit downside gas price risk, but can also limit upside potential. EQT's gas utilities offer some buffer to gas price volatility as higher gas prices can be passed onto customers. However, the regulated utility and pipelines are subject to regulatory risk.

- Proposed removal of U.S. tax credits for energy companies, if approved, could increase cash taxes and reduce aftertax cash flow.
- EQT's concentration in Appalachia makes it more sensitive to changes in regional pricing, pipeline or infrastructure disruptions, and environmental or regulatory issues.
- EQT's regulated utilities and pipelines are subject to regulatory changes that could lead to lower tariffs, lower allowed returns, or higher costs.

<b>Close Competitors</b>	TTM Sales \$Mil	Market Cap \$Mil
<b>EQT Corp.</b>	<b>1,510</b>	<b>4,881</b>
* <a href="#">Questar Corporation</a>	3,384	6,128
* <a href="#">Williams Companies, Inc.</a>	11,276	9,682
* <a href="#">NiSource, Inc.</a>	8,306	3,086
* <a href="#">El Paso Corporation</a>	5,578	6,996

\* Morningstar Analyst Report Available

Data as of 03-31-09

### **Strategy**

In 2003, CEO Murry Gerber began a multiyear effort at EQT to boost efficiency at gas exploration and production, midstream, and utility businesses via management changes and new projects. The company increased capital spending to drive drilling-driven production growth at the E&P unit, boost gas gathering capacity, and build up its utility via infrastructure upgrades.

### **Management & Stewardship**

We applaud EQT's efforts to tie management compensation with stock price and shareholder return, which actually resulted in negative total compensation for some of its executive officers in 2008. The firm's 2005 Executive Performance Incentive Program (2005 EPIP) included provisions that tie EQT's stock price performance with stock awards. The drop in EQT's stock price in 2008 resulted in a reversal of previous stock option awards and negative total compensation for CEO Murry S. Gerber and CFO Philip P. Conti. Gerber's 2008 salary was a modest \$649,036, which together with bonus, option awards, and other compensation totaled \$2.7 million before the negative \$10.5 million reversal on stock awards flipped Gerber's total 2008 compensation to negative territory. EQT also made major changes to its 2009 EPIP plan by resetting its peer group to firms more closely tied to its mix of E&P, transportation, and utility businesses with an emphasis on companies operating in the Appalachian Basin. We're also encouraged that EQT set its operating and performance metrics to a broad set of conditions including EPS compared with business plan, safety, drilling and production metrics, project execution, and customer service. EQT has preset compensation allocations per group of metrics and performance categories. Chairman and CEO Murry S. Gerber joined EQT in 1998, after serving as CEO of Coral Trading and treasurer of Shell Oil. Gerber retooled senior management soon after his arrival, hiring executives from the energy sector and other industries. Under Gerber, EQT has renewed its focus on earning targeted returns on capital, looking for cost savings and efficiency gains to boost margins. In February 2007, Gerber ceded his president's title to David Porges, who is now president and chief operating officer of EQT.

### **Profile**

Pittsburgh-based EQT Corporation (formerly Equitable Resources) is an Appalachian-based integrated natural gas firm. EQT Production produces gas with more than 3.1 trillion cubic feet of proven reserves and average daily production of 228 million cubic feet of gas equivalent. EQT Midstream processes and transports gas production to markets further east. EQT Distribution operates a gas utility that distributes gas in Pennsylvania and West Virginia to 274,000 customers.

### **Growth**

EQT's growth plans are focused on its E&P and midstream unit with long-term drilling plans and projects to boost gathering and pipeline transportation capacity. Low near-term gas prices and lower drilling activity and field production could ease the pace of near-term growth. However, the firm has several years of drilling sites and long-term midstream projects to drive long-term earnings and cash-flow growth.

### **Profitability**

Operating margins averaged 30% during the past five years, due in part to high gas prices over the past three years. We look for operating margins to dip in 2009 due to low expected gas prices, before improving as gas prices recover.

We also look for operating margins to improve from initiatives to raise gathering fees and from rate-case-driven utility margin gains.

**Financial Health**

EQT's financial flexibility is helped by strong cash flows from regulated utility and pipeline operations. The firm plans to incur debt in 2009 to fund growth plans, but looks for future operating cash flow from new fields and midstream facilities to generate cash for operations and debt repayment.

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