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[Quote](#)
Analyst Research
[Morningstar Rating](#)
[Options](#)
[Data Interpreter](#)
[Valuation Ratios](#)
[Financial Statements](#)
[Key Ratios](#)
[Charts](#)
[Dividends & Returns](#)
[Company Filings **new**](#)
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[Print](#)


XTO Energy, Inc. XTO

Analyst Report
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 by [Eric Chenoweth, CFA](#)
Analyst Note 05-06-2009

XTO Energy [XTO](#) reported first-quarter results on May 6. XTO's production topped our already-high expectations, and based on company comments and our early estimates following its conference call, XTO should be able to slightly exceed our current 2009 total production forecast of 2,660 million cubic feet of gas equivalent per day. XTO's production grew sequentially in its Eastern, North Texas, and Midcontinent regions, driven by large gains in the Freestone trend, Barnett Shale, and Fayetteville & Woodford Shales, respectively. Small sequential declines in production in both the San Juan and former Permian and South Texas regions (now split into two separate regions--Permian and Gulf Coast) were not unexpected, as these are regions where XTO is reducing drilling activity the most sharply.

Despite this quarter's performance, we do not expect robust sequential quarterly gains in production over the next few quarters at XTO (and we may see sequential declines in the third and fourth quarters), as reduced spending levels and natural declines offset growth out of the company's newer producing regions. Although production growth will start to slow down, XTO's large hedge book for 2009 and 2010 combined with a manageable debt position places it in a relatively attractive place compared with many of its peers currently. Costs also appear to be dropping, which should continue to contribute positively to profitability throughout the remainder of the year. We still expect 2009 EBITDAX of roughly \$6.5 billion compared with a 2009 capital budget of \$3.3 billion.

On its conference call, XTO threw cold water on fears of a repeal of the expensing of intangible drilling costs (IDCs), one subject we have paid considerable attention to ever since President Obama's initial budget proposal earlier this year (which suggested a repeal of IDCs). This sentiment has been echoed by others in the U.S. oil and gas industry with whom we've recently spoken, suggesting a growing ease of concerns within the industry over a significant increase in its tax burden.

Thesis 04-01-2009

A disciplined strategy has helped XTO Energy assemble a portfolio of high-quality natural gas producing properties, and boost operating margins and returns on invested capital.

XTO's strategy is not unique. Rather, focus and discipline, as well as large positions in a number of key natural gas producing regions in the United States, are what set the company apart. XTO acquires and develops onshore oil and gas properties in the United States, typically in regions with an established production record. XTO boosts investment in these properties, leading to higher production. Much of XTO's strategy hinges on its ability to produce more from these properties than previous owners or other bidders anticipated.

Morningstar Rating [?]

★ ★ ★ ★

Stock Price

 As of 05-06-2009
\$41.97

Fair Value Estimate

\$58.00

Consider Buying [?]

\$29.00

Consider Selling [?]

\$116.00

Fair Value Uncertainty [?]

High

Economic Moat [?]

Narrow

Stewardship Grade [?]

C

Bulls Say

- A dramatic reduction in oilfield drilling activity should drive demand and costs down for drilling and services, which will reduce XTO's costs.
- XTO's large hedge position in 2009 and 2010 should help it achieve higher realized prices than many of its peers should oil and natural gas prices remain low.
- XTO's large positions in multiple producing regions across the country position it well for future profitable growth through acquisitions.
- Historically, XTO has produced ROICs and operating margins above the peer average.

Bears Say

- XTO's aggressive growth through acquisitions strategy requires access to external sources of capital from time to time, which may not always come on as favorable terms as in recent years.
- Recent actions taken by the government suggest that the U.S. E&P industry could

Given the firm's strategy, management's ability to allocate capital efficiently is crucial. XTO earns high marks in this regard. The firm's finding and development costs (measuring the cost of adding new reserves) have been impressive relative to its peers. XTO's operating costs have also been lower than peers'. As a result, in each of the last five years, XTO's operating margins and ROICs have been among the best of the independent producers we cover. Higher natural gas prices have provided a nice tail wind to XTO's explosive growth and profitability, too. Since the late 1990s, natural gas prices have risen greatly, boosting XTO's sales and increasing the value of the firm's reserves.

Even while keeping a tight lid on costs, XTO has managed to build enviable positions in a number of large producing regions throughout the United States, mainly through acquisitions. The firm has remained nimble with its acquisition and development program, even as it has become a much larger company. The composition of XTO's most recent deals has changed, with the last few deals including sizable undeveloped acreage positions as opposed to producing properties. Many of these recent acreage acquisitions have established new major producing regions for XTO. Of particular note are the recent deals with Headington Oil, Hunt Petroleum, and Linn Energy LINE. The Linn deal marks XTO's entry into Appalachia, a region in which the firm has long lacked a presence. Like many others, XTO appears interested in the exploration potential of the Marcellus Shale in the region. The Headington deal places XTO in the middle of much of the exploratory activity happening in the oil-bearing Bakken Shale in Montana and North Dakota. In addition to adding to many of XTO's existing producing regions, the Hunt deal adds acreage in the North Sea and Gulf Coast regions, both of which are new for XTO.

An investment in XTO holds several risks, and a tighter credit environment and lower oil and natural gas prices are producing a stiff head wind for the firm's aggressive growth plans. Additionally, given its larger size, the company will have to find more or larger acquisitions if it wishes to keep growing at a rapid pace. Further, if natural gas prices hover at or below \$5 for a long period of time, returns on invested capital would likely suffer.

Valuation

We're leaving our fair value estimate at \$58 per share. 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 are currently using \$4.80 per thousand cubic feet (mcf) in 2009, \$6.50 in 2010, and \$6.90 in 2011. For oil, we are currently using \$52 per barrel in 2009, \$64 in 2010, and \$69 in 2011. In our base scenario, we assume long-run perpetual oil prices of \$80 per barrel and natural gas prices of \$7.50 per mcf. This scenario values XTO at \$50 per share. Our low-case scenario assumes long-run perpetual oil prices of \$50 and \$5 natural gas. In our low scenario, we assume XTO's drilling and acquisition activity slows considerably as the firm works to reduce debt by about \$2.5 billion during the next two years (all cases assume some debt gets paid down). It also assumes a roughly 1,000-well drilling program versus a 1,300-well program in our base case. Given the dramatically lower activity and pricing assumptions, our low case values XTO at \$25 per share. Our high case assumes long-run perpetual oil prices of \$150 and \$15 natural gas. In this scenario, XTO's large portfolio really hums--putting large amounts of capital to work at great returns, and our valuation is \$140 per share. We assume a cost of equity of 11.5% in all scenarios. In our base case, we project average daily production of roughly 2,660 million cubic feet in 2009. Our 2009 forecast for earnings before interest, taxes,

be a target for new taxes and regulations, thus reducing profitability industrywide.

- Costly exploratory failures, mechanical problems, and environmental disasters are constant concerns for exploration and production companies.
- When supply is tight and demand is strong rising costs for drilling rigs and oil and gas services could eat into XTO's profit margins.
- Rising costs for drilling rigs and oil and gas services could eat into XTO's profit margins when supply is tight and demand is strong.

depreciation, amortization, and exploration expenses is just over \$6.5 billion. XTO's hedges cover more than 75% of our 2009 estimated natural gas and oil production and help reduce XTO's 2009 cash-flow sensitivity to oil and gas prices. XTO's hedges cover roughly 30% of our 2010 natural gas production estimates and 40% of our 2010 oil production estimates. XTO is unhedged beyond 2010.

Risk

A substantial fall in natural gas prices could be very damaging for XTO's shareholders. Lower gas prices would weaken operating cash flow and potentially reduce lender enthusiasm toward the firm. XTO depends on a combination of cash flow and external financing to fund capital spending and acquisitions. Therefore, lower natural gas prices could lead XTO to issue more-expensive debt or to issue equity at less attractive prices.

Close Competitors	TTM Sales \$Mil	Market Cap \$Mil
XTO Energy, Inc.	8,183	23,756
* Chesapeake Energy Corp.	11,629	12,771
* Apache Corporation	10,836	26,144
* Encore Acquisition Company	977	1,640

* Morningstar Analyst Report Available

Data as of 12-31-08

Strategy

XTO acquires and develops onshore oil and gas properties in North America. The firm focuses on purchasing properties with established production records and long expected-reserve lives. XTO hopes to boost production on its properties by applying technology and increasing investment. To achieve this, the company must identify properties where it can add value and purchase them at appropriate prices.

Management & Stewardship

Bob Simpson recently stepped down as CEO and limited his role at XTO to the chairman position. Keith Hutton became XTO's new CEO and Vaughn Vennerberg became president. Simpson cofounded XTO in 1986 with longtime business partner and former president of XTO Steffen Palko, took it public in 1993, and has been chairman since 1996. Hutton and Vennerberg are both long-term employees of XTO (both joining the firm in 1987). Together, Simpson, Hutton, and Vennerberg have led XTO in various roles for some time, so the recent management promotions shouldn't dramatically alter how XTO operates in the future. All told, at the end of March 2008, board members and management owned about 6% of the company's outstanding shares, down from about 6.9% a year earlier. Simpson's stake was about 2.3% of outstanding shares, down from about 2.7% a year earlier. We like to see veteran management with such a significant stake, but other factors reduce our Stewardship Grade. Although arguably well-deserved, management compensation has been extraordinarily high, in our view, and is likely to remain so. We think XTO's level of disclosure is a plus, especially considering its large size. Its investor and quarterly presentations, available on the company's Web site, provide investors with a wealth of useful and detailed information on the company.

Profile

XTO Energy, based in Fort Worth, Texas, engages in the exploration and production of natural gas and oil. Its gathering and processing operation accounts for less than 5% of total revenue. At the end of 2008, XTO reported proven reserves of 13.9 trillion cubic feet of natural gas equivalent,

with average daily production of about 2,335 million cubic feet. Natural gas makes up more than 85% of XTO's proven reserves. Almost all of XTO's properties are in the United States.

Growth

During the last five years, sales growth has averaged more than 45%. Much of XTO's growth has come from greater production added through acquisitions, as well as higher natural gas and oil prices.

Profitability

During the last five years, XTO's operating margins and ROICs have been higher than most of its peers. Because XTO's profits depend on commodity prices, returns can be volatile from year to year. During the next three years, we expect operating margins to contract from the high levels experienced in recent years but to still fluctuate in the 20s and 30s.

Financial Health

After a brief pause on the acquisition front, XTO managed to digest a number of fairly large transactions, including the firm's largest ever, without pushing its debt/total capital ratio above 50%. If oil and gas prices tumbled, XTO's financial health would probably erode.

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