HOUSTON, WE HAVE A PROBLEM

Free Cash Flow, Net Asset Values and the Agency Question

Recent carnage in public E&P land is accelerating debates around the sustainability of current business models as well as the methodologies used to value those businesses. While the industry has walked back from the capital outspend ledge, at least for the moment, we still see analyst reports highlighting EBITDA multiples and forward multiple compression. Acreage values may be more insightful, but the "right" answer is heavily reliant on spacing and development assumptions. More recently, free cash flow and annual free cash flow yields have entered the discussion, but the durability of those cash flows remains open for debate.

None of these methodologies, nor the business plans that they attempt to quantify, address the key issues facing the industry. How do depletion rates evolve as drilling activity fluctuates? What commodity price is needed to generate a fully loaded economic return on a drilling program? How does that change as inventory is depleted? The reality is that the public equity markets provide a feedback loop to the industry. Until very recently, the overly simplistic short-hand valuation methodologies used by many industry participants reinforced self-defeating behaviors which never addressed the fundamental question: what creates actual economic value for shareholders, and how do you measure it?

The answer is simple – economic value is created by investing in projects which generate returns that exceed the cost of capital. The quantum of value creation is measured by estimating the net present value of future free cash flows derived from that investment. In other words, you calculate net asset value ("NAV"). NAV estimates are often derided for their inaccuracy, but as with all calculations, garbage in, garbage out (#GIGO). The reality is that the value of any cash flowing asset is the net present value of the unlevered future **<u>free</u>** cash flows minus liabilities. If the free cash flow is reinvested and generates returns which exceed the stated discount rate, NAV increases over time. Unfortunately, but inexorably, the converse is also true. The critical assumption is WHAT HAPPENS TO THE FREE CASH FLOW. Today, with many E&P stocks trading at or below the value of their proved developed producing reserves, it is obvious that the market no longer believes in the reinvestment economics of unconventional oil and gas, nor the executives who oversee capital allocation. This conclusion highlights both the problem and the opportunity facing the industry and its stakeholders.

For a self-described "growth industry", current valuations are a clear and explicit indictment of a decade of misleading disclosures and poor execution. Half-cycle well returns and inventory forecasts based on "shale math" (**A** [wells per zone] ***** **B** [zones per acre] ***** **C** [acres] = **D** [future drilling locations]) have not reconciled with reported financial results or stock prices, leaving the industry adrift in the public equity markets. Despite historically attractive valuations, there does not appear to be any incentive for generalists to come back to the sector, and dedicated capital is shrinking due to the truncated investment timeframe of most public equity investors. Herein lies the opportunity.

In the absence of a growth mandate, companies are being gifted a chance to reshape the narrative that surrounds the industry. For many companies, free cash flow is real and durable. Growth, managed properly, can be profitable. Equity valuations are unsustainably low. Now is the time for owners, boards and management teams to force the hands of the shale skeptics. Fortunately, the steps forward are simple, and they all tie back to free cash flows and NAV.

First, companies should be transparent about corporate decline rates and the cash-on-cash returns generated by annual drilling programs. If every management team is focused on “creating value for shareholders”, then they should be able to disclose how quickly the existing asset base is depleting, and how much incremental value is created via discretionary reinvestment. The ability to effectively communicate and execute this process allows current and prospective investors to validate the promise of prudent capital stewardship as well as the quality of the underlying assets. The inability to do so is a major red flag. At this point, the right to grow for many companies must be earned.

Second, owners and boards should work together to create long-term compensation schemes that disclose and reward cash-on-cash returns and long-term value creation. This creates explicit alignment with long-term owners (not speculators) and enhances transparency at a time when trust is in short supply. While considerable progress has been made on this front, there is more work to be done.

Third, and most importantly, companies should lay out an explicit capital allocation framework. Real companies generate sustainable free cash flow which can be used to: a) reinvest at acceptable rates of return, b) pay dividends and/or c) repurchase stock when the associated returns are attractive. This is true of all businesses as they mature, public or private, oil producers or pharmaceutical companies. The beauty of the shale industry is that it is relatively short cycle, which means capital programs can be modulated opportunistically. Thus far, only a few companies have taken advantage of their business model’s inherent flexibility. This is a fundamental strategic mistake, and the consequences are reflected in current stock prices.

The unconventional E&P industry is at a cross-road. “Trust but verify” has devolved into “I don’t care”, with dire consequences not only for public companies, but for private investors who rely on the equity markets for liquidity events to crystalize returns. Billions of dollars have been invested, with little to show for it in stock prices. Boards, banks and management teams appear to have enriched themselves at the expense of investors, raising questions about agency conflicts and the fulfillment of fiduciary obligations. The reality is that the industry rarely has been in a stronger position than it is today, with new completion technologies, years of drilling inventory, continued investment in infrastructure, much improved balance sheets and newly aligned compensation programs paving the way for significant economic value creation going forward. However, current stock prices imply a negative value to those realities. The industry needs to seize control of the narrative and determine if the Shale Revolution will go down in history as a parallel to the Industrial Revolution, or the French. Not every business will survive, and not every one should. But for those fortunate few, the clear and unequivocal allocation of free cash flow to maximize economic value is the best way to address these existential questions and put the agency issue emphatically to rest.

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