Shale 2.0 – The Promised Land?

"The problem ain't that there is too many fools, but that the lightning ain't distributed right." —Mark Twain

"I wish I had an answer to that because I'm tired of answering that question." —Yogi Berra

"So when at times the mob is swayed
To carry praise or blame too far,
We may choose something like a star
To stay our mind on and be staid."
—Robert Frost, *Choose Something Like a Star*

Speaking recently at an investor conference, Anadarko Petroleum CEO Al Walker had some interesting thoughts regarding the current state of the U.S. oil and gas industry. Here is what he said to investors:

> *"The biggest problem our industry faces today is you guys. You don't reward capital efficiency, you reward growth. When you guys stop rewarding growth and reward capital efficiency, guess what — and the share prices react, people will stop chasing growth for growth's sake. As long as investors continue to invest in companies with growth with marginal wellhead economics, you'll get more growth. So you guys can help us, help ourselves. This is kind of like going to AA. We need a partner. We need somebody to sit through that class with us, but we do. I mean, we really need the investment community to show discipline, just like you're asking us, I think, appropriately so in this environment, to show discipline. We need you to be disciplined in the way you allocate your investment dollars because first off: a) most of you are not getting big funds flows right now; b) you're underweight in energy because you've made sector bets that are probably a better place to be than energy in the foreseeable future, and those of you that are in energy that want to stay in energy you are probably doing some securities rotation right now. All of that's understandable. So just think about trying to look at situations where capital efficiency actually can be rewarded and that's not a company-specific comment, it's more of a generic, because the more the capital-efficient companies are rewarded in the marketplace and growth is not, then you guys will help us help ourselves and we'll be in a better place, but if you keep rewarding growth without return, you're just going to help compound the problem that we have today, where I think a lot of us feel very much in need of showing growth because if you're a growth and value investor, you need to see little bit of both."*

Sadly, there is some truth to what Mr. Walker said about investors. Many investors do push companies in the sector to grow more quickly, usually at the wrong point in the cycle. Since most companies invest in their lowest-cost projects first, incremental growth is typically achieved by allocating more capital to lower-returning wells. As activity levels rise, costs increase, operators become less efficient, and higher supply eventually pushes prices lower. Left in the wake of the bad capital allocation decisions are higher debt loads, low returns on capital, and, of course, poor shareholder returns.

So, it is true that investors have been enablers – to stick with Mr. Walker's analogy – in two ways. First, most investors tend to allocate capital to the sector in a pro-cyclical way, giving capital to E&P companies at precisely the wrong time. This would not be a problem if all oil and gas companies took their mandate to create value seriously. However, given the track record of most companies in the industry, this trust has been terribly misplaced and has had very negative consequences.

If pro-cyclical, growth-focused investing is the obvious enabling activity of investors, the lack of shareholder engagement is the less obvious, but in some ways more meaningful one. Despite the troubling decline in returns on capital and the increase in financial leverage across the industry since the start of the shale revolution, few shareholders speak with the independent directors that they have elected to represent them when given the opportunity. More concerning, many shareholders have outsourced the proxy voting process to outside firms or departments that do not understand the E&P sector. By not voting proxies directly, shareholders have implicitly endorsed the lack of financial discipline that has characterized this industry for many years now. To the extent that investors would like to see higher returns on capital, better alignment between their interests and management incentives, and a return *of* cash one day, they need to become more engaged and vote their proxies in a manner consistent with their fiduciary obligations.

While investors are to blame for both funding and allowing value-destructive activity in the E&P sector, management teams and directors are ultimately responsible for the decisions that are made at companies. In fact, directors have a legal obligation to make decisions that are in the interest of their companies and shareholders. In order to create economic value, companies need to generate returns that exceed their cost of capital. This is their mandate. By suggesting to investors "that the biggest problem our industry faces today is you guys", Mr. Walker conveniently distances himself from the fiduciary responsibility that management teams and directors have when allocating capital and making strategic decisions. The reality is that investors aren't making those decisions. In our view, the biggest problem facing the industry isn't investors, but rather the poor corporate governance practices that exist at many E&P companies today.

Without question, the most egregious corporate governance practice in the E&P sector is the way in which management teams are incentivized. Despite the overwhelming evidence that shows that there is no relationship between long-term shareholder returns and absolute production growth, most companies in the sector continue to use production growth as one of the primary metrics when evaluating management performance. Production is an outcome of the capital allocation process, not something that should ever be targeted. In addition, most E&P companies use total shareholder return (TSR) relative to other companies in the industry to assess long-term corporate performance. Without an absolute return hurdle, management teams can be rewarded for destroying shareholder value so long as they grow production and have a TSR that is in-line with their value-destroying peers. For those that are looking to understand why this industry continues to generate poor returns, the simple answer is that this is what management teams in the sector are paid to do. If executives like Mr. Walker feel so strongly about the importance of capital efficiency, why don't they ask the directors of their companies to replace the growth-based targets in their incentive programs with metrics that are tied more closely to capital efficiency and returns? We imagine that most investors would be supportive of that change.

Compounding the lack of focus on returns is the fact that many E&P companies choose to provide investors with data that creates a misleading portrayal of the actual returns that are being generated on shareholder capital. The continued use of "half-cycle" return estimates and selective well disclosures by many companies gives the impression that returns on capital in the sector are attractive when in reality returns have declined significantly over the last decade and are now well below the cost of capital. While many companies go to great lengths to calculate theoretical “half-cycle” return estimates to try to attract new investors, very few companies in the sector provide their existing owners with a review of the estimated returns that are being generated on their capital each year or look-backs that show the returns that were generated on key projects and acquisitions. If executives in the industry want investors to focus more on capital efficiency, then perhaps the companies should be more transparent about the real returns that they are generating for investors.

Lastly, the independent directors of most E&P companies appear to be more concerned about being viewed as “outside the norm” by proxy voting services than protecting the interests of the shareholders whom they represent. Unlike boards in other countries and sectors, U.S. oil and gas boards have not provided the checks and balances needed to curb the undisciplined behavior of many management teams and they have not held management teams accountable for the value that they have destroyed in the past. In fact, the exact opposite has occurred. While most boards outside of the energy sector use earnings, returns on capital, and free cash flow to incentivize management teams, the compensation committees of many E&P companies continue to grant large payouts to management teams that have not only generated poor returns, but in some cases have even gone bankrupt. At the same time, independent directors have also left “shareholder engagement” to the executive directors that run the companies despite the obvious conflicts of interest that exist. And, E&P boards have chosen not to provide their shareholders with the transparency required to help them understand how the directors evaluate the performance of management teams from a return on capital perspective. If capital allocation is the problem and investors are an enabler, to continue with Mr. Walker’s analogy, then E&P boards are the pushers that have created the dangerous obsession with production growth through their misaligned corporate governance practices.

So what investors are left with today is an industry which has yet to translate the meaningful technological improvements of the last decade into real financial gains for the owners. Instead of assigning all of the blame to investors, we wish that Mr. Walker would have used the opportunity to start a much-needed conversation about the changes that the companies themselves can make to generate better returns, improve transparency, align management compensation with the interests of the shareholders, return cash to owners, and finally attract investors to a sector that they have historically shunned. Shareholders certainly have a role to play, but E&P management teams and directors need to take their fiduciary obligations more seriously than they have over the last 10+ years.

Fortunately, the environment appears to be changing. Contrary to Mr. Walker’s observation, investors actually do reward capital efficiency. Over longer periods of time, in fact, E&P stocks have been driven more by per-share, debt-adjusted changes in reserves and returns on capital than by production growth. The best performing E&P companies in the public equity market over the last few years have been those with less debt and the smallest free cash flow deficits. Investors are rewarding financial discipline more today than they did prior to the collapse in commodity prices. Second, less capital is being allocated to the sector, given increased concerns regarding the undisciplined behavior of E&P management teams. New issuances in the debt and public equity markets, particularly those used to fund increased capital spending, have fallen significantly so far this year. Lastly, there is a growing recognition within the industry that as growth rates begin to slow in 3-5 years due to the depletion of drilling inventory in the core parts of shale plays, E&P companies will have no choice but to move toward a lower-growth, higher-return business model.

Since the era of easy oil and easy money began, returns on capital for the industry have declined steadily. While the cost of supply has fallen for many E&P companies, their focus on growth over returns has temporarily pushed out higher-cost producers to the point where shale now represents the marginal unit of production. This has benefited management teams, not shareholders.

However, there are limits to this growth. The new technology has reduced the cost of supply primarily by bringing production forward. The offsets are the ongoing decline in the inventory of undrilled locations in the core parts of lower-cost shale plays and the increase in depletion rates. As the cores of these plays are developed, and as well productivity begins to decline, the growth in both shale oil and shale gas production will slow over the next 3-5 years. At the same time, non-shale production will begin to fall as the startup of new projects fails to offset depletion. As a result, growth from low-cost shale plays will no longer be sufficient to balance the oil and gas markets, and oil and gas prices will eventually need to move much higher in order to stimulate investment in higher-cost sources of supply.

Despite the current self-inflicted doom and gloom in the market, the opportunity for the E&P industry has never been better. Many companies in the sector, for the first time in decades, have the inventory that could allow them to grow at a moderate pace for 5-10 years while also generating attractive returns on capital and significant free cash flow. The winners will be the few E&P companies that solve for the long-term and still have low-cost drilling inventory when the marginal cost of supply eventually rises. These companies will be able to grow while returning cash to shareholders, for once. On the other hand, the companies that lever up to chase near-term production growth in a low price environment may find themselves in trouble in a few short years.

Some companies in the industry are beginning to recognize both the opportunity and the necessity of pursuing a more balanced growth and return/income model. They are referring to the next phase of the shale revolution as “Shale 2.0.” To the extent that “Shale 2.0” translates into more sustainable growth, higher returns on capital, and the return *of* cash to shareholders, it should be quite positive for both management teams and investors. In our view, the pivot to “Shale 2.0” will one of the most important differentiators between E&P companies and the sooner that it happens, the better.

Yogi Berra once said, “When you arrive at a fork in the road, take it.” E&P companies and shareholders are at a familiar junction. They would be well-served to take a different path this time – one that takes advantage of the incredible opportunity in front of them in a way that benefits both shareholders and management teams.