SAILINGSTONE
CAPITAL PARTNERS LLC

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We recently read David Einhorn's analysis of the exploration and production ("E&P") industry with great interest, not because he is an expert in the oil and gas industry, but rather because he provides the perspective of a thoughtful investor who is not burdened by the biases or constraints that come with following the sector for many years. While we do not normally comment on the views of others in the market, since we are in the business of trying to profit from differences in opinion, we believe that many of the points made by David Einhorn raise legitimate questions for both E&P investors and companies. In this letter, we focus on those questions and provide some ideas for how the industry, investors and companies alike, might be able to improve in the future.

**Key Points**

From our perspective, David Einhorn highlighted a number of important points in his analysis that E&P investors and companies should consider.

1) Without question, there is a disconnect that exists between the half-cycle returns reported by many E&P companies in their presentations and the overall cash-on-cash full-cycle returns generated by these same businesses as disclosed in their financials. To the extent that some investors focus too much on half-cycle economics, this means that they are probably not focused enough on the true full-cycle returns, as David Einhorn rightly points out in his analysis.
2) There is an important difference between growing production or reserves and creating economic value, and many investors and companies are indeed guilty of focusing too much on the former. Growth should be an outcome, not an objective. Companies that generate attractive returns on their projects should be able to grow value on a per-share, debt-adjusted basis – irrespective of what happens to overall production and reserves. Growth in absolute levels of production and reserves can either be value accretive or destructive, depending upon the returns generated.
3) Commodity mix matters far less than returns on capital over longer periods of time. While many investors still prefer shale oil companies over shale gas companies, the reality is that low-cost shale gas companies generated better returns on capital than the many shale oil companies in 2014, when oil prices averaged more than $90 per barrel. We agree with David Einhorn's view that shale gas looks like a better business than shale oil, at least for some companies, because they have demonstrated better cash-on-cash returns historically.
4) Higher oil and gas prices are clearly needed in order for the industry to generate attractive cash-on-cash full-cycle returns. Investors or companies who believe that the industry can generate attractive returns in today's low price environment are relying too heavily on half-cycle "presentation math."

At the same time, it is also worth highlighting some of the important points that we feel David Einhorn did not adequately address in his analysis.

1) There are significant differences in the returns generated by E&P companies. Returns vary meaningfully between projects, both between basins and within a basin. While some shale oil companies have destroyed value, many E&P companies have created quite a bit of economic value for their owners. For instance, the cash-on-cash full-cycle returns generated by what David Einhorn refers to as the “Mother-Fracker” (Pioneer Natural Resources) are very different than the cash-on-cash returns generated by the “Father-Fracker” (EOG Resources). Furthermore, some of the better-performing stocks in the market over long periods of time have been E&P companies that have generated very attractive returns and seen the economic value of their businesses compound.
2) There are differences in the metrics that are used by E&P company boards to evaluate and compensate management teams in the sector. While many management teams are overly focused on growth in production and reserves, others are appropriately focused on returns and creating economic value across the cycle.
3) There are meaningful differences in how E&P companies are currently being valued in the public equity market. While some companies do indeed appear to discount a significant portion of their future drilling inventory, many others do not. In fact, many E&P companies appear to be trading well below their private-market values, in our view. The gap in valuations that exists today between companies is as wide as we have seen it in a very long time.

While the industry is not nearly as uniformly value destructive as David Einhorn suggests, there is no doubt that it can do better. Below are a few of our suggestions for E&P investors and companies.

**For E&P Investors**

Unfortunately, many E&P investors continue to allocate capital based on views regarding variables that we view as having absolutely nothing to do with longer-term value creation, including the short-term direction of commodity prices, arbitrary cash flow multiples, and, of course, production and reserves growth. Many of these investors are in the business of renting stocks to express an opinion about one of these factors, driven in part by short-term incentive compensation schemes. While these variables can influence short-term performance, ultimately we expect the market to be efficient and E&P stocks to track changes in economic value.

Often times, the investors that push for higher rates of production growth sell their stakes before the economic consequences of their recommendations become obvious. Longer-term investors in E&P companies are then left to suffer the potential effects associated with what frequently is a gross misallocation of capital.

Even worse, the focus on growth over returns leads to overinvestment during periods of cyclical strength and underinvestment during periods of weakness. This behavior, which has a funny way of repeating itself, helps create the boom and bust cycles that characterize the sector. In short, the pro-cyclical behavior of investors probably increases the magnitude of cyclical fluctuations and helps limit the value that is created by many companies in the oil and gas industry.

Rather than push companies to increase production at any cost, E&P investors should instead reward companies for capital discipline and value creation. They should ask for greater transparency of the true costs and returns from drilling and, at the same time, demand that management compensation be linked with returns on incremental capital, not production and reserves growth. And, investors should stop using lazy, short-hand metrics like production growth as a proxy for returns and cash flow multiples as a proxy for valuation. By rewarding "higher-growth" companies with higher multiples and a lower cost of capital, investors create a perverse incentive for some companies to chase more unprofitable growth until, of course, the value destruction becomes apparent and the cost of capital rises again.

What is happening in the market today is a perfect example of the myopic obsession with production growth at the expense of returns. While investors should applaud and encourage lower levels of production, in the defense of returns, they instead continue to reward companies for showing higher and higher levels of unprofitable production. The companies that may be doing the right thing by choosing to drill their inventory later at higher prices are being penalized by investors who are more concerned about next year's production, cash flow, and share price than the returns generated on their own capital. In our view, this clearly needs to change.

Investors also need to recognize the longer-term benefits associated with growing at a more sustainable pace (i.e. spending within normalized cash flow). While a spreadsheet might convince some investors that bringing forward as much value as possible is the best strategy for an E&P company, history suggests that an unsustainable increase in drilling activity can have a very negative impact on operating costs, financial leverage, oilfield service costs and performance, decline rates, and, most importantly, returns on investment. In addition, with the continued improvements in technology, the limited inventory of good projects, and a reasonably constructive longer-term outlook for commodity prices, one could argue that investors would be better off from a return on investment standpoint by drilling at a much slower pace in general. In fact, some of the most successful E&P business models in the past have been those that have drilled wells at a slower pace, thereby managing decline rates, benefitting more from new technologies, and generating sustainable per-share, debt-adjusted growth over a longer period of time than would have been possible if the pace of drilling had been accelerated. We think that a more moderate pace of activity would better serve both investors and the industry.

**For E&P Companies**

There are a number of important takeaways from David Einhorn's analysis for the E&P companies as well. First, E&P companies need to provide more transparency into the true costs of drilling and completing wells, including the costs associated with land, seismic, infrastructure, facilities, and other administrative functions. Surprisingly, the gold industry has taken the lead in this regard by creating the all-in sustaining cost ("AISC") metric, which is now widely reported by most companies in the sector. The E&P industry should follow the gold companies by working together to create useful cost metrics for investors, including data that provides a bridge between the half-cycle costs reported in company presentations and the all-in costs that show up in the financials. Furthermore, the oil and gas industry can do a much better job of reporting the returns generated from their drilling programs at year-end. Peyto Exploration is the only company that we know of that estimates the returns generated on the capital that it spends each year. There is absolutely no reason why shale oil and gas companies shouldn't provide their owners with an estimate of the IRRs generated on their capital. Perhaps that level of transparency could itself result in improved returns for investors.

Second, E&P company boards need to start working for the shareholders. Directors should demand the same level of transparency for the owners whom they represent, and they should link compensation with the returns generated on incremental capital, not production or reserves growth. While companies should retain some flexibility in how they structure their incentive compensation programs, including the incorporation of certain environmental, social, and governance ("ESG") issues, the primary (or even only) financial metrics that should be used in determining compensation should be ones which reflect returns and value creation.

Lastly, E&P management teams need to be more forceful in reminding those investors that are focused on production growth and cash flow multiples that management's job is to create value for their owners – not by focusing on short-term changes in the share price, but rather by creating as much economic value as possible over longer periods of time. All too often, management teams take capital with the promise of providing increased rates of growth, particularly when the cost of that capital is as low as it has been over the last several years. We are not suggesting that companies shouldn't take advantage of low-cost sources of capital. Rather, we are simply stating that management teams should only use capital when they can generate attractive rates of return, even if that means waiting for a better part in the cycle to spend it. In short, companies need to be managed for the long run, not for the stock market.

**For SailingStone Capital Partners**

For our part, we plan on working with our portfolio companies to provide increased transparency on costs and returns and to formalize the link between incentive compensation and value creation. We also plan on encouraging our portfolio companies to work with the industry to promote reporting standards that provide all investors with more transparency around costs and returns in a way that allows for more useful comparisons and analysis, and hopefully a more efficient allocation of capital.

**Endnotes**