SHALE
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# Which Five Shale Companies Are Doing the Best in the Low-Price Environment and Why?

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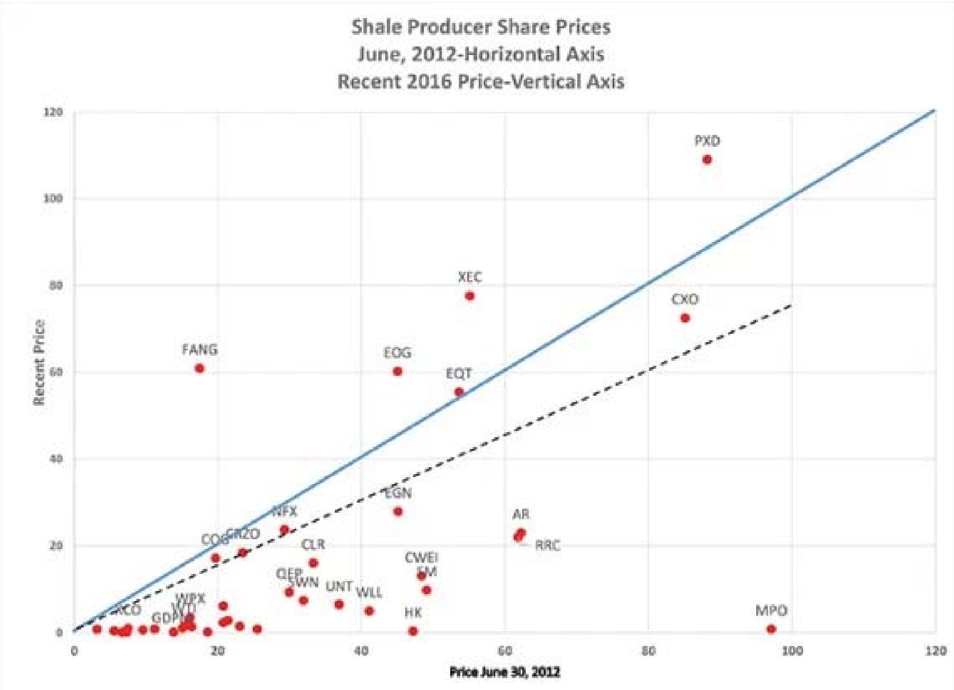
# Thriving In A Low-Price Environment

Before you read any further, make a note of how you would answer the question above. Now consider your relationship to the companies you listed. If you happen to be the CEO of any company on the list, you probably picked that one because it has solid, experienced, skilled, even gifted management. If you are an employee, the company for which you work may or may not have appeared on your list, depending on how things are going at the office or worksite. If you are a supplier, you may have decided based upon how important a customer the company is, if it pays on time and how often you are pounded to lower prices. If you are a customer, you are probably thinking about the company's reliability and its likelihood of staying that way. If you are a lender to shale operators, your list most likely consists of those companies that are most likely to pay you back. If you are an investor, the companies on your list are those you own because you think they will eventually survive and prosper. All of these viewpoints are valid for their purpose, but right now the investor's viewpoint is the most important because it subsumes all others. If the company does survive and prosper, all constituencies will benefit — if not, all will lose.




What is the investor's perspective? The investor's viewpoint must also incorporate time. Are the best companies those who do best when commodity prices are going up, going down or going nowhere? It depends on one's time horizon. From June 2012–January 2016, we have seen oil prices move up from $80 in June 2012 to $106 in June 2014 to the current price of just under $30. Since this time period encompasses high volatility and a wide range of prices, the best companies over this horizon are those that have done well over the entire 43-month cycle.

The chart on the left tells the story of how companies have fared over the cycle so far and shows the share price of 40 domestic companies whose market capitalization in June 2014 was greater than $500 million. The horizontal axis shows the share price on June 30, 2012. The vertical axis shows the recent share price. The diagonal 45-degree line shows those points along which the share price in each period would be the same. Companies shown above this diagonal line had share price appreciation over the 43-month period. As shown in the chart, this is a very exclusive club of five companies: Diamondback Energy (FANG), EOG Resources (EOG), EQT Corporation (EQT), Cimarex Energy (XEC) and Pioneer Natural Resources (PXD).

Three additional companies did relatively well, declining by less than 20 percent: Newfield Exploration (NFX), Concho Resources (CXO) and Cabot Oil & Gas (COG). These companies are shown to the left of the diagonal dashed line. The remaining 32 companies in the universe appear below the dashed line and have fared considerably worse. Eleven are shown as the dots on the horizontal axis indicating these companies' share prices are measured in pennies.

The steep price decline of the 32 companies has had a significant impact in the makeup of the industry. In June 2012, these 32 companies represented 60 percent of the market capitalization of the 40-company universe. As of mid-January 2015, these companies were only 25 percent. This is a near complete role reversal with the top five companies who in June 2012 were 28 percent of the universe and now constitute 58 percent. Why has company performance been so widely diverse?

Superficially, one might expect all shale companies to perform roughly the same. After all, after adjusting for quality and transportation differentials, all companies face the same selling price. But as we have just seen, performance varies widely.

Companies differ financially in two key respects that explain over half the variability in their performance. These two factors are market capitalization and the share of debt in a company's total capitalization. They are offsetting factors. Larger market capitalization at the beginning of the period is positive for performance, while higher debt loads are a negative factor.

About another 10 percent can be explained by an individual company's sensitivity to crude price movements. These factors make intuitive sense. Larger companies have better access to capital, as evidenced by both Diamondback's and Pioneer's recent sales of new equity. Companies that are not highly leveraged are not under pressure to produce and therefore raise cash to pay interest on debt.

The strongest companies have also demonstrated an ability to manage the downside. In the move up to June 2014, nine companies saw their share price increase by over 100 percent, and seven companies saw increases over 75 percent. While four of the five best companies enjoyed increases of over 100 percent, they maintained their position by giving less up on the way down. Size and lower leverage played a key role in helping the top five manage the downturn. At the top of the cycle in June 2014, these five companies as a group had a debt-to-total-capital ratio of 28 percent, while the remaining companies stood at 48 percent. What does this mean for the future? Assuming we are in a "prices will be lower for longer" world, these results portend more of the same. Big companies will tend to become relatively larger at the expense of smaller companies. The commodity price buoyancy of years past that ushered many companies into existence and made their growth possible has been replaced by sinking prices, which will have the opposite effect.

Many of the companies in the lower portion of the chart will cease to exist. The assets they own, however, will not disappear with them. These will remain, but under new ownership, most likely one of the top five companies, each of which has the size and financial staying power to acquire now and wait for the cycle to turn.

None of this is to say that the next few quarters will be easy for the best companies. Upcoming earnings reports from all parties will be dismal. The main idea, however, is not so much what is in the 2015 annual report, but rather if the company will survive long enough to issue an annual report for 2016. The five best are survivors.

*About the author: Dr. Dan Watson is an expert on econometric and statistical analytics, valuation analysis, economic financial damage claim computations, and risk management. He teaches security and asset valuation at Rice University. Dr. Watson is an Affiliate Director at Accumyn Consulting. For more information, visit [www.accumyn.com](www.accumyn.com).*

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