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LARGE-CAP OIL 2Q21 NAV COMPASS

Adding Northern Delaware Names to Our Top Picks

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How are large-cap oil E&P companies positioned on key valuation, financial and operational metrics?

KEY POINTS

- Large-cap oil stocks increased moderately since we published our 1Q21 NAV Compass reports (a 4% median gain) despite significant increases in commodity prices and cash distributions to investors. We believe the group has more room to run. Even if commodity prices slip from recent highs, growing FCF profiles, distribution programs and consolidation opportunities will remain attractive and difficult for value-oriented investors to ignore.

Positive Outlooks:

- After revamping our methodology for estimating well inventory, joins our group of top large-cap picks. Like some other northern Delaware operators, we increased our estimated value of s position after integrating our Play Fundamentals work and accounting for increased multi-zone exposure and lower parent-child risk in that area of the basin. Early execution on one of the group's larger cash distribution programs assuages any concerns about abandoning investors' preference for capital discipline.
- – which will join the large-cap oil group after closing its merger with – is another long pick exposed to the northern Delaware. Increased gas prices have disproportionately benefited the **under-hedged** Appalachia producer. Consolidating net operating loss (NOL) balance to offset the tax liability on cash-generating gas assets represents a valuable deal synergy.

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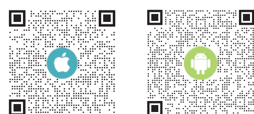

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- We continue to identify compelling value in Midland operators , and . was the main beneficiary of the revision to our inventory estimates in the basin. still lags large-cap peers on inventory depth; we suspect the company may address the weakness with an acquisition in an M&A market that continues to show buyer-friendly conditions. efforts to monetize second-tier assets appear to be more motivated by accelerating distributions rather than striking deals with material value ascribed to undeveloped upside.

Negative and Neutral Outlooks:

- Our view of Delaware inventory was impaired because of our revamped methodology. Most of the company's capital continues to be allocated to the Texas side of the basin, where we perceive lower multi-zone potential and increased parent-child degradation. The downgrade aligns with a downward trend in productivity for **recent wells** in the basin. The name screens poorly on relative valuation, making it difficult to develop a long thesis even for oil bulls seeking exposure to its high sensitivity to crude prices. A bull case for likely requires a positive outlook its low-carbon initiatives to which we ascribe no value in our base case.
- **well performance** in the Delaware is also trending downward, and its inventory also received a downgrade in our model (albeit to a lesser extent than). The position is weighted to the more attractive New Mexico side of the basin. But heavy development to date caused us to classify more of its inventory in the less productive child category. However, we are reluctant to recommend shorting the stock. large cash position, attractive free cash flow profile and strong balance sheet provide more options to the company than . could use its premium valuation multiple to consolidate smaller operators, improve the quality of well inventory and prevent capital efficiency from slipping. Moreover, retains more capacity to announce incremental shareholder distributions than most large-cap peers; such an announcement could catalyze sentiment.
- stock outperformed most of the sector since our last report, widening the dislocation between our valuation and the market's. The strong performance is particularly confounding given the lack of upside that investors (and we) have perceived in the Bakken and Anadarko basins in recent years. But for those looking to short the name, we advise waiting until after 3Q21 earnings season. has potential to beat conservative consensus estimates during 2H21. The 2022 budget season could reveal weakening capital efficiency and inventory depth, presenting better timing for entering any short positions.
- five-year plan offers attractive reinvestment rates, FCF yield and distribution potential. Our model broadly aligns with the plan, but we expect capital efficiency to degrade toward the end of the time frame. We believe emphasis on the five-year time horizon is a testament to the lack of inventory depth beyond that frame. and are the top large-cap names that could benefit from inventory-accretive acquisitions.
- Our improved view of Midland inventory helps bridge the gap until the company's Suriname discoveries come online. But recent disappointing appraisal results and our weaker outlook for **exploration potential in Block 58** offsets some of the upside. stock outperformed Guyana-Suriname peer since our 1Q21 note. The narrowing valuation gap and higher near-term distribution potential cause us to no longer prefer over .

Tax Overview:

- Incorporating income taxes into our NAV estimates increases the median long-term WTI price implied in our models from market valuations by $6/bbl to $64. The delta between pre-tax and post-tax total asset NPV-10 ranges between 15% and 25% for most names, a few percentage points below the range of effective tax rates we apply to our estimates of taxable income.
- Since [illegible] already depleted its NOL balance, taxes reduce its asset NPV-10 by a wider margin than they do for peers. Conversely, [illegible] holds one of the largest NOL balances, and we do not expect it to enter into a full taxable position in the near term. [illegible] also holds a large NOL position for its U.S. assets, and a capital-intensive development program in Guyana delays income taxes beyond the near term. [illegible] higher leverage causes taxes to have the larger impact on NAV relative to peers.

NEED TO KNOW

Click this icon to interact with the well lists and historical data associated with this report in a tailored instance of Enverus Foundations™.

Our new Valuation Analytics module hosts updated outputs from our NAV models in Prism. Use it to quickly benchmark companies on a comprehensive set of metrics with the latest market-based inputs across many commodity-price scenarios.

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VALUATION

We have positive outlooks for [illegible] and [illegible]; neutral outlooks for [illegible] and [illegible]; and negative outlooks for [illegible] and [illegible]. In the absence of guidance or other company-specific nuance, we assume well costs will inflate by 10% in the near term. We aim to model only distribution policies with firm plans and disclosures, and we assume remaining FCF accrues to the balance sheet.

NEED TO KNOW

Inventory

- We aligned the inventory assumptions for most basins in our NAV models with the spatial-based approach featured in our Play Fundamentals reports.
- The spatial-based methodology involves geospatial placement of well laterals in undeveloped areas that we deem economically prospective at the interval level. The geospatial inventory is intersected with each operator's land position to quantify well locations by operator. Adjustments are made to align with our company- and asset-specific assumptions for well spacing, lateral length and working interest.
- In the Permian, we now standardize our type wells into categories for co-developed versus child, Enverus sub-play and interval. The standardization significantly increased our granularity.
- Our previous methodology involved using net acreage disclosures, risking assumptions and analyst discretion to account for items like parent-child relationships and multi-zone potential.

Income Taxes

- We incorporated income taxes into our valuation estimates in response to our coverage group's shift to profitability and acceleration of entering taxable positions.
- Our methodology to estimate taxes involves using NOL balances, blends of state and federal statutory tax rates, and free cash flow as a proxy for pre-tax income after deductions such as intangible drilling costs. We reconcile our default methodology against company guidance and adjust company-specific forecasts accordingly.
- Much of the information needed to increase the accuracy of tax estimates (e.g., tax-specific depreciation schedules) is not disclosed in public filings. We make simplifying assumptions and expect to hone our forecasts as disclosures increase and more cash tax payments are made.

M&A

- We model [illegible] pro forma for the acquisition of [illegible] and [illegible] pro forma for the acquisition of Primexx. We assume a 3Q21 effective date for the transactions for comparison purposes.

INVENTORY

Shifting to the spatial-based methodology to estimate inventory caused a more significant change in our Permian models relative to other basins. In aggregate, our estimate of Permian well inventory for large-caps increased by 30% versus our **1Q21 models**. We now categorize approximately 22% of large-cap inventory as child and 78% as co-developed.

Our estimate of NPV-10 associated with Permian inventory varied across the large-cap group. In most cases, an increase in inventory caused value to increase – but at a sub-1:1 ratio. This was the case for several northern Delaware operators exposed to increased zones of potential and more accurate modeling of lower federal royalty rates. For others, the inclusion of child-well granularity and a more conservative type-well sample of only co-developed locations caused value to decrease.

In the Delaware, our valuation increased by at least 20% for [illegible] (from [illegible]), [illegible] and [illegible]. Conversely, valuation decreased for [illegible], [illegible], [illegible], and [illegible]. The downgrade is particularly significant for [illegible] and [illegible] due to their size and higher portfolio concentration within the Delaware. The downgrades are consistent with trends of declining well performance for each company ([illegible] **(Workbook 1A)**/ [illegible] **(Workbook 1B)**).

In the Midland, valuation increased by more than 10% for only [illegible]. The new methodology revealed a significant increase in inventory in the Jo Mill and the Lower Spraberry zones and economic child wells that were previously being risked more heavily. Value also increased for [illegible] and [illegible] – but by less than 3%.

The increase in total inventory and the introduction of higher-breakeven child well categories provide more exposure to commodity price upside. The value of [illegible] and [illegible] inventory increases by more than 150% from a $50/$2.50 WTI/HH price scenario to $70/$3.50, mainly due to the higher breakevens of its inventory. Conversely, [illegible] inventory is the least sensitive with a value change below 100%.

Workbook 1A | [illegible]	**Workbook 1B |** [illegible]
Click this icon to interact with the linked workbook.	Click this icon to interact with the linked workbook.

FIGURE 3 | Inventory Life by Breakeven

NA Onshore Inventory Life at NTM Completions Activity Level (Years)

0 5 10 15 20 25 30

Large-Cap Oil: <$30, $30-$35, $35-$40, $40-$45, $45-$50, >$50

SMID-Cap Oil: <$30, $30-$35, $35-$40, $40-$45, $45-$50, >$50

Source | Enverus, company disclosures

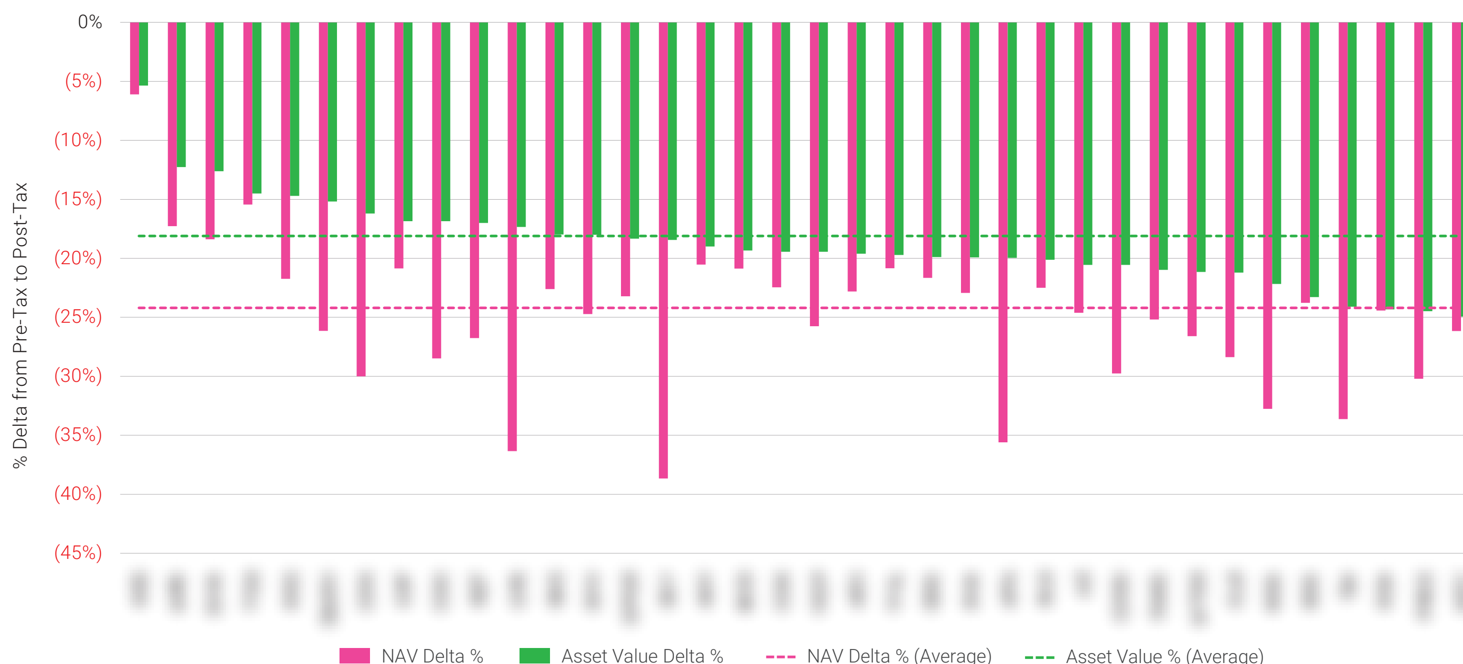
INCOME TAXES

Incorporating income taxes into our NAV estimates increases the median long-term WTI price implied in our models from market valuations by $6 to $64. The delta between pre-tax and post-tax total asset NPV-10 range between 15% and 25% for most names, which is a few percentage points below the range of effective tax rates we apply to our estimates of taxable income.

The normalized size of companies' NOL balances has the biggest influence on the impact of taxes to total asset value, followed by the regime-dependent tax rate assumptions and the shape of a company's FCF profile. Leverage has the most influence on the impact to NAV (equity value), followed by the same factors that influence asset value.

Since [illegible] already depleted its NOL balance, taxes reduce its asset NPV-10 by a wider margin than they do for peers. Conversely, [illegible] holds one of the largest NOL balances, and we do not expect it to enter a full taxable position in the near term. [illegible] also holds a large NOL position for its U.S. assets, and a capital-intensive development program in Guyana delays income taxes beyond the near term. [illegible] higher leverage causes taxes to have the larger impact on NAV relative to peers.

FIGURE 5 | NAV and Asset NPV: Pre-Tax and Post-Tax



Note | Asset Value = NAV per Share * Shares Outstanding + Net Debt
Source | Enverus, company disclosures

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