PERKINS
INVESTMENT MANAGEMENT

ENERGY INVESTMENTS, CHALLENGES AND OPPORTUNITIES

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Since 1980, Perkins Investment Management has approached value investing from a unique perspective. Using extensive bottom-up, fundamental research to identify high-quality, undervalued stock opportunities, we conduct rigorous downside analysis on each prospective investment before focusing on upside potential. Our research team shares insights and opinions with our clients and partners through our Analyst Viewpoints series. In this edition, Perkins' Research Analyst Justin Tugman focuses on the energy sector with Client Portfolio Manager Valerie Newman. Tugman discusses how technology has altered the supply landscape, ramifications from the Gulf oil spill and where Perkins is finding value in the sector.

Q: Energy stocks have been a long-term area of focus at Perkins. Where are you currently finding value?

Justin Tugman: We have identified a number of compelling long-term opportunities in the sector. While there will likely be continued volatility in commodity prices, over time we believe energy prices will continue to rise, albeit at a slower pace than experienced over the past decade. This provides a positive backdrop for energy stocks.

The natural gas segment has been particularly attractive on a reward-to-risk basis, largely because natural gas prices have declined more than oil prices from the recent peaks. In addition, the natural gas market has some intermediate-term supply/demand balancing issues it needs to work through, so it has been largely out of favour with many investors. Oil stocks appear to be a bit expensive in our view, but we continue to take advantage of buying opportunities when they present themselves.

Q: Why have natural gas stocks been out of favour and largely ignored by investors?

Justin Tugman: Natural gas is slowly becoming a global commodity due to growing demand from developing countries and the emergence of liquefied natural gas, or LNG. At this point, natural gas prices are still mostly dictated by regional supply/demand trends, but over time this will likely change. While oil prices clearly benefited from improvements in the global economy, natural gas has only seen limited pricing gains due to supply/demand imbalances. Growth in natural gas supply over the past few years coupled with short-term declines in demand in the United States has created fundamental imbalances that have and likely will take longer to resolve, when compared to crude oil.

Key Points

- Natural gas companies appear attractive on a reward/risk basis, but oil stocks seem less appealing
- We think select large majors are compelling from a valuation perspective
- The Gulf oil spill will likely result in longer drill times and increased regulation, but this may be bullish for long-term commodity prices

Q: What is driving the increased supply and decreased demand of natural gas?

Justin Tugman: When the multi-year run in natural gas prices began in 2003, demand for natural gas was rapidly increasing, but it was difficult to expand supply. External shocks to the system also contributed to the rise in prices. In 2005, Hurricane Katrina shut down a significant amount of natural gas production in the Gulf of Mexico and led to significant price spikes. Three years later, Hurricane Ike again reduced Gulf of Mexico production, but its impact on natural gas prices was more muted as economic conditions in the U.S. had already begun to weaken.

More recently, two different factors have changed the supply/demand balance. First, shale gas has revolutionised the industry, leading to significant supply growth. Shale gas historically has played a very limited role in the market, but with recent advancements in drilling techniques, it has become a repeatable, almost manufacturing-oriented source of natural gas production. As a result, the cost of production has declined, and we have seen improving and larger initial production rates, thus increasing total natural gas production. Unfortunately, production started to meaningfully accelerate at about the same time the economy started to collapse, and natural gas demand had already begun to contract as high prices led consumers to look for other more affordable energy sources, a trend that continued throughout the financial crisis.

Second, many exploration and production (E&P) companies have continued drilling on acreage they leased in 2007 and early 2008 at fairly high prices, but with short-term lease periods. This has also increased supply. These companies could either lose this high-priced acreage by not drilling or proceed to drill and maintain it, usually referred to as “held by production,” a lease provision that perpetuates the right to hold the property as long as it produces a minimum amount of gas.

However, supply/demand fundamentals may be beginning to shift again. There was a drastic reduction in rig count, with an approximate 58% decline from 2008 to 2009. This has slowed the growth of natural gas production. More importantly, E&P companies are currently focusing more on crude oil and liquids, rather than natural gas. Both of these factors will, of course, slow supply growth.

There has also been stronger industrial demand, and some electric utilities have switched from coal to gas. This should lead to somewhat higher prices. While a return to $13- and $14-per-Mcf* natural gas prices is unlikely, we think the market bottom has been set and expect somewhat stronger pricing levels in the years ahead.

Q: Explain shale gas — is this an area Perkins is focusing on?

Justin Tugman: Shale gas is natural gas located in shale rock far beneath the earth’s surface. Shale has low permeability, so gas production in large quantities requires fracturing or “cracking the rocks” to provide permeability. Shales are different than a conventional resource base where gas is trapped in pockets in the earth’s formations. Drilling and completion of the well is typically easier in a conventional play, but output is usually smaller and less repeatable.

The industry has taken advantage of newer technology in fracturing, which creates extensive artificial fractures in the shale formations, and advanced horizontal drilling techniques to complete these wells more efficiently. As I mentioned earlier, this has led to higher initial production rates, expanded estimated ultimate recoveries (EURs) and overall stronger economics for these wells. As a result, shale gas has become a more repeatable and desired energy resource.

We have found some opportunities in this area, but many of these stocks don’t meet our investment criteria, in terms of balance sheet strength, downside price risk and reward/risk characteristics. Our focus has been on firms such as Questar Corporation (STR), historically a Rocky Mountain producer with an attractive balance sheet. While Questar has E&P exposure, its business mix provides some defensive characteristics with exposure to consistent cash flow generating midstream assets, such as pipelines. Questar has been perceived as offering predominately unconventional natural gas resources in the Pinedale/Jonah area of Wyoming. However, we believe the company has done an admirable job expanding its asset base to include several prominent shale plays, including the Bakken Shale, the Haynesville Shale and the Granite Wash.

We also think valuations have been attractive for several companies located in less sought after geographic regions with potentially significant shale deposits.

* One thousand cubic feet of gas.

Q: How do you expect shale gas to shape the natural gas segment over the longer term?

Justin Tugman: It goes back to the supply/demand dynamics discussed earlier. An increase in shale gas helps alleviate possible supply constraints. We think this should benefit long-term demand because natural gas will be a more reliable resource of energy. For example, in the earlier part of the decade there was greater emphasis on using natural gas-fired electric generation. This made sense given attractive natural gas prices at the time, but as demand began to exceed supply, prices spiked higher.

The potential risk of this type of price volatility is completely unpalatable to utility companies and particularly industrial consumers. Advancements in shale gas production should lead to a more stable supply and price environment. As utility firms continue to become more comfortable with supply levels, we expect a growing number to look to natural gas to meet their electric generation needs. Likely climate change regulation will probably also further increase demand as coal is de-emphasized.

Q:The large majors have significantly underperformed over the past 18 months. Has this offered potential buying opportunities ?

Justin Tugman: The large majors are the bigger energy companies everyone is familiar with, firms such as Exxon Mobil Corporation (XOM), BP p.l.c. (BP) and Chevron Corporation (CVX). These are usually large integrated companies that operate worldwide and focus on all aspects of oil and gas production and distribution. This group outperformed in 2008 and early 2009, but they have underperformed for the past year and a half as investors shifted to more aggressive stocks with greater upside potential.

We believe some of the majors are attractive for several reasons. First, these companies generate a lot of free cash. Second, they offer healthy dividends which improve their return profiles. And third, valuations are very depressed compared to historical norms. For example, Exxon has traded at market multiples close to the S&P 500. It is now trading at approximately a 40% discount, and we expect those valuations to recover over time.

A primary driver of recent underperformance is concern about these companies' ability to generate production growth. To be fair, the majors do face challenges in this area, but we think they are making decent strides in terms of growing production, typically anywhere from 1-3%. These companies, however, could be more aggressive with mergers and acquisitions, particularly as more of the world's resource bases become controlled by national oil companies.

Looking at Exxon again, many investors did not like its acquisition of XTO Energy Inc. (XTO), an onshore U.S. natural gas producer. However, with the recent events in the Gulf of Mexico, this now looks like a very shrewd deal, especially if natural gas prices have in fact bottomed out.

Q: While there are still a lot of unanswered questions about the oil spill in the Gulf, what type of long-term impact do you think it will have on the industry?

Justin Tugman: It's not exactly clear what happened at this point, but there is a growing consensus that some poor decisions on the part of the operator were made. As a result, we expect significant long-term ramifications as both the government and industry start to focus more heavily on what can be done to prevent this type of catastrophe.

Drilling costs – particularly for deep-water drilling – will most likely increase for E&P companies, as well as for the majors undertaking exploration projects in the Gulf and potentially around the world. There will also probably be longer drilling times, which further increases costs.

Rig operators will most likely face higher costs as well, and there probably will be more safety procedures and greater redundancy with safety equipment. This could offer an opportunity for firms that provide equipment to new-build and refurbished offshore rigs.

Longer drill times, more equipment and increased regulations may decrease some industry economics short term. As such, some exploration and development projects that had marginal economics prior to the spill may no longer be attractive and thus abandoned, further limiting supply growth. Over time, however, we think this will actually be bullish for commodity prices.

Q: Given all the changes in the sector, is Perkins approaching energy stocks differently?

Justin Tugman: Our investment process hasn't changed, and we continue to apply the same disciplined, research-driven methodology that has served our investors well in the past. As we evaluate energy firms, we closely examine these companies from two perspectives.

First, we focus on downside risk by assessing a range of probability-weighted scenarios. We try to determine maximum risk exposure in a trough environment for each prospective investment. We then weight that based on a combination of estimates for earnings before interest, taxes, depreciation and amortization (EBITDA), which usually incorporates an outlook for current and future commodity prices.

We also examine how very depressed commodity prices could affect company reserves and assets – essentially a “cycle over” scenario – and weight those appropriately based on where we think we are in the business cycle. This helps us develop a realistic downside target.

Second, we assess upside potential by determining what company reserves would be worth in a much higher commodity price scenario, coupled with our EBITDA estimates. We weight these potential valuations based on the current business cycle as well. This upside target typically also includes an analysis of potential undiscovered or unbooked reserves, using estimates of fair market value based on what public and private companies have paid for these types of assets in a particular geographic region.

Our focus remains on high-quality firms with strong balance sheets and solid free cash flow generation. In the case of smaller E&P companies, we focus on those that don’t materially overspend cash flow to fund capital expenditures, decreasing their need to be reliant on the capital markets for future success. If a stock meets our criteria in these areas, we then assess its reward/risk ratio. Using this strict valuation process, we have identified some very compelling investment potential in the sector. Looking ahead, we think energy will remain a good place to be for value investors.

About the Featured Analyst

Justin Tugman, CFA

Justin Tugman joined Perkins in June 2004 as a research analyst covering the energy and utilities sectors. In March 2009, Mr. Tugman's role was expanded to also include serving as Co-Portfolio Manager for the Perkins Small Cap Value strategy. Prior to joining Perkins, Mr. Tugman worked at Simmons & Company International as an analyst covering the energy sector during his four-year tenure at the firm. He received his bachelor of science degree in finance from the University of Wyoming and an MBA, with a concentration in finance, from Tulane University. He holds the Chartered Financial Analyst designation and has 10 years of financial industry experience.

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