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**EOG Resources Inc**  EOG

**EOG's consistent execution and attractive assets position the firm for strong growth.**



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**Investment Thesis** 03/13/2015

Around the middle of 2011, the Eagle Ford took the lead-dog position in EOG's portfolio from the Bakken and hasn't looked back. Eagle Ford production increased over threefold from early 2012 to 2014, thanks to EOG's enviable position in the sweet spot of the oil window and improvement in drilling and completion methods that have helped the company deliver ever more impressive well results. With more than 10 years of remaining drilling inventory and an innovative crude-by-rail system helping to optimize prices, we don't expect EOG's Eagle Ford production to slow anytime soon. All this isn't to suggest that old man Bakken is dead. Down-spacing and secondary recovery efforts look promising and should help extend the productive life of this field. Beyond these two giants, EOG remains active in multiple fields across the Permian and continues to look for new horizontal liquids plays in and outside the U.S.

EOG's liquids-rich assets--almost all of which have been proved up and captured since 2006--include dominant acreage positions in the Bakken/Three Forks and Barnett Combo plays and strong footholds in the Eagle Ford and Niobrara regions. EOG also holds oil-rich acreage in the Permian Basin (including its Leonard combo and Wolfcamp positions). We believe EOG's liquids-rich portfolio will generate the majority of the company's incremental production growth over the next handful of years, with especially strong contributions from the Eagle Ford region. Niobrara is a bit of a wild card for EOG, given the company's modest drilling activity to date, although with 215,000 net acres in this play and attractive preliminary well results, EOG is well positioned to ramp up activity should the economics prove compelling.

EOG's gas assets include its substantial legacy position in the Barnett Shale, which should continue to generate strong production despite its relative maturity, as well as sizable acreage positions in the Horn River in Canada, the Haynesville/Bossier plays in eastern Texas and western Louisiana, and the Marcellus Shale in Pennsylvania. The firm is unlikely to commit any meaningful amount of capital to these plays until gas prices recover, however.

**Economic Moat** 03/13/2015

The competitive advantage of E&P firms largely stems from the quality of their assets. In particular, we consider the rates of return of wells drilled on the company’s acreage as well as the number of potential drilling locations remaining. The former depends on the productivity of the well as well as the cost of drilling and operating it. Hydrocarbon flow rates are primarily a function of the underlying geology, but the company’s completion methodology will also have an impact. Typically, more aggressive completion techniques will boost productivity but at a greater cost; management will seek to optimize these variables to maximize return. Other factors influencing the cost of a well include drilling cost, royalty rates, leasehold outlays, production taxes, and lifting expenses. EOG's portfolio of low-cost positions in major plays throughout North America should help drive strong revenue and profit growth and, in our opinion, merits a narrow moat rating.

EOG's liquids-rich assets are relatively early in their production life cycle, with ample remaining drilling opportunities, and include close to 600,000 net acres in the Williston Basin targeting the Bakken and Three Forks formations, 300,000 in the North Barnett combo, 624,000 in the Eagle Ford oil play, 423,000 in the Permian Basin, and 215,000 in the emerging DJ Basin Niobrara region. EOG's dominant, first-mover positions and extensive history in the Bakken and North Barnett fields should translate into meaningful contributions from these plays over the next several years, with the Eagle Ford and Permian ramping up significantly. EOG's sizable Niobrara acreage could ultimately become a core area if the company can make it work, despite this play's minimal current production.

EOG's gas assets include 127,000 net acres in Horn River, 143,000 in the Haynesville/Bossier region (the majority of which is early-mover acreage in the Texas "sweet spot"), and 208,000 net acres in the Marcellus. We think Haynesville/Bossier, especially, has the potential to be a driver of EOG's results longer term, although as long as gas prices remain depressed, production should stay relatively flat.

[**Valuation**](http://quicktake.morningstar.com/StockNet/StockValuation.aspx?Country=USA&Symbol=EOG&culture=en-US) 03/13/2015

We are lowering our fair value estimate for EOG to $75 per share from $100, after incorporating the firm's fourth-quarter results and management's updated drilling plans and outlook for 2015, which call for a sharp reduction in activity across a number of EOG's operating areas in response to less-than-favorable oil and natural gas prices. We have updated our midcycle price forecasts for oil and natural gas, which are reflected in our price deck after 12 forward quarters of strip pricing, to lower price points of $69 (from $90) and $4.00 (from $5.40), respectively. Our fair value estimate implies a forward 2015 enterprise value/EBITDAX multiple of 11.5 times and is based on our five-year discounted cash flow model and an assessment of trading multiples, comparable transactions, and longer-term resource potential. We project average daily production of 3.6 billion cubic feet of equivalent in 2015, 3.7 bcfe in 2016, and 4.1 bcfe in 2017, with EOG's liquids production growing at a 12% compound annual rate over this period. We expect the Eagle Ford and Permian to drive most of EOG's oil and natural gas liquids production growth. In the Eagle Ford, we expect EOG to increase net production by more than 150 mboe/d from 2014 to 2017, reaching 390 mboe/d. In the Permian, we forecast a rig count of 10 by 2017, with production increasing to 77 mboe/d. We project EOG's EBITDAX to reach $4.8 billion in 2015, $6.0 billion in 2016, and $7.7 billion in 2017, driven by strong production growth. EOG's hedges cover only a modest portion of our projected volumes, exposing the firm's cash flows to oil and gas price movements. Because EOG's portfolio contains acreage positions with significant resource potential that will take time and investment to convert to cash, we also consider longer-term reserve growth potential and the marketplace for these reserves in our valuation. Our analysis indicates that proven reserves could climb from 15 trillion cubic feet equivalent at the end of 2014 to 20.0 tcfe by 2017. This growth trajectory in proven reserves and greater ultimate resource potential--considered within the context of historical marketplace transactions (on an EV/reserves basis)--supports valuation in line with our fair value estimate.

**Risk** 03/13/2015

EOG's biggest risk is a substantial and prolonged drop in oil and gas prices, which would depress profits, slow development plans, and reduce the value of its properties. Other risks include infrastructure bottlenecks that could reduce drilling activity or lead to lower selling prices, higher services costs given tight supply in emerging plays, and headwinds from Washington, D.C.--including budget proposals and stricter environmental regulations--that could eat into profitability.

**Management** 03/13/2015

EOG is led by Bill Thomas, who has more than 30 years of service with the company. He was named president in February 2011 and took over as CEO in mid-2013.

EOG has demonstrated good stewardship over the years, with reasonable management compensation packages closely tied to returns on capital, a steadily increasing common stock dividend, and encouragement of equity ownership by key individuals through options issuance. Long-term incentives, such as performance and restricted stock, tend to weigh heavier in EOG's total executive compensation than its peers, encouraging greater alignment in the interests of officers and stockholders. EOG's executives currently less than own 1% of the common stock. We believe investors would benefit from greater and more consistent disclosure, however, especially regarding average operating metrics across certain plays.

**Overview**

**Profile:**

EOG Resources explores for, produces, and markets natural gas and oil primarily in North America, with additional operations in Trinidad, the United Kingdom, and China. The company focuses on horizontal drilling in unconventional plays. At year-end 2014, EOG's proven reserves totaled 15 trillion cubic feet of natural gas equivalent, with daily production of 3.6 bcfe. Natural gas made up 38% of production and 36% of reserves.

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