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Buying a Hot Energy Stock on a Dip

XTO Energy is aggressively expanding its natural-gas reserves, and the recent high-flyer currently looks cheap.

By Naureen S. Malik

FINDING NEW RESERVES is one of the toughest challenges facing the oil and gas business throughout the world. But in the U.S., natural-gas explorers have been making the biggest discoveries in 50 years.

And XTO Energy, (ticker: XTO), a fast-growing onshore natural-gas producer, is operating in hot spots in states including North Dakota, Texas, Pennsylvania and Arkansas. About 15%-20% of this year's production will come from crude oil.

The company's fortunes and share price have been fueled by the 57% rise in price of natural gas and 70% gain in crude oil over the past year.

To continue to fuel its double-digit production growth, XTO has been going on an acquisition binge this year. In 2008, the company has spent more than $8 billion purchasing reserves, double the record amount it spent on deals last year.

Higher production rates along with robust commodity prices and operational synergies gained from XTO's acquisition of Hunt Petroleum and reserves of Bakken Shale (mainly oil) in North Dakota will help drive earnings growth over the next several years.

Not surprisingly, XTO shares are up 22% over the past 12 months, slightly ahead of the Dow Jones U.S. Exploration & Production Index's 19% gains.

However, the stock has staged a dramatic pullback in recent weeks, falling 27% since touching a record high of $73.74 on June 18, in part due to the recent acquisitions and volatile commodity prices. In fact, XTO fell 7% today to $54.14, hurt by a third straight decline in oil and natural-gas prices.

That makes XTO's stock, trading 12.7 times 2008 and 9.5 times 2009 earnings estimates, attractive given its growth projections. It was a $2 billion stock in 2001 and is now valued at close to $30 billion.

Geoffrey Jones, senior E&P energy analyst at Baron Capital, says the market is now valuing XTO shares based on natural gas priced at around $7.50 per thousand cubic feet equivalent (Mcfe). That's a rather deep discount to today's closing price of $10.53.

XTO's projects are still economical at $6 natural gas, adds Jones. About 60% of 2008 production is hedged (above $8 per Mcfe) and $10% of 2009 production (above $10).

Certainly, the continued decline in commodity prices will pressure XTO's growth and curb profits, as could delays on projects, higher costs or labor issues. Fadel Gheit, managing director of energy research at Oppenheimer, says XTO is "one of the fastest growing companies in the history of the industry," but that an overdue commodity correction will pressure shares.

Still, Sterne Agee analyst R. Michael Henzi wrote on June 10 that XTO's revenues should grow from $6 billion over the past 12 months to $10.5 billion in 2009 and $12.7 billion in 2010. His projections are based on natural gas in the $7-range and $105-to-$110 oil.

XTO should continue to distinguish itself as one of the lowest-cost producers, and with plans to increase production 28%-30% this year and 20% in 2009.

Jones expects double-digit product growth at XTO for the next five years compared to low-single-digit growth in the industry and possibly negative growth at major integrated companies. He values the stock at $90 based on XTO's current reserves.

Energy insiders and Wall Street alike pay homage to XTO's chief, Bob Simpson, for guiding the company through disciplined but explosive growth. (See Barron's, "Finding the Right Rock," Sept. 10, 2007.)

Simpson "is a proven money maker in the oil patch, and I have every reason to believe that he is going to continue to do smart acquisitions and allocate capital to the drilling program prudently," Jones adds.

These days, the industry is all about shale, the hard-to-crack rock with large pockets of natural gas and sometimes oil, that was uneconomical to mine until the emergence of more sophisticated drilling processes and technology in recent years.

CEO Simpson tells Barron's Online, "We are having [natural gas] discoveries the size of which you haven't seen for 50 years in our business." The Barnett Shale located in Texas, where XTO is the largest producer, could be "one of the greatest gas fields ever found" with potentially 50 trillion cubic feet of reserves. In the past, reserves of one-to-two trillion cubic feet were considered big finds.

Simpson says greater supply visibility created by new reserves could expand market demand for the gas.

Simpson expects oil to stay above $100 a barrel and notes that natural gas, which has historically sold six times less than oil, is trading at a wider discount of 12-13 times.

XTO willingly paid close to $4 per Mcfe of reserves for the Hunt and Bakken shale acquisitions because they complemented its current operations. Prior to the commodity run-up, deals were being minted closer to $3 per Mcfe.

Rather than chasing after "the cheapest acreage [of newly discovered shale plays] they would rather come in a little later and coax more resources from the ground," says Chris Pikul, senior E&P energy analyst at Morgan Keegan.

Known for being able to double output from acquired reserves, he says the company is now "approaching tripling the reserves on the average acquisitions" by putting industry veterans on those fields and leveraging its technical expertise.

XTO's finding and development costs for reserves, including acquisitions, averaged $1.59 per Mcfe over the past five years.

Through the Hunt acquisition closing later this year, XTO will gain offshore assets in the Gulf of Mexico, a veritable cash cow, and small exposure to the North Sea.

Tristone Capital analyst Joe Magner, says XTO can generate free cash flow yield of 40%-45% next year, giving it a great deal of flexibility to pay down debt and pursue additional acquisitions.

Despite the volatility in commodity prices, XTO's growth and strong execution could make its stock piping hot again.

At a Glance

XTO Energy (XTO) [xto]

Stock Price:	$54.14
52-Wk High:	$73.74
52-Wk Low:	$40.40
Market Cap:	$27.7 billion
Est. 2009 EPS:	$5.68
2009 P/E:	9.5x
Est. Long-Term EPS Growth: *	11%
Est. ('09/'08) EPS Growth:	33%
Revenue (trailing 12 months):	$6.02 billion
Dividend Yield:	0.8%
Chief Executive Officer:	Bob R. Simpson
Headquarters:	Fort Worth, Texas

* Based on analyst estimates looking ahead three to five years.
Sources: Thomson Reuters, Barron's Online