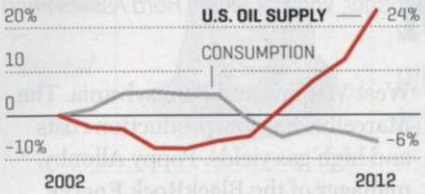
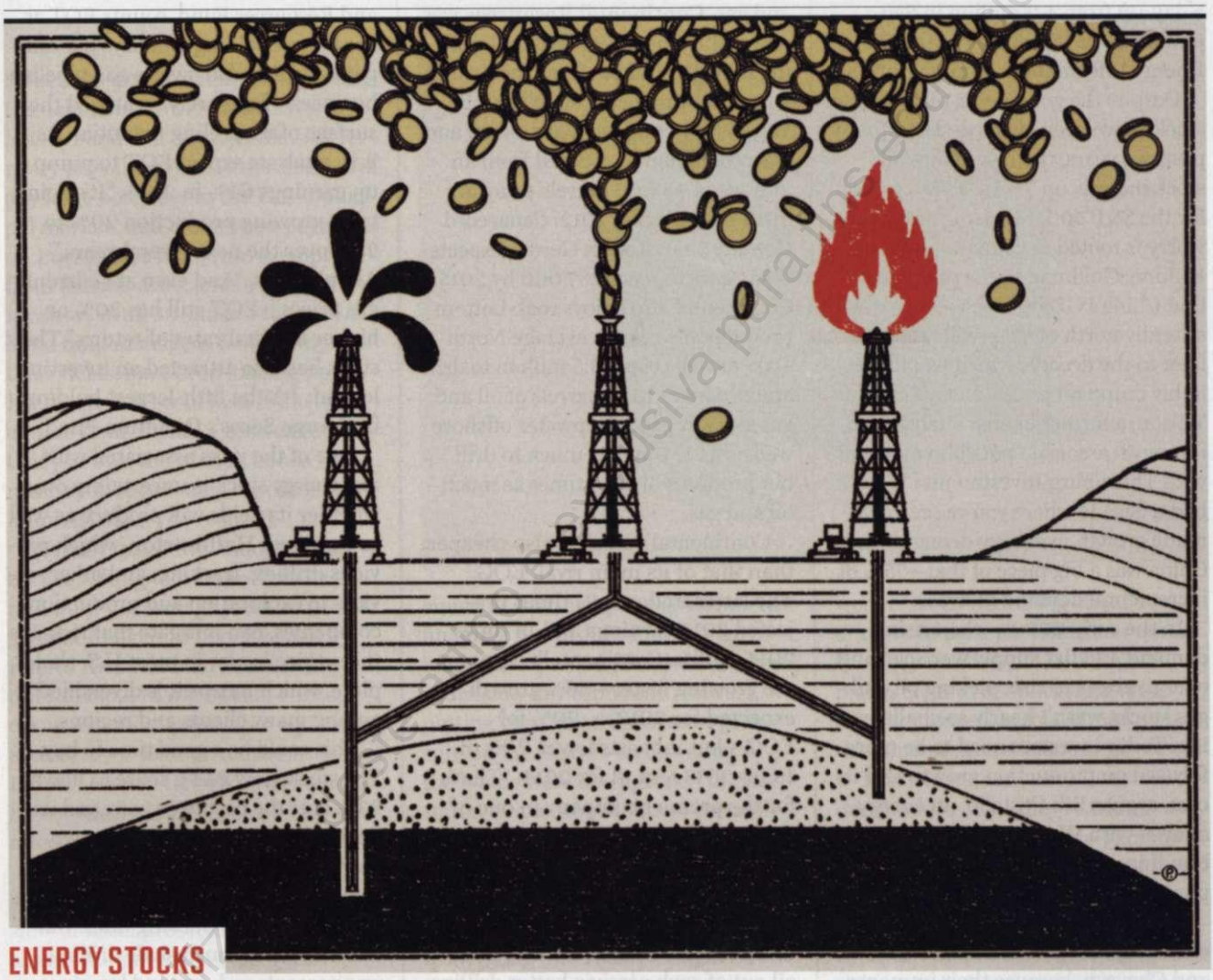
THE NEW OIL GAP

Fueled by new drilling techniques, U.S. production has surged even as consumption has fallen. Robust demand in Asia, though, has kept prices high.



INVEST



ENERGY STOCKS

Seeking a Gusher in U.S. Oil and Gas

The industry is thriving—but stocks are lagging. We've found three good opportunities for investors. *by Jon Birger*

GRAPHIC SOURCE: EIA

THESE SHOULD BE good times for North American oil stocks. Petroleum prices have been hovering between $90 and $100 a barrel for the past 2 1/2years and recently pushed past $105. Thanks to advances in hydraulic fracturing and horizontal drilling, American shale-oil fields such as the Bakken

"When you go from drilling hundreds of wells a year to drilling thousands, it's like running an army."

—Shawn Reynolds, manager, Van Eck Global Hard Assets Fund

in North Dakota and the Eagle Ford in Texas have reversed what had been a two-decade decline. U.S. production now stands at 7.1 million barrels a day, up from 4.2 million in September 2005, according to the U.S. Energy Information Administration.

Despite the good news, oil and gas stocks have been laggards. Over the past two years, the Dow Jones oil stock index is up 7% vs. a 25% gain for the S&P 500. Much of the current worry is rooted in Chinas slowdown. In June, Goldman Sachs predicted that China's GDP growth—once consistently north of 8%—will fall to 6% later in the decade, which would inevitably crimp oil prices. Notes Charlie Wilson, a former energy analyst who is now an associate portfolio manager with Thornburg Investments: "You've had a decade where you've seen dramatic growth in energy demand, and China was a big piece of that—75% of incremental demand at times."

In the early 2000s, when rising demand and flat supply were causing energy prices to rise, picking oil and gas stocks wasn't nearly so challenging. Today investors need to be more focused on production growth and its cost, argues Bill Costello, an energy analyst with Westwood Funds: "Bottom line, you want to own the companies with the premium acreage."

That suggests avoiding the so-called supermajors like Exxon Mobil and Chevron, because their immense size makes production growth expensive and risky. For example, Royal Dutch Shell has so far invested $6 billion in offshore Alaska but has yet to drill a single well. The supermajors do still provide income (Shell has a 4.7% yield). But for investors seeking total return, small and midsize peers, for whom the addition of 50 onshore wells can have a real impact on earnings, are more likely to deliver.

The three stocks we're recommending are all big players in U.S. shale oil and gas. Continental Resources was one of the pioneers of shale-oil drilling in North Dakota (now the second-largest oil-producing state behind Texas). The company's annual oil and gas production has soared from an average of 43,000 barrels a day in 2010 to 98,000 in 2012. Canaccord Genuity analyst John Gerdes expects that figure to reach 187,000 by 2015. Continental also enjoys rock-bottom production costs. Its average North Dakota well costs $8.5 million to drill and produces 1,125 barrels of oil and gas a day. A good deepwater offshore well costs 17 times as much to drill but produces only 10 times as much oil and gas.

Continental's stock is also cheaper than that of its main rival, EOG. The latter trades at 21 times projected 2013 earnings and 18 times 2014 profits. Continental's earnings are growing faster—56% growth expected for 2013 vs. 20% for EOG—but it boasts lower P/Es of 18 for 2013 and 13 for 2014. "That's for the premier company in one of the biggest oilfields ever discovered," says Mike Breard, an energy analyst for Hodges Funds, a large Continental shareholder. Breard adds that the company has been squeezing more oil out of each acre via better drilling.

In contrast to oil companies, U.S. natural-gas producers have suffered. Prices for gas have fallen 66% since June 2008, taking profits with them, as supply has soared. Still, there are pockets of significant earnings growth in natural gas, and EQT is one of them. EQT owns 565,000 acres in the Marcellus Shale in West Virginia and Pennsylvania. The Marcellus has low production costs and high gas yields. Poppy Allonby, manager of the BlackRock Energy and Resources Fund, counts EQT as her largest holding. She says the company—which also owns a gas-pipeline business—has barely scratched the surface of its drilling potential. As it is, analysts expect EQT to pump up earnings 64% in 2013. "It's going to be growing production 20% to 25% over the next several years," Allonby says. "And even at [current gas prices], EQT still has 20% or higher internal rates of return." The stock has also attracted an investing legend: It's the fifth-largest holding in George Soros's Quantum Fund.

One of the risks associated with any energy stock is uncertainty over whether its fields will produce as well as expected. Halliburton, which provides drilling, tracking, and other services to exploration and production companies, can mitigate that risk. It's the service leader in most U.S. shale plays, which means it is diversified among many clients and regions.

This could be a good time to buy. The stock, now $44 a share, is down 23% over the past two years, and its forward P/E ratio—in the 20s two years ago—has fallen to 14. The reason: A glut of new oilfield service providers depressed tracking rates. But that was when much shale drilling was nascent, and demand has since exploded. "When you go from drilling hundreds of wells a year to drilling thousands, it's like running an army," says Shawn Reynolds, manager of Van Eck Global Hard Assets Fund, which has a 4.2% position in Halliburton. "You need someone who can organize that, and you need someone with the latest and greatest technology."

Fonte: Fortune, Amsterdan, v. 168, n. 3, p. 19-20, 12 Agu. 2013.