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More Red Flags on Fracking:
Weak Third-Quarter Results as Cash Losses Persist Even With Production and Price Increases

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December 2018

Key Findings

- Even with a production boom and the highest prices since 2014, US fracking-focused oil and gas companies continued their nine-year losing streak through Q3, 2018.
- The 32 mid-size U.S. exploration companies included in this review reported nearly $1 billion in negative cash flows through September.
- Falling oil prices and rising interest rates will pose additional financial challenges to the industry in Q4.

Analysis of Third-Quarter Results

Even though oil prices rose and oil and gas production boomed during the third quarter of 2018, the U.S. fracking sector continued its nine-year streak of cash losses.

A cross-section sample of 32 publicly traded fracking-focused companies spent nearly $1 billion more on drilling and related capital outlays during the quarter than they generated oil and gas sales.

These results may come as a surprise to investors who incorrectly equate rising output with financial success. U.S. oil and gas production hit an all-time high during the quarter, even as oil prices rose to $70 per barrel, their loftiest level since late 2014. Even with those advantages, our sample of mid-size oil and gas producers continued to hemorrhage cash due to the high cost of drilling and the industry's seemingly insatiable thirst for capital.

This analysis of third quarter results is part of our ongoing research of the fracking industry and is focused specifically on cash flow.

Though disappointing, the Q3 results represented an improvement over the first half of the year, when the same set of companies bled a total of $3.9 billion. Four of the 32 companies that were cash-flow negative in Q2—Anadarko Petroleum, Devon Energy, QEP Resources, and Range Resources—moved into the black in Q3. Similarly, the first nine months of 2018 represented an advance over 2016 and 2017, when these same 32 companies racked up negative free cash flows of $11 billion and $7.2 billion, respectively.

Still, only 10 of the 32 companies secured positive cash flows for the quarter, and only eight generated positive cash flows over the trailing 12-month period.

The inability of fracking-focused companies to generate consistent free cash flows, even with soaring production and higher oil prices, raises a critical question: will these companies ever produce enough cash from oil and gas sales to cover their capital outlays? Only when they do that will the industry have any hope of paying back its sizable debts—or of producing robust rewards for equity investors.

Moving forward, the drop in oil prices in recent weeks poses additional financial challenges to the industry. From Oct. 1 through the end of November, the U.S. benchmark price for a barrel of oil dropped to $51from $75, a precipitous 32 percent plunge. Considering how fracking companies generated negative free cash flows while Q3 oil prices averaged $70/barrel, cash flows likely will turn even more negative in Q4.

Rising interest rates raise another red flag for the debt-fueled sector. Companies that issue below-investment-grade debt, which includes nearly all of the 32 companies in our sample, have benefited from a long period of low interest rates. But rates are creeping higher. The five-year U.S. Treasury yield, which began 2018 at 2.25 percent, has risen to 2.9 percent. Meanwhile, the "spread," or interest premium, for high-yield debt has widened by nearly a percentage point over the past two months. The double-whammy of higher rates and wider high-yield debt spreads could increase interest costs for fracking companies, placing additional demand on the sector's cash flows.

Financial stresses have already pushed many oil and gas companies into insolvency. By the end of August, more than 160 oil and gas firms holding a combined $100 billion in debt had filed for bankruptcy since 2015. Recent cash flow trends suggest that these bankruptcies could continue.

Stock market investors have become keenly aware of the financial risks facing fracking companies. The VanEck Vectors Unconventional Oil and Gas Fund (an exchange-traded fund that trades under the symbol FRAK)—trails the S&P 500 by more than 20 percent for the year. Much of the fund's underperformance started at the end of September as the market absorbed disappointing third-quarter results, even as oil prices fell by nearly a third.

Investors would do well to continue to regard the oil and gas industry with a wary eye. Until the fracking sector as a whole can reliably produce cash, money managers should view industry as a risky and highly speculative investment.

Data and Methods

This report tracks the financial performance of 32 U.S.-focused oil and gas exploration and production companies. The analysis started with the list of stocks held as components of the SPDR S&P Oil & Gas Exploration & Production ETF (ticker symbol XOP), and then excluded companies that:

- Lacked comprehensive income or cash flow data for 2010 through 2017;
- Declared bankruptcy at some point between 2010 and the second quarter of 2018;

- Derived a significant share of their revenues from midstream (transportation) or downstream (refining and petrochemicals) operations; or
- Had significant revenues from exploration and production operations outside the U.S.

The final list includes the following 32 U.S.-focused oil and gas exploration and production companies. All financial data are taken from Morningstar Research.

Data Appendix

Free Cash Flow by Company, by Quarter

Company	Symbol	2017 Q4	2018 Q1	2018 Q2	2018 Q3
Anadarko Petroleum Corporation	APC	$ (103)	$ (117)	$ (505)	$ 33
Antero Resources Corporation	AR	(186)	(4)	(266)	(146)
Apache Corporation	APA	(95)	(262)	96	64
Cabot Oil & Gas Corporation	COG	1	117	43	(18)
Callon Petroleum Company	CPE	(72)	(19)	(79)	(41)
Carrizo Oil & Gas Inc.	CRZO	(83)	(96)	(59)	(64)
Chesapeake Energy Corporation	CHK	(185)	148	(232)	(57)
Cimarex Energy Co.	XEC	(4)	41	(43)	(66)
Concho Resources Inc.	CXO	(31)	(5)	124	(85)
Continental Resources, Inc.	CLR	237	258	11	98
Denbury Resources Inc.	DNR	58	35	69	60
Devon Energy Corporation	DVN	(743)	(34)	(107)	236
Diamondback	FANG	(162)	(147)	(192)	(173)
Energen	EGN	(3)	56	(58)	(68)
EOG Resources, Inc.	EOG	271	111	258	540
EQT Corporation	EQT	(360)	172	(328)	(253)
Hess Corporation	HES	(211)	(190)	(68)	(117)
Laredo Petroleum	LPI	(58)	(56)	(50)	(37)
Marathon Oil Corporation	MRO	(93)	(13)	129	194
Matador Resources Company	MTDR	(146)	(85)	(162)	(563)
Murphy Oil	MUR	19	5	5	129
Newfield Exploration Company	NFX	(135)	(118)	77	(26)
Noble Energy, Inc.	NBL	(160)	(204)	(499)	(110)
Oasis Petroleum	OAS	5	(26)	22	(77)
PDC Energy Inc	PDCE	(43)	(174)	(62)	(58)
Pioneer Natural Resources Company	PXD	43		(456)	(106)
QEP Resources, Inc.	QEP	(985)	(246)	(186)	27
Range Resources Corporation	RRC	(162)	62	(101)	32
SM Energy Company	SM	(121)	(161)	(275)	(80)
Southwestern Energy Company	SWN	(17)	62	(82)	(17)
Whiting Petroleum Corporation	WLL	69	55	99	(67)
WPX Energy, Inc.	WPX	(27)	(176)	(56)	(129)
TOTAL		$ (3,482)	$ (1,011)	$ (2,933)	$ (945)

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