A NEW ERA FOR HESS

Emerging from a multiyear metamorphosis and shedding its legacy downstream businesses, Hess Corp. is taking flight as a streamlined, pure-play E&P.

Hess Corp.’s new 28-story office tower in downtown Houston overlooks the city’s Discovery Green Park, a recently added oasis in the midst of gleaming skyscrapers. The park, which teems with activity, represents a rebirth for a once-stagnant part of the city. Like Discovery Green, Hess Tower signifies a rebirth of Hess Corp. as it completes a transformation from an integrated oil and gas company to a pure-play E&P.

Since the beginning of 2010, Hess has strategically sold down more than $11 billion in assets, carving off all of its legacy downstream business units and half of its global E&P operations while building a world-class unconventional business in the U.S. The sale of its retail gasoline division announced in May essentially culminates the metamorphosis. The stock is up 87% in the past 18 months.

The 80-year-old company joins a host of other integrated oil and gas companies separating exploration and production from other business units—ConocoPhillips, Marathon Oil, Murphy Oil, Williams Cos.—in an effort to capture the higher margins of a streamlined E&P, and the larger equity values bestowed by the Street. Rather than split into unique public entities as did the others, however, Hess instead sold assets for cash, and reinvested into debt repayment, upstream operations and stock repurchases.

“Starting in 2010, we took the tough medicine of pruning mature assets and reducing our exposure to downstream that’s positioned us for this great trajectory that is going to distinguish us for years to come,” said Hess chief executive John B. Hess, son of the founder. “Downstream was the right strategy at the time, but by exiting our downstream businesses and becoming a pure-play E&P, we’ll have more growth opportunities and more sustainable value creation.”

As the company approaches the first stages of a new era without refining, storage and fuel trucking as anchors, Hess sat down with Oil and Gas Investor for an exclusive interview to discuss the company’s forward strategy.

Three-pronged mission

At the depth of the Great Depression, Hess’
father Leon Hess at 19 years old began a residential fuel hauling business in Asbury Park, New Jersey, that grew to be one of the largest petroleum distribution, storage and refining companies in North America, along with retail gasoline. The iconic Hess toy truck, a decades-old traditional Christmas gift, signifies this era.

When John Hess took the helm in 1995 following his father’s retirement, he expanded the company’s global reach for the next 15 years through high-risk, high-impact exploration. “And while we found hydrocarbons and had a high technical success rate, we didn’t have a high commercial success rate,” Hess said. “We knew we had to reposition ourselves.”

Although exploration and production has been part of the integrated portfolio since the early 1970s, in 2010 the company began to put a plan into motion to become a pure-play E&P, not coincidentally shortly after Greg Hill, a veteran of Shell, joined the company as president of E&P. “There were better returns and more sustainability” in the E&P space, Hess said. The company initiated a three-pronged strategy to deliver a 5% to 8% sustained annual production growth rate through 2017 balanced among unconventional resource plays, exploitation of discovered resources, and a more focused, smaller exploration program.

That plan did not include downstream operations. The company began closing each of its refineries, and initiated a process to sell its terminal network, energy marketing and retail businesses.

The revamped Hess E&P portfolio will be more risk and growth adjusted. It will also retain its global presence. “It’s about balance,” Hess said. “In the next several years we’ll be 50% unconventional, 50% conventional; 50% onshore, 50% offshore; 50% U.S., 50% international. That change gives us lower risk and higher growth that’s sustainable. If you did just one of those, you put all your eggs in one basket. We have a strategy to position the company for superior sustainable returns over the long-term.”

As Hess refocused to upstream, it divested more than half of its existing E&P portfolio in the process. High cost, low growth and small interest assets were targeted. “Azerbaijan, as an example, was a highly profitable asset, but was very mature,” Hess said. Russia, sold for $1.9 billion, “wasn’t one of our best-return assets. We were fortunate to get a strategic price for it from Lukoil.”

Growth assets such as its Tubular Bells project in the Gulf of Mexico and the Bakken Shale are better allocations of capital with higher returns, he said. “It’s not about getting bigger; it’s about getting better.”

The unconventionals

Of the three strategic foundations set forth, Hess projected unconventional oil and liquids plays will comprise half of the company’s production profile, with half its total 2014 capex directed to unconventional assets. And with 640,000 net acres and current production in excess of 80,000 barrels of oil per day, the Bakken Shale is the cornerstone of Hess’ unconventional portfolio, as well as its highest growth asset.

While the company had a legacy position in the Williston Basin, it tripled down on the Bakken in 2010 with the acquisition of American Oil & Gas and Tracker Resources. Since, it has spent more than $2 billion annually to develop the acreage.

“We incurred debt as we built up the Bakken. Held-by-production drilling is very inefficient, and the integration cost us more than we thought it would. We had to make some...
choices.” That choice was to sell about $8 billion of mostly E&P assets with lower cash returns than the Bakken. “And look where we are today,” Hess said. “We have some of the best acreage in the Bakken that will generate cash for many years to come.”

With 17 rigs plying the play and more than 3,000 drilling locations, including the Three Forks horizons, Hess anticipates the cash burn is almost over and that the Bakken will be cash-flow positive by next year. And cost efficiencies continue to improve returns. Spud-to-spud days have improved 49% since 2011, and drill-and-complete costs are down 44%, to $7.5 million. Thirty-day initial production rates range between 750 and 900 barrels of oil equivalent per day (boe/d), while estimated ultimate recoveries are 550,000 to 650,000 boe.

“We’re one of the lowest cost operators and producing some of the best returns,” he said. “We’re practicing lean manufacturing.”

Hess upgraded its production guidance in the Bakken to 150,000 boe/d by 2018, with estimated total recoverable resources of 1.2 billion boe.

Downspacing pilots’ results govern the current rig pace. Guidance numbers are currently based on five Middle Bakken and four Three Forks wells per 1,280-acre drilling spacing unit (DSU). However, half of all wells being drilled this year are testing the equivalent of seven Middle Bakken and six Three Forks wells per DSU, with a couple of DSUs being drilled with the equivalent of nine Middle Bakken and eight Three Forks wells.

“The reason we’re not going faster on rigs is because, once you do a five and four, you can’t come back and do a seven and six,” he said. “You have to define early in the process what’s the optimum spacing and depletion plan.

“If we find that the wells are not interfering with each other, basically we just got a lot more reserves to recover. The initial returns are encouraging; we’re finding the interference may not be that great. We should know by the end of the year what the optimum depletion is for the Bakken.”

Hess counts on one productive bench from the Three Forks zone, occasionally two, with two-thirds of its acreage prospective. “We think there’s a second bench in some cases, but we’re not so sure of the economics of the third or fourth benches. In many cases we think there’s communication between the third and fourth bench.”

Early in Bakken development, Hess realized the pipeline infrastructure would lag its production growth profile, so it built its own approximately $200 million rail terminal to move product with 936 newly designed rail cars. Considering the pricing differential over the past two years, the terminal has already paid out.

“We wanted to have multiple markets to maximize the netbacks of our crude,” Hess said. “Our netback is one of the highest in the Bakken because of the market options.”

Every 14 days the cars make a round trip to the highest-value market at the time of loading, with a capacity of 54,000 barrels per day (bbl/d). Yet the company is putting more crude into pipelines now due to recent compressed price-differential spreads. “Every day we optimize the best-value market. That’s an advantage we have that other companies don’t.”

Additionally, the completion of its Tioga gas
processing plant this spring boosted liquids recovery and reduced gas flaring by approximately half. “We should be able to reduce our gas flaring to 10% or less over the next few years.”

Hess counts its 43,000 net acres in the Utica wet-gas window, being developed in conjunction with Consol Energy, in the appraisal phase and potential growth in the outer years beyond 2017. “It could be impactful,” he said. “Once we go to full development, we’ll give the dimensions on ultimate reserves and resources.”

Only one well has been in production for more than a year, but he emphasized with confidence that “the economics are going to be competitive with the Bakken.” Initial production rates are in the 1,000 to 2,000 boe/d range. Hess plans to spend about $550 million to drill 32 Utica wells in 2014.

“We love the wet-gas window there,” he said.

However, Hess sold its dry-gas Utica acreage to American Energy Partners for more than $900 million earlier this year, or for $12,500 an acre.

“A number of those wells had very good production rates, but we were better off selling it,” he said. “When we looked at allocating capital there with projected gas prices, it did not offer the same rates of return that our wet-gas Utica acreage has. We’ve got better places to put our money.”

Hess said the company is scouting for another unconventional play, but not limiting itself to the U.S. in its endeavors. “We have global capability in unconventional,” he said, “so we’re looking in China and a few other places. We have a couple of options we’re studying now. The one with the best returns will shape our future beyond 2017 to 2020.”

Exploiting successes

The second prong of the new strategy is to exploit existing discoveries, led by Tubular Bells in the deepwater Gulf of Mexico, Valhall Field in the North Sea, and North Malay Basin in the Gulf of Thailand.

“We’re investing in better growth assets, which are going from cash users to cash generators,” he noted. “So where Tubular Bells was in the investment mode, it’s going to start generating a lot of cash in the second half of this year.”

Located in Mississippi Canyon, Tubular Bells is expected to come online in the third quarter at approximately 25,000 boe/d net, with a fourth well scheduled to be drilled this year.

Redevelopment of the Valhall complex offshore Norway, operated by BP and completed first-quarter 2013, is also a forward contributor to reserves, production and cash flow. This long-life asset is expected to contribute 30,000 to 35,000 boe/d this year and up to 50,000 by 2017. Hess holds 64% working interest.

“Valhall has about 3 billion barrels of oil in place, and if you have an improvement of just 25% recovery, that’s a 500-million-barrel prize for us. And it’s low risk; it’s just drilling producing wells and getting more efficient.”

North Malay Basin comes online in 2017, adding another expected 25,000 barrels equivalent per day to the existing 45,000 the company already produces in the region. “We’ll be producing 70,000 barrels equivalent a day of natural gas from the Gulf of Thailand, which is going to be a low-cost, long-life, high-return asset that will provide a nice balance to the portfolio.”

Hess’ portfolio is stacked with additional projects shifting into full development: Denmark’s South Arne complex; Equatorial Guinea; and JDA offshore Malaysia.

“We’re trying to build a very focused portfolio of low-risk, long-life, high-growth assets. These assets will generate cash flow for the next 20 years, which is quite unusual in the E&P business.”

Going long

Global exploration remains a pillar of Hess’ forward plan, but with less geographic diversity and more partnerships to mitigate risk. Hess will spend $550 million in 2014 on exploration, out of a total $5.8 billion budget, concentrated in four geographic areas: deepwater Gulf of Mexico, offshore West Africa, Kurdistan and Malaysia.

“We cut back on exploration to bring more focus and manage the risk better going forward,” Hess said. “We used to spend about $1 billion a year on exploration, and it wasn’t as successful as we would have liked. It was too risky. We want to build a portfolio that has lower risk, higher growth and more sustainabil-
ity for the long term.”

Exploration projects are not counted in Hess’ near-term growth targets, but in years beyond 2017.

In the Gulf of Mexico, Hess anticipates sanctioning its Stampede discovery by year end, a Miocene target like Tubular Bells. “That’s a multi-billion dollar investment that should give us production for future growth. Going forward, the deepwater Gulf is going to speak for a decent amount of our exploration capital.”

Tano Cape Three Points features seven discoveries offshore Ghana, with three appraisal wells planned starting this year. And Hess is testing two onshore Jurassic licenses in Kurdistan, with one well down to date. “We should have a definition if that’s a commercial development by next year. Kurdistan is still a very underdeveloped petroleum province.” He points to eight nearby discoveries with 200 million boe each.

Hess believes the company’s operating expertise gives it an advantage in partnering in the best exploration projects.

“We’re developing, drilling and producing some of the lower-cost wells in the areas where we do business. The numbers prove it.

“In Tubular Bells, Chevron supported us as operator because of our performance. Shell has supported us in the deepwater Gulf as well. In the Gulf of Thailand, Petronas has us jointly operate with them in the Joint Development Area (JDA). They didn’t pick a major or national oil company. So our operating capabilities give us access to good, sustainable, superior return opportunities.”

Shareholder response

Like a number of other oil and gas companies, in early 2013, Hess became the target of an activist shareholder and a proxy fight ensued. Although the transformation had begun three years prior, hedge fund Elliott Management wasn’t satisfied with the progress and sought five seats on Hess’ board of directors. Unlike the fate of some other targeted energy companies, though, Hess worked a compromise. That deal added three Elliott nominees to the board.

Hess emphasized the decisions made represented the best interests of all shareholders.

“This is a carefully structured strategy that’s been given a lot of thought, and is not something that happened overnight as a result of an activist. Certainly, as a result of the events last year, we accelerated a number of things.

“It’s important to know that the plan put in place has the unanimous support of our board, including the three members that were nominees from Elliott. That tells you something. Our shareholders today are benefitting from that plan.”

Financial strength

The $11 billion Hess generated from asset sales has first gone to pay down $2.4 billion of short-term debt and fund a $1 billion cash-flow deficit in 2013, with an additional $1 billion maintained as a cash cushion on the balance sheet. Its debt-to-capitalization ratio is now down to 18%.

Excess proceeds from divestitures were used to support a $4 billion share repurchase program that the company announced in 2013, which was increased to $6.5 billion this year following the sale of its retail business. Thus far, Hess has bought back more than $2.8 billion of shares. It also increased its dividend by 150% last year. Further, Hess anticipates generating excess cash flow next year, giving the company added financial flexibility.

One other asset monetization remains on the sale block toward completing the transformation—Hess’ Bakken midstream infrastructure, expected in 2015. The sale will likely be via the formation of a master limited partnership, in which Hess will maintain operating control.

“We don’t want to be shutting in oil production because someone else is holding the MLP,” he said. “At the end of that, the portfolio restructuring is done, and then it’s a matter of optimizing our portfolio on an ongoing basis. We’ve gone from a period of portfolio restructuring to executing the portfolio we’ve assembled to generate the growth profile and cash generation we put forth.”

Balance is the theme, he said, both in terms of conventional and unconventional, and also in terms of generating growth and cash returns.

“This is the journey we’ve been on. The company is in a great position today to offer a unique value proposition of superior sustainable returns. It’s going to have a strong balance sheet for long-term growth in production. I see this as a viable strategy going into 2020.”

But the burning question remains: Will the Hess toy truck survive the transformation? “Yes, it will,” Hess said. “It’s a tradition that brings smiles to many kids’ faces, and it’s a tradition that will continue.”