Devon Energy Corporation (NYSE:DVN)

The Babson College Fund is initiating coverage on DVN with a **buy** rating and a $78 target price, representing a potential upside of 43%.

Company Overview:

Founded 1971, HQ: Oklahoma City, OK

An independent energy company, Devon Energy, explores for, develops and produces –

1) Oil
2) Natural gas
3) NGLs (Natural Gas Liquids)

assets onshore in the U.S.

Devon's primary productive assets are in the Eagle Ford, Powder River Basin, Anadarko Basin, Williston Basin and Delaware Basin.

As of		12/2/2022	
Stock Rating |			
Price Target			$78
Current Price			$54.11
Upside			43%
Consensus			$57
Key Statistics			
52-Wk Range		$19.00	$55.00
Avg. Daily Vol in MM			11.50
Market Value (MM)			$36,633
Ent Value (MM)			$41,225
Shares Out (MM)			677
Dividend Yield			7.00%
Beta 5y			1.44
% Short Interest of float			2.6%
Insider Buying			1.0%
Share Price	**1M**	**3M**	**12M**
DVN	9.0%	29.6%	187.8%
S&P 500	-5.1%	-5.3%	13.9%
XLE	11.7%	24.0%	65.0%

Investment Thesis:

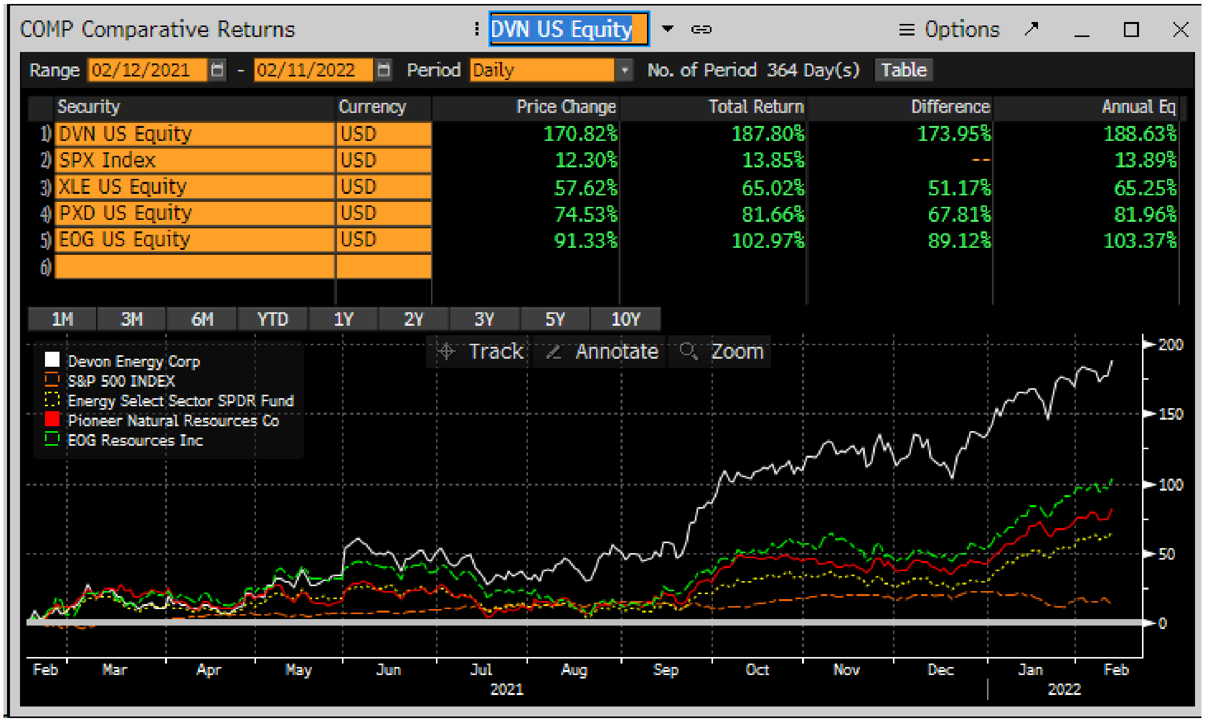
1) Devon has one of the lowest oil & gas hedges among its peers for 2022 – a substantial advantage against the backdrop of rising oil & gas prices
2) Devon has identified greater than 10 years of development inventory, giving it the optionality to engage in additional production should higher oil prices persist
3) Devon's cash return business model significantly de-risks long-term industry uncertainty

Valuation:

Our weighted average target price of $78 for Devon Energy is derived from a discounted cash flow analysis (50% weight) and a comparative company analysis (50% weight).

Valuation Summary		
	Price	% Weight
CompCo	$82	50%
DCF	$74	50%
Target Price		**$78**
Current Share Price		$54.1
Upside		**43%**

Comparative Returns (LTM):



Company Overview and Portfolio:

Headquartered in Oklahoma City, Devon Energy is a Fortune 500 company and is included in the S&P 500 Index and our XLE benchmark.

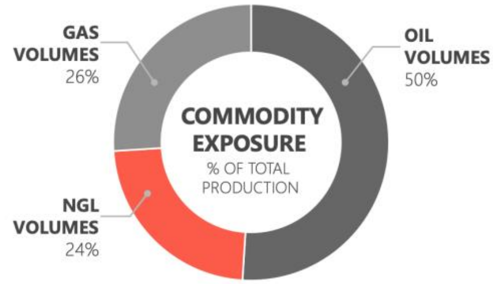
Devon Energy Corporation operates as an independent energy company that is involved primarily in oil and gas exploration, development and production, the transportation of oil, gas and NGLs and the processing of natural gas. The company also has marketing and midstream operations that include gas, crude oil and NGLs. Devon's operations are focused onshore in the United States.

Devon's business strategy is focused on delivering a consistently competitive shareholder return among their peer group. Devon boasts proved developed and undeveloped reserves of nearly 180 million barrels of oil - equivalent to about 2300 net producing wells. In 2021, Devon and WPX completed an all-stock merger of equals.

Devon has five key areas of operations, with the Delaware Basin accounting for about ~70% of total production volumes. Devon's operations in the Delaware Basin of southeast New Mexico and west Texas, with current focus in the oil-rich Wolfcamp, Bone Spring, Leonard and Delaware formations, provide both oil and natural gas production from its core acreage position consisting of approximately 400,000 net acres. Horizontal drilling with extended-reach laterals and multi-zone developments are being used to unlock the vast resource that still remains in this historic oil and natural gas field.

Oil accounts for ~50% of total production volume at DVN, natural gas accounts for ~25% of total production volume, and NGLs account for the remaining ~25% total production volume.

DVN Production Assets	MBOED	% of total production
Delaware Basin	409	68%
Anadarko Basin	75	12%
Williston Basin	58	10%
Eagle Ford	42	7%
Powder River Basin	20	3%
Total	604	100%

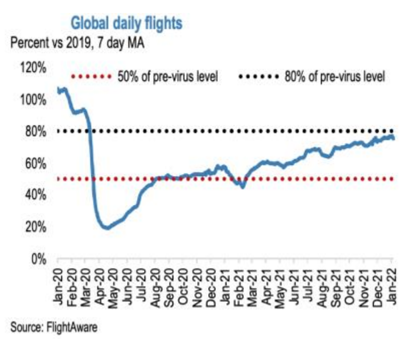


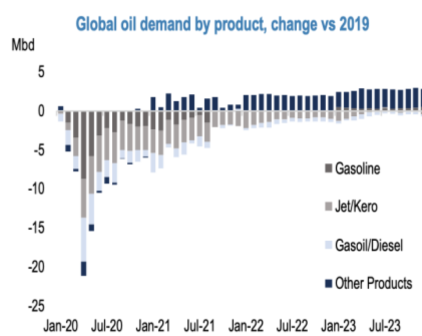
In addition to its commodity production facilities, Devon hosts a marketing and midstream division that accounts for ~30% of firm revenue. Devon's marketing function is responsible for the sale of its oil, gas and natural gas liquids (ethane, propane, butane and natural gasoline), as well as other related activities such as transportation, storage, processing and treating of hydrocarbons. Employees at the company's headquarters in Oklahoma City perform these marketing functions for Devon's production. The company's midstream function is responsible for the construction and operation of pipelines, storage and treating facilities and compression and gas processing plants.

Crude Oil Outlook:

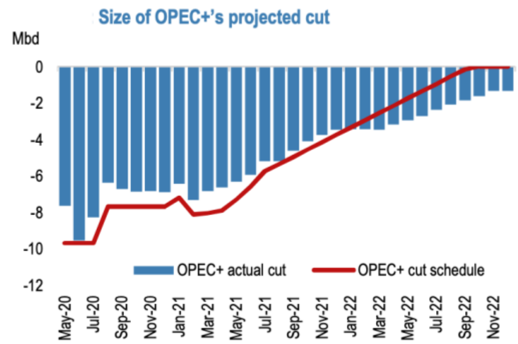
We expect crude oil prices to head over $100/bbl in 2022, due to a combination of the following three factors:

1. **Strong demand despite COVID infections continuing to soar:**
   The Omicron variant has shown to be a lesser threat compared to the previous Delta variant. As a result, demand for oil, as measured by mobility, is holding up well – even as COVID infections continue to soar far above previous peaks. The new Omicron wave has not generated mobility weakness as compared to previous waves. Global mobility and oil demand per product category are improving, indicating strong demand, despite soaring COVID infections.

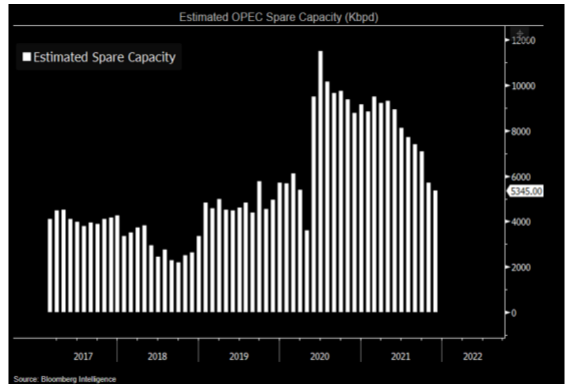




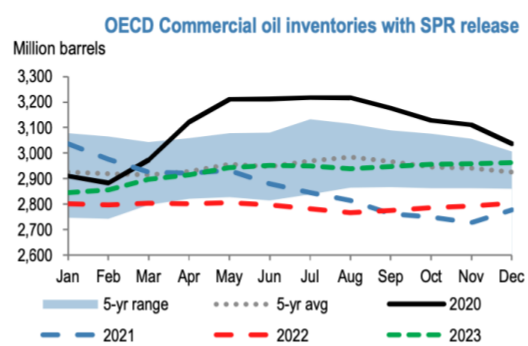
2. **OPEC+ to maintain pricing power:**
   Despite oil prices currently north of $90/bbl along with rather inelastic global demand, so far, OPEC+ has rejected calls from major consuming nations to pump more oil sooner. OPEC+ is continuing to take a cautious stance to production, with many members actually cutting production by an amount more than that promised. Furthermore, spare capacity among OPEC members is heading lower, which is also price supportive.

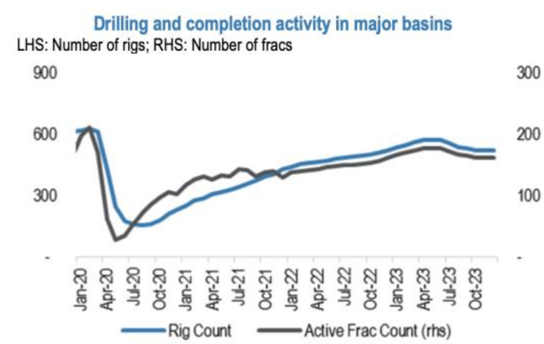


Source: J.P. Morgan Commodities Research



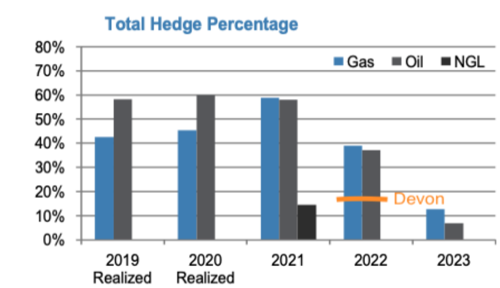
3. **U.S. producers are nowhere near pre-pandemic activity:**
   Investors are demanding high cashflow discipline and are making it difficult for oil companies to get financing as global investors stress efforts towards decarbonization and sustainability. Furthermore, policymakers are also looking to drive a more 'sustainable energy' agenda forward. This leaves oil and gas companies uneager to engage in max production and capex, despite higher oil prices. This is evident through OECD inventories sitting at ~8% below their five-year averages, and rig count materially lower compared to pre-pandemic levels.



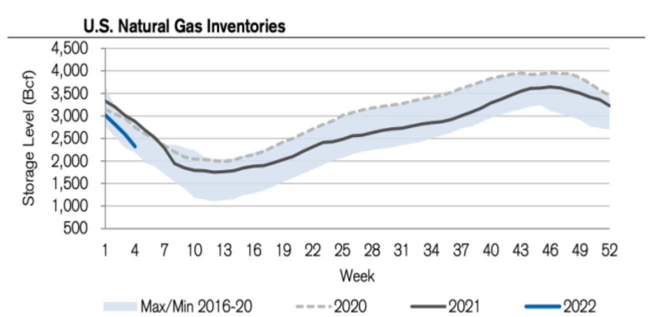


<u>Investment Thesis 1:</u> Devon has one of the lowest oil & gas hedges among its peers for 2022 – a substantial advantage against the backdrop of rising oil & gas prices

Devon boasts a strong balance sheet post-merger with WPX. With over $2 billion in cash and a $3 billion credit facility in its armory, along with ~$1.5 billion in debt reduced over the last 12 months, Devon is on track to get to 1x Net Debt/EBIDTA. Furthermore, ~60% of this outstanding debt is due post 2030. Given Devon's strong balance sheet and improved FCF outlook, management intends to utilize lesser hedges going forward. In the past, DVN ran hedges for ~50% of total production. However, for 2022, Devon has only 16% of oil & gas production hedged – one of the lowest among its peers who sit at ~40% hedge ratio.



Source: J.P. Morgan Global Commodities Group



Given our positive outlook on oil as outlined in the section above and with US natural gas inventories running at the lower end of the historical range, we believe a combo of higher oil & gas prices is likely this year. Devon stands to greatly benefit from higher prices this year as they have one of the lowest hedge ratios. We projected DVN revenues taking into account lower hedges and our positive oil & gas outlook, and came up with a projection significantly different from consensus:

DVN Production:	2021E	2022E	2023E	2024E	2025E	2026E
Oil (in million bbl)	106	110	115	119	124	129
Natural Gas (in MMBTU)	324	337	350	364	379	394
NGLs (in million bbl)	48	50	52	54	56	58

Commodity Prices based off futures curve	2021E	2022E	2023E	2024E	2025E	2026E
Oil (per bbl)	-	87	78	73	70	68
Natural Gas (per MMBTU)	-	4.11	3.63	3.35	3.22	3.15
DVN Hedge ratio		16%	20%	20%	20%	20%

Commodity Prices BCF projection	2021Actual	2022E	2023E	2024E	2025E	2026E
Oil (per bbl)	68	100	90	80	75	68
Natural Gas (per MMBTU)	3.84	4.50	4.00	4.00	4.00	4.00
NGLs (per bbl)	32	38	40	42	45	46

Realized Prices (including hedges)	2021Actual	2022E	2023E	2024E	2025E	2026E
Oil (per bbl)	54	98	88	79	74	68
Natural Gas (per MMBTU)	2.8	4.44	3.93	3.87	3.84	3.83
NGLs (per bbl)	29	38	40	42	45	46

Realized revenue (in $ mn)	2021E	2022E	2023E	2024E	2025E	2026E
Oil	5724	10792	10038	9371	9178	8774
Natural Gas	907	1495	1376	1411	1457	1510
NGLs	1392	1897	2077	2268	2527	2686
Total E&P revenue	8023	14184	13490	13049	13162	12971
Marketing and midstream	3777	4500	4280	4140	4176	4115
Total Revenue	11,800	18,684	17,770	17,189	17,338	17,086
Consensus revenue	11,517	13,677	14,003	13,707	13,612	12,394
Difference from consensus	2%	37%	27%	25%	27%	38%

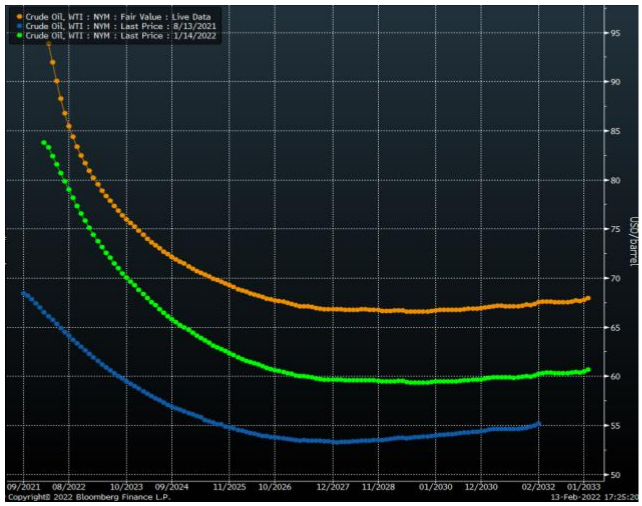
Furthermore, DVN is trading close to its historical average forward EV/EBITDA. Oil prices are north of 2018 levels. The last time we were at such high prices, the forward EV/EBITDA multiple averaged around 8x.

Putting the two points above together – 1) high revenue forecast vs consensus and 2) currently trading at average multiples – we believe that DVN will outperform the XLE benchmark.

<u>Investment Thesis 2:</u> Devon has identified greater than 10 years of development inventory, giving it the optionality to engage in additional production should higher oil prices persist

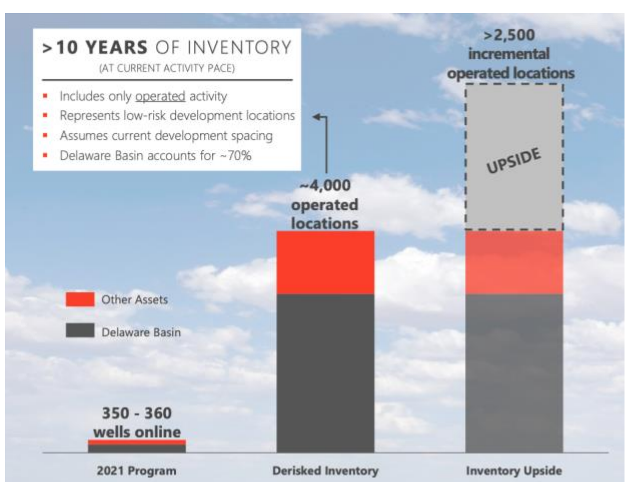
Currently, given the uncertain 3 year outlook for oil amid greater calls for decarbonization and sustainability movements, management has undertaken a disciplined growth strategy with extremely moderate production growth targets – up to 5% annually.

The WTI futures curve has seen an upward shift over the last six months – from the blue line (6 months ago) to the green line (1 month ago) to the current orange line. This is the result of current demand and supply dynamics.



If the WTI crude oil futures curve continues this upward shift trend over the next year, we believe that management would be incentivized to engage in increasing production by tapping into proven reserves and locking in the additional production output sale price through long-term futures hedges.

We believe DVN's core franchise assets have potential to provide a large inventory of lower risk, high rate-of-return development drilling opportunities. They have identified greater than 10 years of low-risk and high-return development inventory – providing significant inventory upside from higher commodity prices & emerging opportunities like the Deeper Wolfcamp appraisal in Delaware Basin, Anadarko Basin gas & liquids upside and by optimizing the Powder River Basin.



Note: Derisked inventory represents locations generating >30% IRR at $55 WTI

Investment Thesis 3: Devon's cash return business model significantly de-risks long-term industry uncertainty

In the very long term (20 years out), the future of crude oil is bleak. Peak oil demand is expected to occur ~2030 and it is lower oil demand from there. This explains why the energy sector trades at a significant discount to the SPX Index. In order to combat this structural downtrend the oil industry faces, Devon has its primary focus on cash-return to shareholders in the form of recurring standard & variable dividends and share buybacks. Devon's cash-return business model is designed to moderate growth, emphasize capital efficiencies, maximize returns and prioritize the return of increasing amounts of cash to shareholders. These principles have positioned Devon to be a prominent and consistent builder of economic value through the cycle.

Devon's cash-return business model hinges on the following:

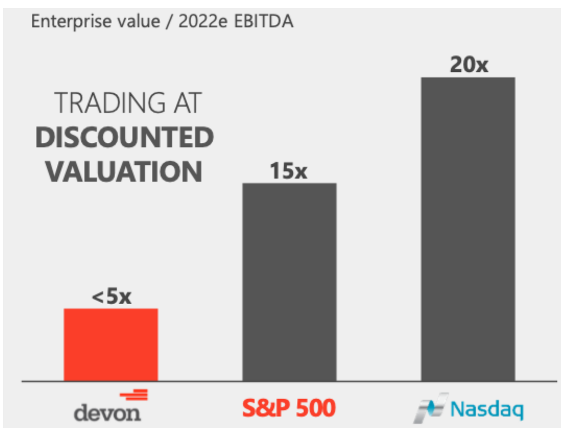
- **Disciplined growth strategy:**
  - Moderate oil growth targets: up to 5% annually
  - Growing margins through operational and cost reductions

- **Reduced reinvestment rates:**
  - Prioritize FCF generation
  - Low capex going forward

- **Maintaining low leverage:**
  - Net Debt/EBITDA target at 1x

- **FCF priorities:**
  - Fixed-plus-variable dividend is top funding priority
  - Excess funds deployed to share repurchases and debt reduction

In our view, this cash-return strategy de-risks long term industry uncertainties and can led to DVN stock multiples holding ground/rerate higher, and put the risk of a de-rate much lower.



Investment Catalysts:

1) Higher Oil Prices: With a low hedge ratio, DVN stands to greatly benefit from rising oil prices. Furthermore, at a production cost basis of $30/bbl WTI crude, higher oil prices increase operating leverage, further driving its cash-return strategy full steam ahead.

2) Stock multiple re-rating: Energy and financials are primarily the only two sectors that have a positive correlation to changes in the US 10Y interest rates. With rates moving higher, capital might rotate into the energy sector. DVN trades at multiples close to industry average and can benefit from a sector re-rate higher. Additionally, DVN's strong balance sheet and growth prospects going forward can result in a multiple re-rate higher relative to the other large cap E&P names.

3) Reduced uncertainty around Federal Lease positions: DVN has meaningful exposure to federal acreage given its positions in the Delaware Basin. About 55% of the company's Delaware Basin acreage resides on federal leasehold in New Mexico. Since everyone is suffering from high inflation, it is likely that the talk around cancelling federal leased land for oil will be put on hold, at least until crude oil prices go lower.

Investment Risks:

1) Low oil prices: Continued oil price downtrend could impact play economics and ultimately corporate level cash flow, which could cause the stock to deviate from our expectations.

2) Energy sector divestment: DVN would not be immune from sector divestment due to global decarbonization efforts. However, in the near term with oil prices high, we view it to be unlikely.

3) Fall in the long end of futures curve: A fall in futures prices ~3 years out reduces the optionality element to hedge DVN's proven inventory reserve, making DVN less attractive.

Management:

Rick Muncrief: CEO

Richard E. Muncrief, 63, was appointed to the board of directors and elected president and chief executive officer of the company in January 2021 following Devon's merger with WPX Energy. Muncrief previously served as chief executive officer and chairman of the board of WPX Energy. Prior to joining WPX, he served as senior vice president, operations and resource development of Continental Resources, Inc. Muncrief has been in the oil business since the 80s.

Clay Gaspar: COO

Clay Gaspar, 49, was appointed executive vice president and chief operating officer in January 2021 following Devon's merger with WPX Energy. He is responsible for Devon's geosciences, reservoir, production, drilling, completions, facilities, field operations, environmental, health and safety and ESG functions. Gaspar most recently served as president and chief operating officer of WPX Energy and served on the company's board of directors. Prior to joining WPX, he worked for Newfield Exploration, Anadarko Petroleum and Mewbourne Oil serving in a number of technical and leadership roles.

Jeff Ritenour: CFO

Jeff Ritenour, 48, was appointed to the position of executive vice president and chief financial officer in April 2017. Ritenour is responsible for Devon's corporate finance, treasury, planning, reserves, accounting, tax, internal audit, investor relations, marketing and supply chain functions. He has been with Devon since 2001, serving in various leadership roles, most recently as senior vice president of corporate finance, investor relations and treasury.

Valuation:

Our valuation uses a DCF weight of 50% and a CompCo weight of 50% to come up with a target price of $78, representing a potential upside of 43%.

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DCF:

Perpetuity Growth Method	
Cumulative PV of FCF	26,471
Terminal FCF	5,355
PGR	2.0%
Terminal Value	54,955
PV of Terminal Value	31,268
Enterprise Value	**57,739**
Less: Total Debt	6,776
Less: Preferred Stock	0
Less: Noncontrolling Interest	137
Plus: Cash and Cash Equivalents	2,321
Implied Equity Value	**53,147**
Shares Outstanding	677
Implied Share Price	**$79**
Current Price	$54.11
Upside	**45.1%**

Exit Multiple Method (EV/EBITDA)	
Cumulative PV of FCF	26,471
Terminal Year EBITDA	7,432
Exit Multiple	5.8x
Terminal Value	43,107
Discount factor	0.57
PV of TV	24,527
Enterprise Value	**50,998**
Less: Total Debt	6,776
Less: Preferred Stock	0
Less: Noncontrolling Interest	137
Plus: Cash and Cash Equivalents	2,321
Implied Equity Value	**46,406**
Shares Outstanding (post dilution)	677
Implied Share Price	**$69**
Current Price	$54.11
Upside	**26.7%**

Target Price Calculation	Price	% Weight
DCF (EV/EBITDA)	$69	50%
DCF (PGR)	$79	50%
Target Price	**$74**	
Current Share Price	$54	
Upside	36%	

WACC	2
Base	11.9%
Low	11.1%
Base	11.9%
High	12.7%

CompCo:

Company Name	Ticker	EV/EBITDA NTM (x)	P/CF NTM (x)
Devon Energy	DVN-US	5.25x	5.32x
Chesapeake Energy	CHK-US	3.03x	3.15x
Continental Resources	CLR-US	4.56x	4.05x
Cheniere Energy	LNG-US	8.45x	8.92x
Diamondback Energy	FANG-US	5.01x	4.59x
Pioneer Natural Resources	PXD-US	5.86x	6.05x
EOG Resources	EOG-US	5.37x	6.48x
Average		5.36x	5.51x
Median		5.25x	5.32x
25th percentile		4.78x	4.32x
75th percentile		5.61x	6.26x

Valuation		
Metric	EV / EBITDA 2022	P / CF 2022
2022E EBITDA Metric	11,304	11,304
Median EV/Metric Comps	5.25	5.32
TEV	59,397	60,145
Cash and Equivalents	2,321	2,321
Minority Interest	137	137
Total Debt	6,776	6,776
Fair Equity Value	54,805	55,553
TSO	677	677
Expected Stock Price	81	82
Weight	50%	50%

Fair Value Stock Price	$82
Current Stock Price	$54.11
Up / Downside potential	50.6%

Portfolio fit:

We expect DVN to replace EOG in our energy portfolio as we believe that going forward, DVN has greater upside as compared to EOG. Both DVN and EOG have similar gas exposure and are E&P names. However, DVN's low hedge ratio, proven reserve optionality and cash-return strategy put it in a position of higher upside compared to EOG and also our XLE benchmark.

Disclosures:

Babson College Fund

The Babson College Fund (BCF) is an academic program in which selected students manage a portion of the Babson College endowment. The program seeks to provide a rich educational experience through the development of investment research skills and the acquisition of equity analysis and portfolio management experience. Please visit http://cutler.babson.edu for more information.

Definition of Ratings

BUY: Expected to outperform the S&P 500 producing above average returns.
HOLD: Expected to perform in line with the S&P 500 producing average returns.
SELL: Expected to underperform the S&P 500 producing below average returns.

References

FactSet
Bloomberg
Company reported financials / reports / earnings calls
Company Investor Relations Materials
Various Analyst reports

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