HESS CORPORATION

Recommendation: Buy

Current Price (4/5/22): $107.63

Target Price: $123.35 (+14.61%)

APRIL 6, 2022

Analyst: Duke Tran

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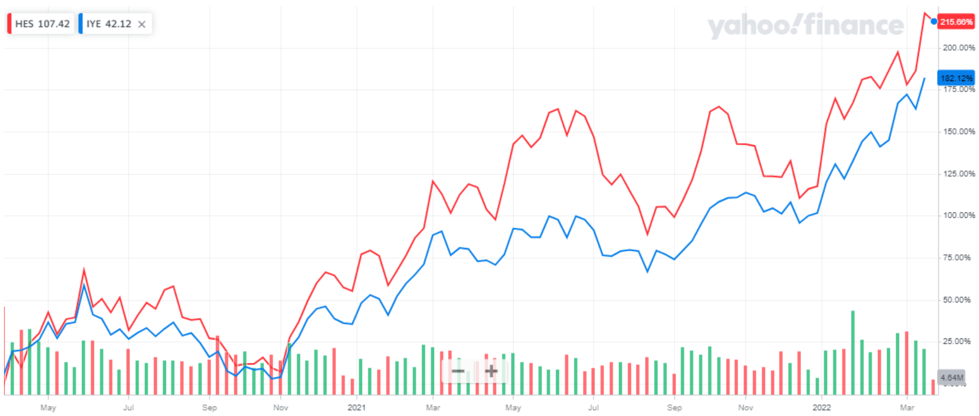
Executive Summary

Business Overview

Hess Corporation is an American global exploration and production (E&P) company focused on the exploration and production of crude oil, natural gas liquids (NGL), and natural gas. It was formed by the merger of Hess Oil and Chemical and Amerada Petroleum in 1968. It's headquartered in New York City and has production operations located in the United States (U.S.), Guyana, the Malaysia/Thailand Joint Development Area (JDA), and Malaysia. They conduct exploration activities primarily offshore from Guyana and secondarily in the U.S. Gulf of Mexico and offshore from Suriname and Canada.

HES has outperformed the energy ETF over the past 2 years



KEY FINANCIALS

Ticker: HES

Sector: Energy

Industry: Oil & Gas E&P

Current Price: $107.63

Target Price: $123.35

52 Week Range: $61.93 - $109.23

Market Cap: $33.273 B

Shares Outstanding: 309.75 M

Dividend Yield: 1.40%

INVESTMENT THESES

Thesis 1: Hess's increasing financial strength will foster strong cash flow growth and capital returns.

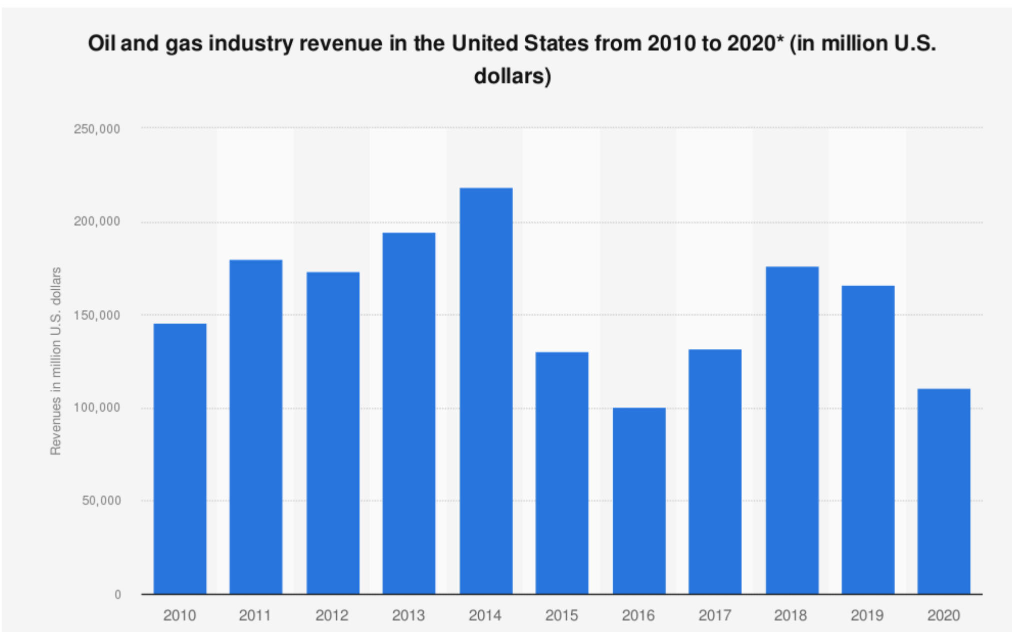
Thesis 2: Investments in lucrative projects within key provinces will bolster growth and maintain low costs.

Thesis 3: Hess's portfolio is poised to deliver long-term value while incorporating measures for sustainability.

Sector Overview

Market Overview

The energy sector is composed of companies that produce and supply energy. They are primarily involved in the exploration and development of oil or gas reserves, oil or gas drilling, and refining. Some companies are also involved in renewable energy sources such as solar and hydro power, although most of them deal with fossil fuels and other non-renewables. This sector is incredibly crucial to the success of society, as everything from households to businesses requires power to fuel the economy and facilitate manufacturing and transportation. As a result, energy prices (and tangentially, earnings of energy producers) are driven by global supply and demand for energy.



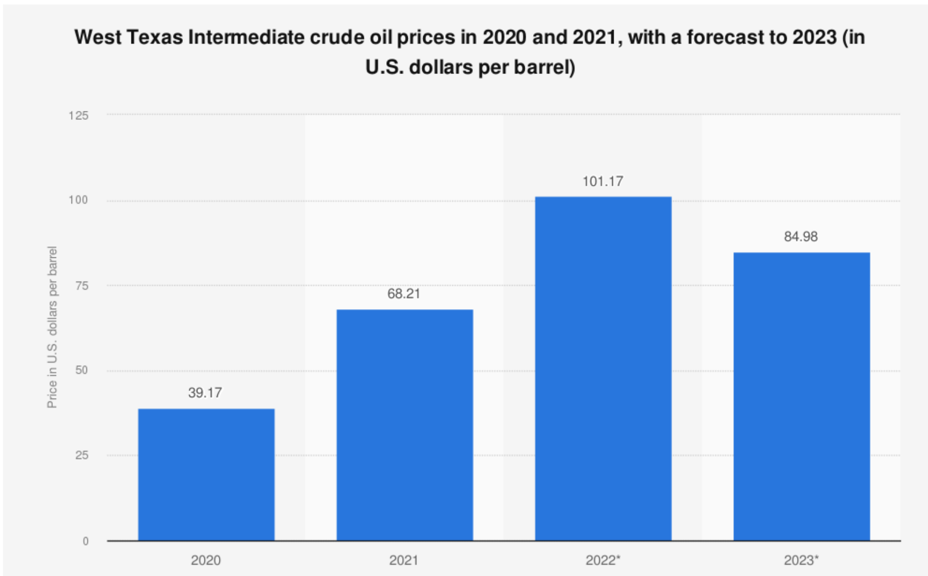
There are several different types of companies within the oil and gas industry of the energy sector. Hess is known as an E&P company, which focuses on the drilling, pumping, and production of oil and natural gas. Since it's only involved in the search and extraction of oil and gas from the ground, Hess is primarily known as an upstream company. It also has a midstream segment that processes, stores, and transports the oil from production sites. They sell this oil to downstream companies that operate refineries to convert the crude oil and natural gas to finished products such as gasoline and distribute them to energy providers and gas stations.

Market Trends

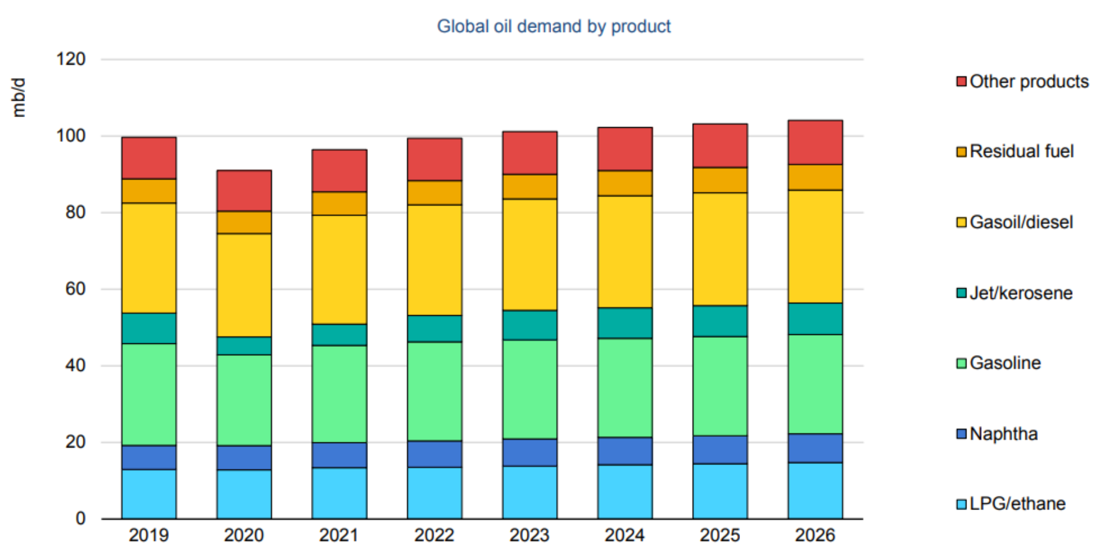
Oil and gas producers generally have better earnings performance when oil and gas prices are higher. During the pandemic, with most countries being under lockdown and people staying at home rather than commuting to work or travelling, crude oil prices dropped significantly due to the lack of demand. By early 2021, oil had returned to pre-pandemic price levels. Upon the emergence of the developed world from the pandemic recession, people began returning to work and thus the demand for oil rapidly increased. Yet, the supply of oil was slow to ramp up. Early this year, with the onset of the Russia-Ukraine conflict, crude oil and gasoline prices began increasing rapidly due to the lack of ample supply to meet consumer demand. These elevated price levels will greatly benefit energy companies, especially if they remain at these levels for a substantial period. Realistically, this is highly likely to be the case through 2022 and early 2023, especially as production hasn't been increased sufficiently to meet demand.

Crude oil prices per barrel over the past 3 years

The energy sector is known to be heavily sensitive to geopolitical events, historically leading to higher volatility in oil prices. Currently, due to geopolitical tensions, particularly with Russia and the ongoing war in Ukraine, many energy companies have pulled out of deals and ceased business with Russian producers. Additionally, the Organization of Petroleum Exporting Countries (OPEC) is slow to mobilize its participant nations to increase oil production. Because of these factors, the prices of crude oil have soared and fluctuated rampantly during 2022 due to a lack of ample supply to meet consumer demand. While production gradually increases over the remainder of 2022 (and for the near future), we can expect crude oil prices to continue to fluctuate as supply struggles to keep up with demand. Regardless, prices are expected to remain relatively high, most probably through to 2023.



In conjunction, global oil demand is expected to surpass demand levels from prior to the pandemic over the following years, necessitating production and supply of crude oil and other fuels. This signifies that the energy sector will be able to continue generating healthy revenues, capitalizing on the world's need for oil.

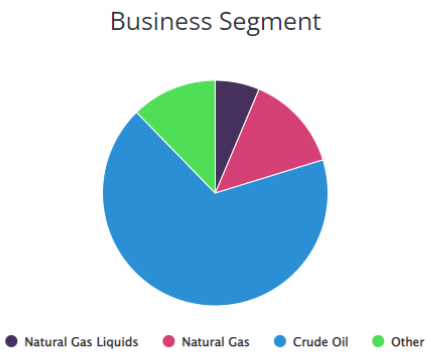


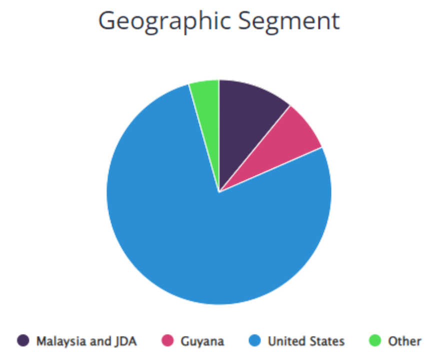
Business Overview

Hess operates in two segments, upstream (E&P) and midstream. As of December 31, 2021, it had total proved reserves of 1,309 million barrels of oil equivalent, 769 million from developed reserves and 540 from undeveloped. Developed reserves can be expected to be recovered using existing wells, equipment, and operating methods for which the cost of the required equipment is relatively minor compared to that of a new well. Undeveloped reserves, on the other hand, can be expected to be recovered from new wells on undrilled acreage or from existing wells that require relatively major expenditures for recompletion.

Hess also has a mix of working interest (WI) with several companies, the most notable of which being ExxonMobil, Equinor, and PETRONAS. Working interests are a type of investment in oil and gas drilling operations in which companies are liable for a portion of ongoing costs associated with the exploration, drilling, and production within a given area. In return, they share in the profits of production. There are also tax benefits associated with costs and losses in working interests. Hess has two types of WI agreements in various locations across the globe: operating and non-operating. Operating WI means that Hess is the operator of the given province, responsible for making all operational decisions such as selecting wells and determining drilling. On the other hand, non-operating WI means that Hess isn't involved in daily operations but is consulted on prior to major production decisions. Non-operating WI is less costly for non-operators since the operator bears responsibility for most operating expenses, but non-operators receive less revenues in return.

Revenue Breakdown





- **Crude Oil: 67.5%**
- **Natural Gas: 13.9%**
- **Natural Gas Liquids: 6.4%**
- **Other: 12.3%**

- **United States: 77.2%**
- **Malaysia and JDA: 10.9%**
- **Guyana: 7.5%**
- **Other: 4.3%**

Upstream Segment

Hess is primarily known for its upstream segment. Most of its E&P operations are done within the U.S., specifically at the Bakken Shale Play in the Williston Basin of North Dakota and from offshore properties in the Gulf of Mexico. As of December 31, 2021, it holds about 462,000 net acres in Bakken with varying WI, and 61,000 net developed acres in the Gulf of Mexico. Hess also has a 30% interest in offshore Guyana with the Stabroek Block, which covers 6.6 million acres.

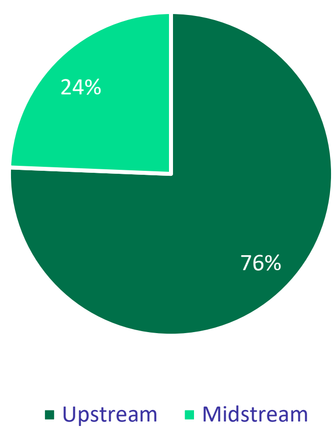
In the more minor, but still substantial, areas of interest, Hess has 50% WI in the Malaysia/Thailand Joint Development Area (JDA) in the Gulf of Thailand through their Block A-18. It also has 50% WI in Block PM302 located in the North Malay Basin (NMB) offshore from Peninsular Malaysia and another 50% in Block PM301, adjacent to Block

A-18 of the JDA. Finally, Hess has 8% WI in several oil fields in Libya, 33% WI in Block 42 and Block 59 located offshore from Suriname, and 25% WI in three exploration licenses offshore Newfoundland, Canada.

Midstream Segment

The midstream operating segment is comprised of Hess's approximate 43.5% ownership interest in Hess Midstream LP. The remainder of the company is owned by mutual funds and institutions. Some of the institutions with the largest percentages of shares include CI Investments, Inc. (9.03%), Energy Income Partners LLC (7.02%), and Invesco Advisers, Inc. (6.21%). It provides fee-based services such as gathering, compressing, and processing natural gas and fractionating natural gas liquids (NGL). It also services gathering, terminaling, loading, and transporting crude oil and NGL. Concerning primarily the Bakken Shale Play in North Dakota, this segment is also used for storing and terminaling propane and water handling. To carry out these services, they have a sizeable portfolio of assets, including the Tioga Gas Plant and Rail Terminal, Hawkeye Gas Facility and Oil Facility, and Little Missouri 4 Gas Plant.

Adjusted Net Income (FY2021)



- Upstream: $888 million (76%)
- Midstream: $286 million (24%)

Management

John B. Hess - Chief Executive Officer and Director

- Chief Executive Officer since 1995
- Employed by Hess since 1977
- Over 40 years of experience in the oil and gas industry

Gregory P. Hill - President and Chief Operating Officer

- Chief Operating Officer since 2014
- 25 years at Royal Dutch Shell and its affiliates in a variety of operations, engineering, technical, and managerial roles

John P. Rielly - Executive Vice President and Chief Financial Officer

- Chief Financial Officer of the Corporation since 2004
- Vice President and Controller of Hess from 2001 to 2004
- Former Partner at Ernst & Young, LLP for 17 years

Gerbert Schoonman - Senior Vice President, Global Production

- Senior Vice President, Global Production of the Corporation since January 2020
- Various operational leadership roles, most recently as Vice President, Offshore since January 2017
- 20 years with Royal Dutch Shell serving in operational and leadership roles

Competition

Marathon Oil Corporation (MRO) engages in the exploration, production, and marketing of crude oil and condensate, natural gas liquids, and natural gas. It is also involved in the production and marketing of products manufactured from natural gas, such as liquefied natural gas and methanol. Their portfolio consists of WI in Texas, the Bakken in North Dakota, Oklahoma, and the Permian in New Mexico.

Coterra Energy Inc. (CTRA) engages in the development, exploration and production of oil, natural gas, and natural gas liquids in the United States. It primarily focuses on the Marcellus Shale with approximately 177,000 net acres in the dry gas window of the play located in Susquehanna County, Pennsylvania.

Diamondback Energy, Inc. (FANG) focuses on the acquisition, development, exploration, and exploitation of unconventional and onshore oil and natural gas reserves in the Permian Basin in West Texas. It focuses on the development of the Spraberry and Wolfcamp formations of the Midland basin; and the Wolfcamp and Bone Spring formations of the Delaware basin.

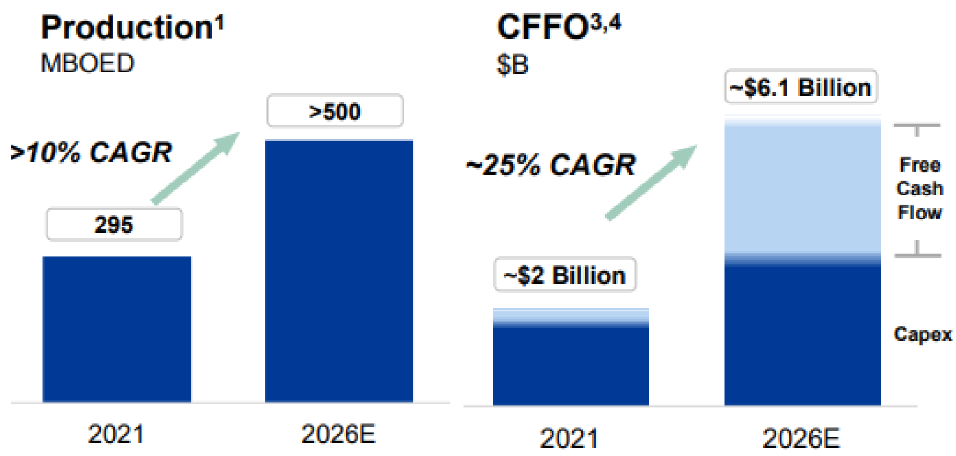
Continental Resources, Inc. (CLR) explores for, develops, produces, and manages crude oil, natural gas, and related products. They have notable WI in the Bakken in North Dakota and Montana, the Anadarko Basin of Oklahoma, and the Permian Basin of Texas.

Investment Thesis 1

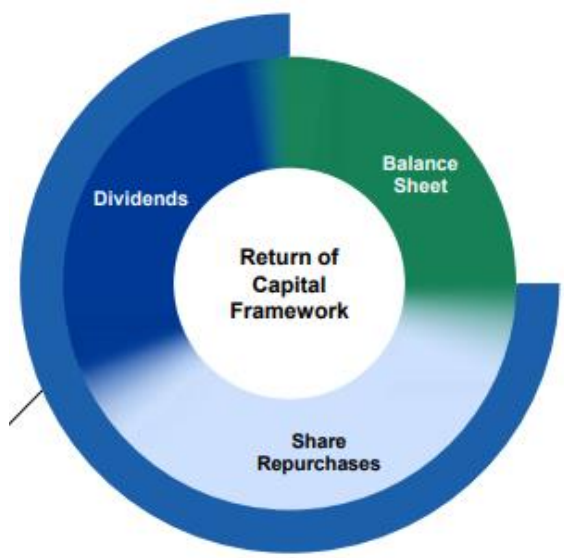
Hess's increasing financial strength will foster strong cash flow growth and capital returns.

Hess is focusing on significantly improving several of their key financial metrics over the following years to bolster its financial strength, which will in turn generate increasing free cash flows. As of December 31, 2021, Hess had $2.7 billion in cash, and during February 2022, they used $500 million to repay the remainder of a term loan. A large focus of their financial strength will be on reducing their debt levels. Within the next 10 years, they have $2.4 billion in near term debt maturities. With the expected increase in cash flow growth, they should be well poised to pay off this debt while maintaining their expectation of having at least $1 billion in cash. Hess is also aiming to expand its cash margins by decreasing cash costs, primarily through increasing the efficiency of production. By extracting oil more effectively, they will be able to profit more on their operations through cost reductions. They aim to bring their costs of $12/BOE (barrel of oil equivalent) down to $9/BOE within the next 5 years.

Additionally, Hess is planning to increase its cash flow from operations through two main approaches. Firstly, they're limiting capital expenditures at the various reserves in the provinces of which they have WI. In their reserves at the JDA and North Malay Basin, net capex for 2022 is expected to be limited to $270 million, Gulf of Mexico around $90 million, and Bakken around $790 million. In total, their net capex would total around $1.15 billion for those specific reserves in 2022 compared to the $1.70 billion for E&P in 2021. Through this approach of strictly managing capital expenditures, they will be able to keep their cash outflows low. Secondly, they are striving to boost production, a large part of which will result from the investments in Guyana and the Stabroek Block. Hess is aiming for over a 10% CAGR within the next 5 years, pushing their production from 295 MBOED (thousand barrels oil equivalent per day) in 2021 to over 500 by 2026. Both plans will contribute to the goal of a 25% CAGR in cash flow from operations, greatly fueled by immense growth in free cash flow while maintaining low capex.



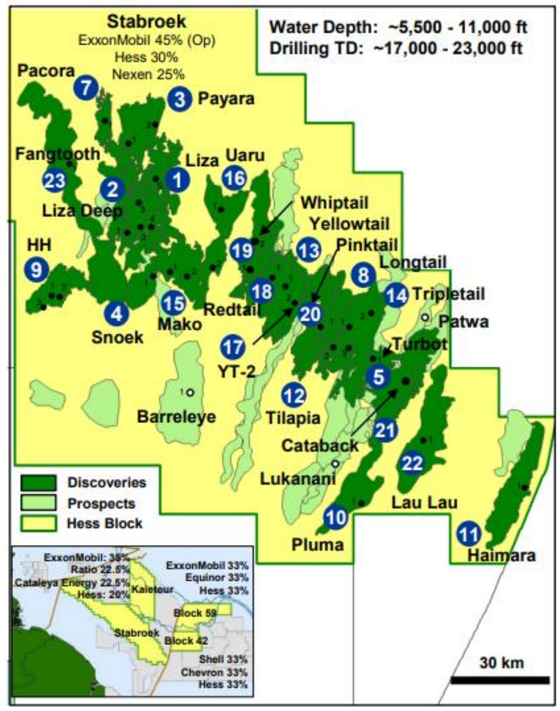
As a final remark, Hess is also committed to increasing capital returns, with up to 75% of annual free cash flow to be used to increase dividends and repurchase shares. This will greatly benefit shareholders while not impacting their core business nor financial health. They have already increased the regular dividend by 50% on March 1, 2022 and plan on continuing to increase it further. As free cash flow grows, they will also accelerate share repurchases, especially in today's environment of high oil prices.



Investment Thesis 2

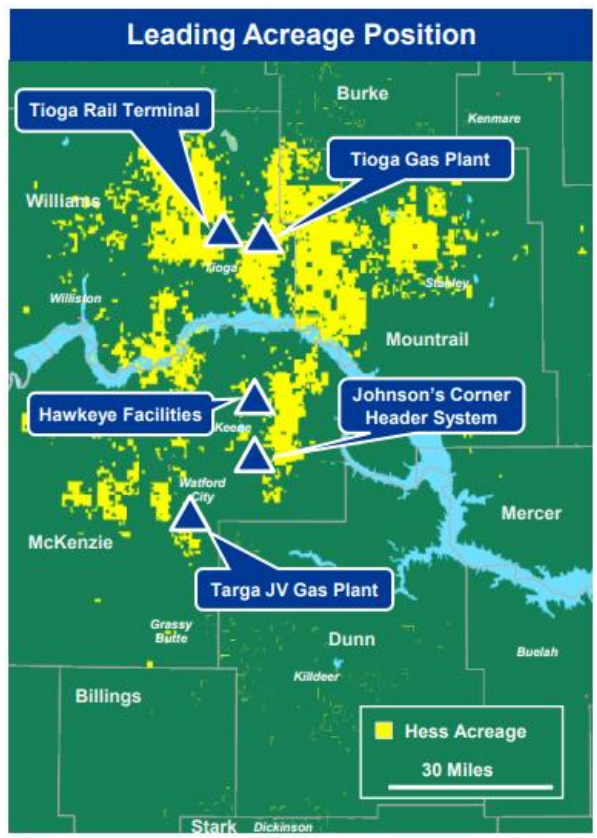
Investments in lucrative projects within key provinces will bolster growth and maintain low costs.

The central province of Hess's asset portfolio lies in Guyana with the Stabroek Block. Hess has a 30% interest in this province, whose operator is ExxonMobil (ExxonMobil has 45%, Nexen has 25%). The province occupies 6.6 million acres, and it has low entry cost. To date, Hess has made 23 major discoveries and over 10 BBOE (billions barrels of oil equivalent), which yields the potential for up to 10 FPSOs (floating production, storage, and offloading vessel). Their sanctioned projects in the province have a breakeven oil price of $25-$35/BBL, which is considerably cost-effective. It also takes less than half the drilling time and cost to produce in this province compared to typical offshore deepwater provinces. Two main drivers for these low costs are low royalties and favorable contractual terms established with Georgetown, the capital of Guyana. That is to say, this Block has exceptional reservoir quality with the benefit of low development costs.



Their earliest project in this province was Liza Phase 1, which began producing oil in December 2019 using the Liza Destiny FPSO at about 120,000 gross BOPD (barrels of oil per day). They achieved an approximate $35/BBL breakeven for Liza Phase 1, managing to reduce gross development costs from $4.4 billion to $3.5 billion. In 2022, they will work on optimizing the production capacity of the Liza Destiny, aiming to increase it to more than 140,000 gross BOPD. Their subsequent project was Liza Phase 2, which began producing oil in February 2022 using the Liza Unity FPSO at about 220,000 gross BOPD. They'll work on ramping up Liza Phase 2 production throughout the year following a slowdown in production the previous year due to the pandemic.

Another of their key provinces lies with the Bakken Shale Play. Hess has a 75% WI as an operator of the play, occupying about 460,000 net acres. Other companies retaining the remaining 25% include Continental Resources, ExxonMobil, Whiting Petroleum, and EOG Resources. It's projected to yield 160-165 MBOED through 2022, with D&C (drilling and completion) costs forecasted to remain at $5.8 million per well, consistent with that of 2021. They plan on using Lean principles to optimize infrastructure within this play, seeking to maximize cash flow. Hess also has several Hess Midstream facilities located within the play, allowing them to leverage their advantaged midstream infrastructure to support upstream growth.



Investment Thesis 3

Hess's portfolio is poised to deliver long-term value while incorporating measures for sustainability.

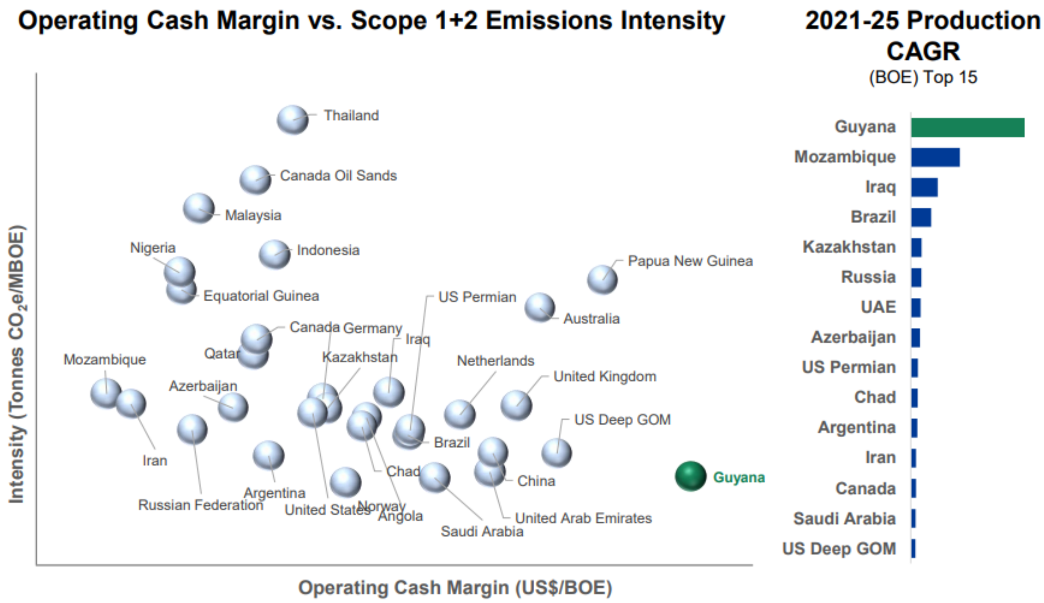
Hess is structuring their portfolio with the aim to provide value through the long-term. Starting in 2022, all their assets will generate positive free cash flow. In Guyana, they're generating high returns and are planning to invest in up to 10 FPSOs to develop over 10 BBOE of their gross discovered resources. The petroleum found in the area also has the added bonus of being a sweet crude oil, which has a low sulfur content and reduced carbon intensity. This would enable Hess to help in the mission of reducing the global carbon footprint through selling a less-carbon-intensive oil. In Bakken, they're looking to optimize their infrastructure and cash flow generation; conjunctly, they expect to reach 200 MBOED net production by 2024. Altogether, their portfolio is expected to generate about $3 billion of free cash flow in 2026 as a result of their careful planning and optimizations. Moreover, by expanding their cash margins and reducing portfolio cash costs, they're aiming for a portfolio breakeven of $45/BBL by 2026.

Hess is committed to reducing emissions while keeping up with their growth targets. They support the Paris Agreement and the goal of achieving net zero emissions by 2050. They have already outperformed 5-year emission reduction targets for 2020 by reducing their operated GHG emissions intensity by 46% in 2020 compared to their 25% target vs. 2014 and flaring intensity by 59% compared to their 50% target vs. 2014. For 2025, their goal is to reduce operated GHG emissions intensity by 50% vs. 2017 and methane emissions intensity by 50% vs. 2017. By 2025, Hess plans to have zero routine gas flaring, also known as production flaring, which is a practice of disposing of large unwanted amounts of associated petroleum gas (APG) during crude oil extraction.

They have also contributed $12.5 million in February 2020 to the Salk Institute's Harnessing Plants Initiative (HPI) aiming to enhance plants' natural ability to store carbon and mitigate the effects of climate change. With this gift, they are advancing two primary projects: the CRoPS (CO_2 Removal on a Planetary Scale) Program and the

Coastal Plant Restoration (CPR) Program. Both build on the Salk discovery of a crucial gene that will help the Institute research and develop plants capable of storing billions of tons of atmospheric carbon per year (plant-based carbon capture and storage).

With their projects in Guyana, Hess is also poised to benefit in both long-term value and sustainability. Guyana offers the highest operating cash margin and production growth potential globally while maintaining low emissions intensity.



Valuation

DCF Valuation	Weight	Premium
Bear Case	20%	-25.48%
Base Case	55%	20.55%
Bull Case	20%	55.46%
Relative Valuation	5%	-53.81%
Weighted Premium		**14.61%**

Stock Price Analysis	
Current Stock Price	107.63
Calculated Premium	14.61%
Target Price	**$123.35**

Relative Valuation: Since there are many oil and gas companies that focus primarily on the upstream segment, I weighted the relative valuation at 5%. I looked at 6 companies since their business is derived from E&P just like Hess. I felt that these companies served as good comparables as they regularly compete against Hess for provinces, lease contracts, and oil reservoirs.

Bear Case: In the bear case, I projected the revenue growth to decline in future years to account for lessening demand for oil and gas, both as oil production and prices return to “normal” levels. I also considered the prospect of Hess being unable to capitalize on their investment projects to reduce their exploration/drilling and property impairment costs.

Base Case: For the base case, I went for a more conservative approach and limited my optimism for the near future. I only expected their working capital to increase modestly, signifying they fell just short of their expectations of maximizing cash flow and reducing costs. I also reduced their net interest expense by 5% YoY to account for their gradual paying off debts.

Bull Case: Finally, for the bull case, I assumed that Hess would be able to near (but not exceed) their targets for cash flow growth through reductions in operating costs. I also incorporated a healthy increase YoY in their total working capital as a result of cash accumulation and debt paydown.

Risks

- **Global Environment/Price Risk:** Operations and resultant cash flows are highly dependent on market prices, which can be particularly volatile. Especially now, with the Russia-Ukraine conflict still ongoing, crude oil prices are extremely sensitive and fluctuate often in response to global developments.
- **Government Regulations:** Since Hess conducts business in numerous countries and localities, they will be subject to changing laws and regulations of that area. This is also related to the risk of political instability which may occur in developing oil and gas markets.
- **Alternative Energy:** With the increasing concern towards climate change and human effects on the environment, sustainability initiatives may require significant operational changes and expenditures, impacting the returns and cash flow growth of the business. Moreover, it may also reduce demand for crude oil and natural gas products, hurting revenues in the long run.
- **COVID-19:** The possibility of this risk being realized is less likely, but in the event that a stronger variant emerges or the virus resurges back through the U.S., another shutdown could be disastrous for the oil and gas industry. Consumers remaining at home in quarantine would mean less travel and therefore less demand for oil and natural gas.

Sources

NETADVANTAGE

INVESTOPEDIA

YAHOO FINANCE

WALL STREET JOURNAL

SEEKING ALPHA

STATISTA

BUSINESS INSIDER

CNBC

MORNINGSTAR

INTERNATIONAL ENERGY AGENCY

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