Pangea Global, LLC

Continental Resources

A Case Study in Survival

Introduction

This case study is part of a continuing series prepared by Pangea Global in its ongoing research project on the business of oil and gas. The project examines the three key business dimensions of performance, People, Strategy and Business Processes for the North American exploration and production industry segment. The case study series illustrates specific sources of high performance within those three dimensions unique to each company. These case studies are used to help companies seeking to improve their performance by illustrating how high performing companies have found their way to success. The case studies are developed from public documents with clarification from the companies. As such, proprietary information is never collected and respect for full disclosure is strictly adhered to.

Summary

Continental Resources (Ticker: CLR) has delivered the greatest excess return to capital over the 10 year period 2004-14 in the North American Upstream (Figure 1). That is, it has returned 6.73% *above* its risk adjusted Weighted Average Cost of Capital.

It has been rewarded by the equity market with a $9.7 Billion Market Value premium over Fair Value (Figure 2). This represents a 59% Market Value Premium indicating the equity market is supportive of Continental's ability to deliver value (Figure 3).

Since 69% of CLR's equity is owned by founder and Chairman Harold Hamm, CLR is only an acquisition candidate with his consent. Nevertheless, the company would not be vulnerable to a takeover due to the high market confidence in the company's leadership.

Continental is a top performer due to its strength in all three business dimensions: People, Strategy and Process and their alignment. Mr. Hamm founded the company in 1969 and it has only recently achieved significant success. Through multiple boom periods Continental never emerged as a significant player.

It was only in the last five years with its notable success in the Bakken shale, that CLR surfaced as a significant producer. The Bakken growth has been the driver of its returns. Recently, CLR has pioneered two new plays in its home field, the SCOOP (South Central Oklahoma Oil Play) and STACK (Sooner Trend, Anadarko, Canadian, Kingfisher). Both are extensions of the Cana-Woodford shale play, but Continental has greatly expanded their size and potential for further growth.

While we would not necessarily recommend the path to success CLR has taken, it shows every indication of future success and illustrates solid People, Strategy and process pillars and strong alignment of all three dimensions of business performance.

Overview

People Dimension

Harold Hamm is a classic American success story. The youngest of 13 raised by an Oklahoma sharecropper, he does not have the resume of some of his CEO colleagues. However, in terms of sheer tenacity, determination, and persistence he is without parallel. Continental was founded by Mr. Hamm in 1967. From 1974-1985 the company experienced spotty performance, but avoided the excesses of the late 70s oil boom that culminated in the Penn Square fiasco. In the aftermath, Mr. Hamm made an apparently astute countercyclical acquisition of Petro-Lewis in 1985, the company's single largest. Steady growth through the 90s allowed the company to expand, including a strategic move into the Rocky Mountains in 1993. One event that illustrates Mr. Hamm's unique visionary thinking style was the discovery of Ames Hold, an Ordovician age meteor crater. Unlike most craters, Ames has become a significant discovery as it became a small, but significant sedimentary sub-basin within the greater Anadarko.

Among independents, Continental was an early adopter of 3D seismic. The first result was the Cedar Hills field and one of the first applications of horizontal drilling development. Two pioneering ventures that helped build Continental into the top performing position among North American independents.

It would be easy for Hamm to take major credit for Continental's success. While it is probably the case that his contrary vision gave rise to much of CLR's success, the company's public persona emphasizes team work. "Star" centric companies are not typically sustainable once the luminary departs. Take Chrysler for example. Following Lee Iacocca's successful tenure, the company slipped back into mediocrity. However, Continental seems to have built a culture that shares the credit. The type of innovation that CLR has consistently created comes from recognizing contributors. Nevertheless, once Mr. Hamm turns over the reins, whether his cultural legacy endures remains to be seen.

Employee engagement is difficult to judge in the absence of rigorous data collection. However, compared to its peers, CLR gets reasonably high ratings from current and former employees. Mr. Hamm personally enjoys unusually high regard. Ratings range from 3.7 (Glass Door) to 4.0 (Indeed). The trend in Glass Door ratings is down sharply since the first of 2015. This is no doubt due to industry conditions impacting the company, but highlights the biggest challenge the company faces, sustaining team morale.

Like any organization there are those that judge the company harshly. However, a consistent theme seems to be politically motivated promotions and job assignments. Benefits and pay have been highly rated, but career development and recognition have not. This is odd given the company's performance and track record for innovation. This could be a sign that management needs to address the people dimension and employee alignment with the strategic imperatives faced by the company.

The talent pool at the top is deep and stable and certainly has been a contributor to the corporate culture. This bodes well for a transition, but an heir apparent is not evident. No officer other than Hamm has a board seat. The five member board is comprised of close confidants of Mr. Hamm. While CLR is given good ratings by analysts for its governance, the question of succession is crucial to the company's future. It is likely there is a closely guarded succession plan (i.e. Berkshire-Hathaway). Analysts have not raised the issue as a concern for investors. However, companies seeking to rise to Continental's level and sustain that position should be very mindful of succession. Jack Welch has long maintained that the key role of a CEO is to ensure his succession. Other companies with similar roots (such as Occidental) have gone through many decades of turmoil following the departure of an iconic leader.

Mr. Hamm has exercised remarkable leadership in growing his company rapidly over the past 10 years and has built an apparently strong leadership team. One move that speaks to both the people and the strategy dimension is the creation of a new senior role: Vice Chairman of Strategic Growth Initiatives. Jeff Hume had been Chief Operating officer and President from 2008 and 2009 respectively. He joined Continental in 2002 and has no doubt been instrumental in the company's growth. He was appointed to this position in 2012. While public documents do not specify his responsibilities, the title strongly suggests that Continental places high value on designing an intentional strategy for future growth.

Jack Stark, another long time lieutenant was elevated to the President and Chief Operating Officer role. This again underscores the depth of the leadership team and Mr. Hamm's ability to attract, retain and, above all, leverage talent. Both of these moves appear to have been deliberate and carefully considered. It also suggests that succession at CLR will be a marked contrast to the turmoil endured by Occidental.

Strategy Dimension

For the present, Continental's strategy is clear enough. The company's success though is more due to opportunity meeting preparation and a contrarian leader with strong survival instincts. Indeed, it took Mr. Hamm the better part of three decades to achieve success. The Petro-Lewis acquisition, an opportunistic move probably gave CLR the critical mass to fuel growth. Ames Hold, like a lot of discoveries was an opportunity that grew out of a chance realization.

Hamm made his first strategic move in the early 90s when a friend relayed his wife's observation that most of the large fields in the Rocky Mountains were operated by major oil companies. The friend opined that the large fields in the Rockies were "company makers". That was Hamm's impetus to move north from Oklahoma to the largely abandoned Williston Basin. Astutely, Hamm recognized that the success enjoyed by producers on the Canadian side of the basin was due in part to the favorable tax treatment in Saskatchewan. Convincing North Dakota's governor that such treatment would stimulate much needed economic activity in his state, Hamm began exploring in the Red River Limestone. North Dakota's typical sedimentary formations have been notoriously difficult to exploit economically. Thin and discontinuous, up to that time, stratigraphic traps on the flanks of the Cedar Creek anticline were the major finds. Apparently Continental's 3d seismic revealed a prospective target. Exploiting it with horizontal wells alleviated some of the challenge of thinning reservoir rocks.

Eight years after Cedar Hills (2003), Hamm took a major move, buying 300,000 acres in the Bakken. The next year, the first commercial well in the Bakken is drilled horizontally and hydraulically fractured. While there is no official documentation, it is clear the astute Harold Hamm observed the success his colleague George Mitchell was beginning to experience in the Barnett shale. While the Barnett is a dry gas producer, the insight that the oil prone Bakken may well be amenable to the technology probably occurred to Hamm. To be sure, this is not a blinding flash of the obvious. Other shale formations have proven difficult to fracture economically. The key point is that CLR's move into the Bakken was strategic and intentional and based upon sound data. Hamm did what he could to shape the battlefield by advocating for competitive tax treatment and moving when competition was virtually non-existent. He made a big commitment, not because he was reckless, but because the unique nature of North Dakota oil and gas regulation forced him to do so. As a newcomer to oil and gas, North Dakota was not saddled with the antiquated paper record keeping of the early states. Rather, the state took steps to build and maintain state of the art electronic systems with a greater degree of transparency. As such, Hamm probably realized that if he made a discovery, the word would spread fast. He thus needed to control significant acreage to protect and exploit his first mover advantage.

Harvard Business School Professor Michael Porter's observation that the essence of strategy is "deciding what not to do" very much applies to CLR. The company strategy is very focused on the Bakken. With this major discovery the company has a lot to manage in its development. Another key element of strategy is leveraging success. Some recognition that the new Cana-Woodford play in Oklahoma had similar characteristics to the Bakken. It remains to be seen if that is the case, but the move seems to have worked out, with discovery of oil bearing rock in the Springer sand, as well as the deeper Woodford shale.

Much is made of grand, elaborate, time consuming and complex strategic planning processes. There is something to be said for working around the challenge until something good happens. Had Harold Hamm not been the sole shareholder for 40 years, he probably would not have had that opportunity. That said, once he happened on to something big, he was astute to exploit it and match the opportunity with capabilities. The approach many existing companies take is the opposite, seek opportunities that match skill sets.

The creation of the Vice Chairman of Strategic Growth Initiatives indicates a new approach to strategy for CLR, one that is more intentional. How this will play out remains to be seen. However, it is apparent that the SCOOP initiative is an outgrowth. Leveraging the skills learned in the Bakken and recognizing the Woodford's similarities suggests a high degree of leveraging existing capabilities. The Springer, long known for its enormous gas potential elsewhere in the Anadarko, may be another example of serendipity. Alternatively it could be the result of strategic intent, recognizing the Woodford as source rock for the overlying Springer. The fact that the long-time favorite Williston target was the Madison Group (above the Bakken source rock) suggests that Continental purposely went after both the shale and the more conventional reservoir rocks above.

Process Dimension

Very little public information is available about Continental's business processes. Most observations are inferences from company tactics. It seems reasonable to assume that CLR's business processes are pretty basic and simple by design. Rapid growth and the demands of public disclosure probably drive a lot of the process side of the business. Accounting and reservoir engineering seem to be getting a lot of attention currently.

One area that Continental has been leading the industry is transportation and logistics. Pipeline constraints out of the Williston required that Continental develop innovative transportation options to refineries on all three coasts. The use of rail to transport crude oil is a practice dating back to the beginning of the industry. However, it has taken on a new importance and Continental has taken a leading role in its use.

Capital Allocation Process

At its simplest level, capital allocation is about developing the best locations first. With over 1.1 million acres and a relatively homogeneous formation, it is not readily apparent what the "best" locations might be for CLR. The highest productivity from the Bakken is spread over 6 counties in North Dakota and 2 in Montana. Public documents provide very little indication of CLR's attempts to high-grade if they even exist. Protecting leases may be a driving imperative at this point.

That said, Continental has scaled its CAPEX back to more closely align with operating cash flow. That means there are decisions being made about where to allocate that capital. Our view is that CLR rightly views these decisions as strategically critical and proprietary. For what reason? The answer would seem to be that CLR plans to acquire additional acreage and is loathe to signal its competitors.

The Bakken will receive the major capital allocation (65%) in 2015, yet the SCOOP may be competing for a larger share, suggesting some challenging decisions in 2016 and 2017 if oil prices continue to stay low and cash is a constraint.

Capital Deployment Process

Like most of its high performing peers, CLR has dramatically improved its capital efficiency reducing cycle time for both vertical and horizontal drilling. The efficiency gains have been between 15% and 26%; impressive, but not enough to compensate for the dramatic fall in oil prices. However, CLR is well positioned for significant profitability gains should oil prices recover. Innovation is clearly a priority as evidenced by the Eco-Pad approach to drilling.

Field Operations

Continental has been relentlessly driving down production costs, even during the boom period 2010-14. While production cost has not been a major factor the discipline of cost control is evident. This is typical of the high performing players. But there is simply not enough leverage to offset price erosion.

The new pipeline capacity will provide some margin enhancement, perhaps $5/barrel. That would materially impact CLR's operating margins. If there were a place to focus on, this would be it. Other top performers, notably Peyto, have invested in midstream assets for both the return on incremental investment and the improved netback. This could be one initiative Continental may be considering.

One innovation mentioned earlier is the Eco-Pad technology CLR is exploiting to both reduce costs and its environmental footprint. Cost reductions are reported in the range of 20-25%. Greater Reductions may be possible if well count is increased and more extensive exploitation of the resource can be achieved.

Administrative

While G&A is not now a big expense for CLR, a public comment made by Mr. Hamm emphasizes the cost control focus of CLR. When Devon Energy moved from its Oklahoma City offices, Continental seized upon the opportunity to acquire the space as it was already built out to production company specifications. That type of stewardship is a differentiator between CLR and its peers, notably Chesapeake.

Conclusion

Any pace setting organization accustomed to high performance and achievement is unlikely to be happy with a business environment where the best are merely surviving. Unfortunately, that is the situation with Continental and its peers in the star category. Faltering profitability and falling share prices are going to be the norm for some time to come

The Challenge

As is often heard, "it beats the alternative". The biggest challenge for Continental will be sustaining morale and growing the best circumstances will allow. It did not become the best at ROI without having done the basics right. The company has gone through several, if not many, rough patches, and the leadership, Mr. Hamm in particular is highly resilient.

The biggest mistake would be to make a course change. Seeking new initiatives to leverage its capabilities, sustaining innovation, maintaining cost discipline are the attributes that got them here.

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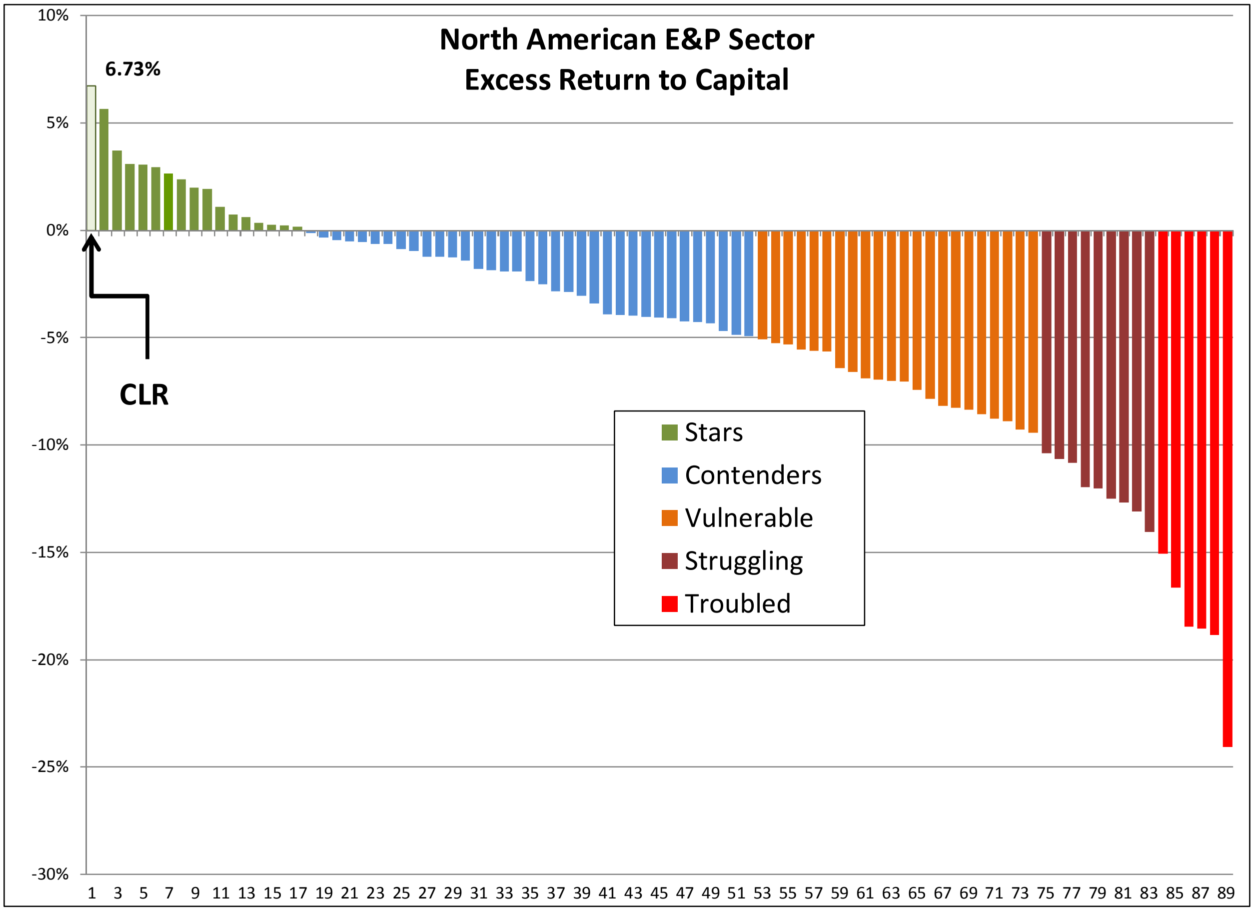
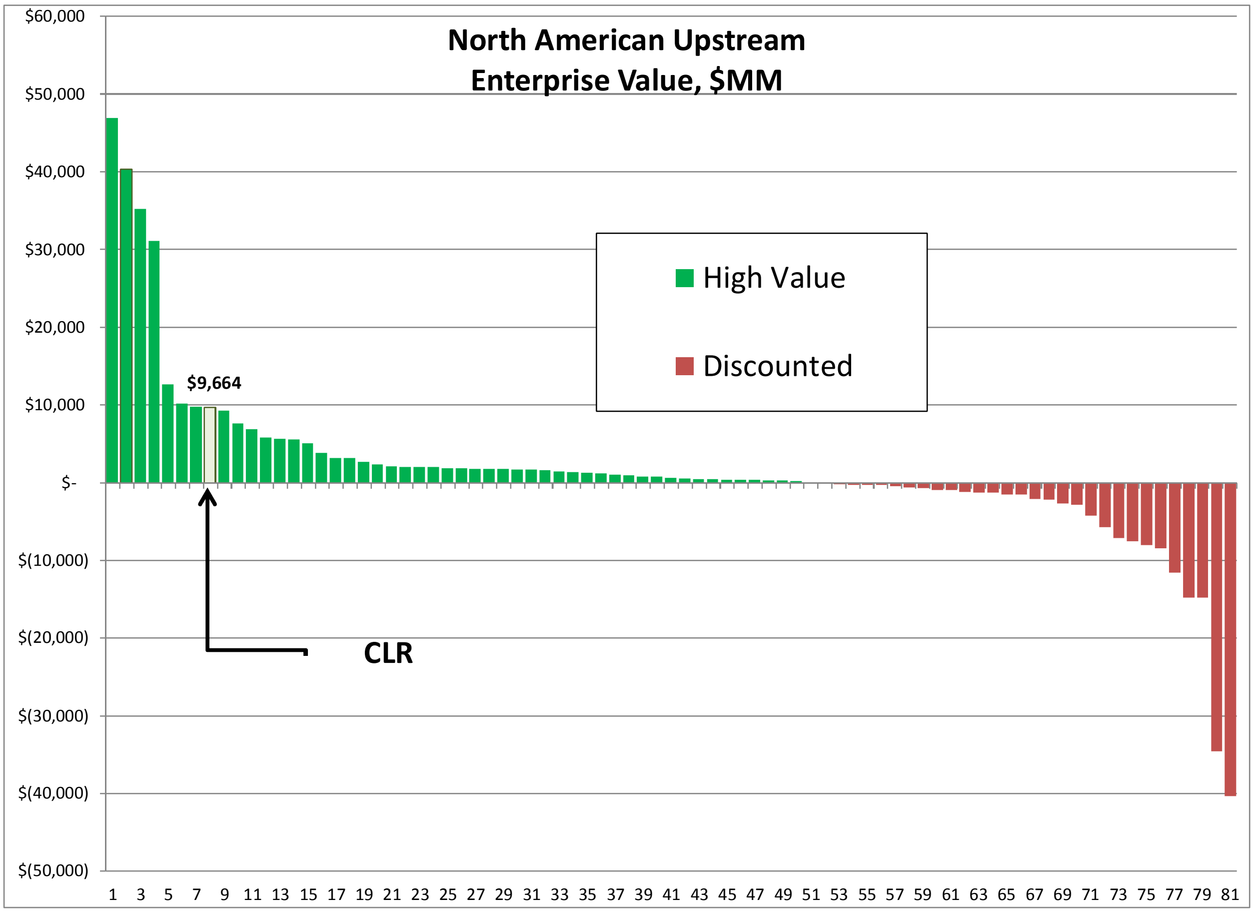
Figure 1



Source: Morningstar, Pangea Analysis

Figure 2



Source: Morningstar, Pangea Analysis

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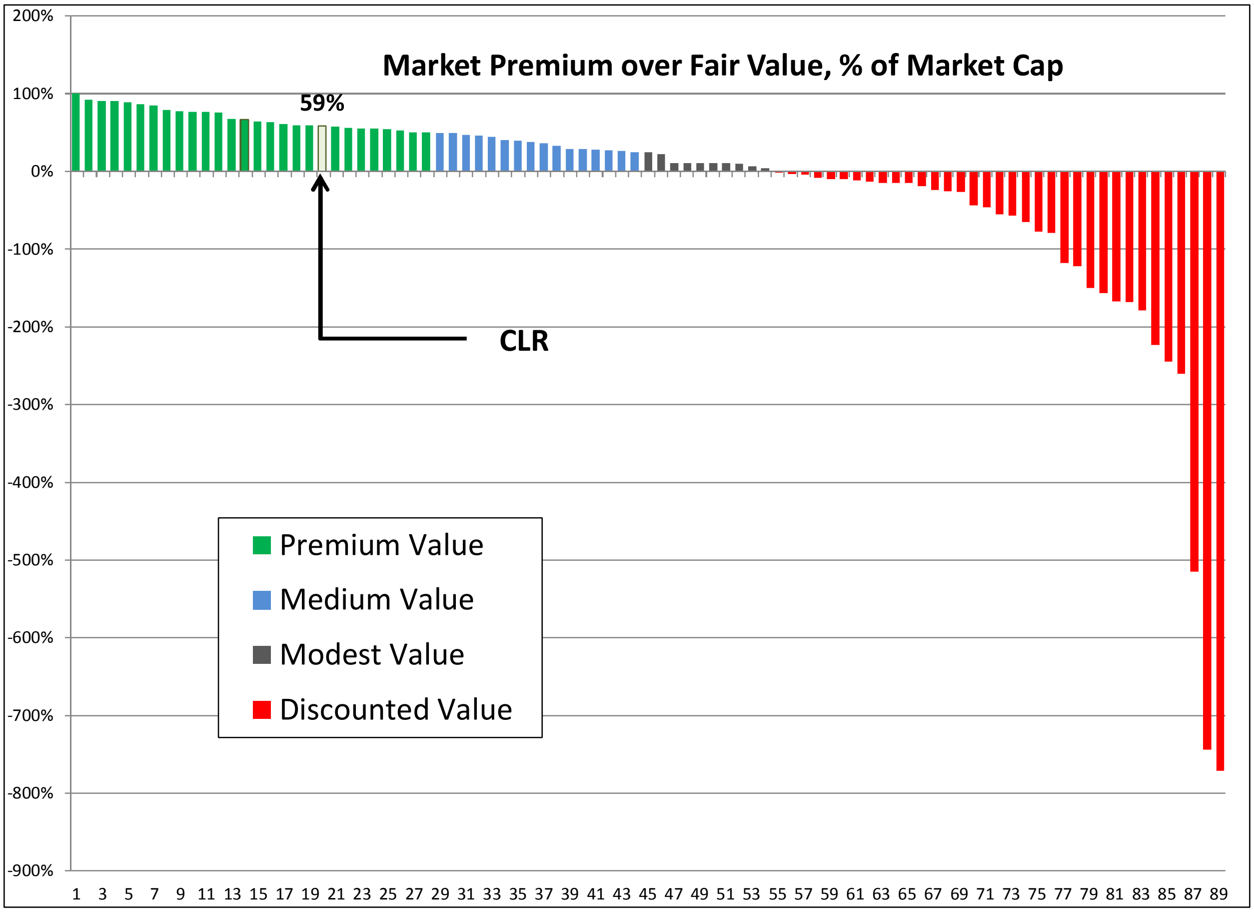
Figure 3



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