Pangea Global, LLC

Occidental Petroleum

It's a long way from Westwood to Greenway

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. 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

Occidental Petroleum is the second largest (in Market Value) North American independent oil and gas producer, second to ConocoPhillips. It is also a top performer, third behind Continental Resources and Peyto Exploration in Excess Return to Capital (Figure 1). It enjoys the second largest Market Value Premium over Fair Value (Figure 2) and seventh largest premium as a percent of Market Value (Figure3). It can surely be said that Oxy has done well by its shareholders and vice versa. However, Oxy has had a turbulent history as a company known for high profile, marqee projects and a celebrity Westwood, California address. Now headquartered in Houston it is emerging as a mainstay of the North American upstream.

Oxy's people dimension personifies its controversial management style. Run by the late Armand Hammer from 1957 to 1990, the company had a turbulent history and, until recently, an incoherent strategy. The company has had only three CEO's in nearly 60 years and successions have been less than calm. A new CEO is slated to take the helm in 2016 and the transition seems to be going smoothly. One concern is that the incumbent has responsibility for the western hemisphere upstream and midstream operations with less experience in the chemicals and Middle East-North Africa (MENA) business units. However, the strategy is clearly focused on growing the US upstream business in core areas where Oxy has strong capabilities. The business process dimension is less clear, but appears to be functioning reasonably well. The environmental, safety and succession crises of the past have not been repeated, suggesting that a process oriented culture has taken root. Another aspect of both people and process dimensions is talent development and succession at the middle management and supervisory level. All companies face the same demographic challenge, but a company building a new culture is particularly vulnerable to talent and experience gaps. Yet with plentiful talent available due to recent industry reductions, Oxy may be able to fill these gaps and continue building its culture with high performers.

Overview

Oxy has the majority of its assets in the Permian basin with conventional, shale and enhanced oil recovery (EOR) Operations. In addition, Oxy has a significant presence in the MENA region, principally in the UAE, Qatar and Oman. Approximately 42 percent of production and 23 percent of assets are in the region. Legacy operations in Iraq and Libya are slated for diminishing exposure. A small ~$2 Billion asset base is in Latin America (Colombia and Bolivia). Oxy is mainly an oil producer, with a long term, deep position in the Permian Basin where it operates both unconventional shale oil development in the Wolfcamp and EOR assets. It operates midstream assets in the Permian as well as proprietary CO_2 pipelines for EOR. A remnant of the Hooker Chemical Company subsidiary manufactures a focused line of commodity chemicals, only a few of which are petrochemicals.

People Dimension

Any organization led by a strong personality for an extended period of time is subject to uncertainty, turbulence and succession challenges in the aftermath of the leader's departure. Oxy is no exception. The Occidental name was for years nearly synonymous with Armand Hammer who assumed the CEO position in 1957 and retained it until his death in 1990. Strategic decisions were made solely by Hammer perhaps with input from other senior executives, often without. While the company was able to attract talented competent technical staff, some with solid leadership skills, it was not until Ray Irani succeeded Hammer that any sense of professional management in the executive suite became apparent. Even though there was pressure from the board in the mid '70s to rationalize at least cash management, Oxy remained the personal province of Armand Hammer. It appears that although Irani, a chemical engineer, sought a more rational decision making culture, he appears to have continued Hammer's top down practices.

Irani was succeeded by CFO Stephen Chazen as CEO in 2011 under investor pressure. Irani was removed from the board in May 2013. The hall mark of the Irani years was the highly publicized compensation he received. In light of the increases in share values during his tenure, a high compensation would be reasonable. However, the level exceeded that of the CEO of ExxonMobil. Further Irani made several high profile but controversial commitments to projects in Iraq in 2010 and development of the Shah sour gas field in Abu Dhabi.

Chazen is slated to retire at the end of 2015 and is due to be replaced by Vicki Hollub currently President Oxy Oil and Gas and corporate EVP. Hollub is a career veteran with Oxy and a Certified Professional Engineer. This transition is certain to be less contentious than the previous one and will bring an added level of industry professionalism.

Employee ratings of the company seem to be actually increasing since oil prices began collapsing in mid-2014. This is perhaps surprising, but may reflect relief at having a job or it could be the predominant opinion of high performing survivors. Ratings on third party websites, Glassdoor and Indeed, indicate a median of 3.4 out of 5.0 and a mode of 4.0. Other ratings provide similar indications. These are closely watched by HR professionals and provide useful insights on the people dimension of performance. Compensation gets the highest rating followed by career opportunities. Senior management is rated lowest followed by culture and values. Yet the CEO received approval of 64% suggesting Chazen's tenure has brought a good deal of professional leadership to the company. Oxy's ratings are not as favorable as peers Anadarko, Apache, Devon and EOG, but suggest it is certainly competitive in attracting talent.

Oxy makes a point on its website about promoting professional development. Comments from current and former employees underscore the learning and development emphasis. It appears the company expects employees to take control of their own development, a strategy that should clearly differentiate the high achievers.

Overall, the people dimension appears to be a source of competitive advantage for Oxy and a contributor to its performance. That said, opportunities to improve in this dimension also seem evident. Professionals in the technical field enjoy the responsibility, but a recurring theme is the need for better team building at this level.

Strategy Dimension

The strategic theme for Oxy is focus on its highest potential assets, principally in the Permian Basin and politically stable MENA countries: Qatar, UAE and Oman. The company has divested assets in the Hugoton gas field and the Williston Basin and its original operating base in California.

Oxy has long experience in the Permian and is one of the larger producers in the basin (~10% of Permian production) providing scale economies. Oxy's main focus is on EOR and because of its scale, expertise and experience is probably the low cost producer. The question is, even at that, are the economics adequate during an extended low price regime. It is not clear whether the EOR business is increasing, decreasing or maintaining.

The other business in the Permian is the giant Wolfcamp field primarily the "A" zone, a horizontal shale play. Consistent with other companies, Oxy's strategic trend is to focus on what they know best. It has been reported that the company maintains 40 years of drilling inventory that is economically viable at a $60 oil price. With current prices well below that, the question remains: How viable is that inventory at prices below $50? The IEA and EIA are expecting oil prices to recover to $60+ within the next few years. This is predicated on falling production and rising demand, both plausible assumptions. However, the possibility of sustained low prices in the $40-$60 range is also possible. Others, including this author, expect low prices for much longer.

Oxy like every other operator is pursuing cost reductions: drilling, completion and operating. In addition, they are pursuing productivity gains to increase IPs and EURs. The Wolfcamp is amenable to innovative approaches to fracturing and it is reasonable to expect a continued incline of the learning curve. Of the operators in the Wolfcamp, Oxy has among, if not the largest, opportunity to refine and optimize its drilling, completion and production practices.

The al Hosn (Shah) gas project in Abu Dhabi, UAE began production in January, 2015 and is the second major strategic initiative for Oxy. While it is large, prolific and probably exhibits favorable economics, it is in a part of the world richly endowed with gas and resulting competition for market share. Marketing plans for the gas are vague at best. The Shah gas field was discovered in 1967 has had several development false starts, most recently when ConocoPhillips pulled out in April, 2010. Oxy stepped in as of January, 2011 and has proceeded with the balance of development with Abu Dhabi National Oil Company under different, reportedly more favorable terms than ConocoPhillips had. While certainly a marquee project, al Hosn varies from Oxy's core oil expertise and draws upon new capabilities, including sour gas processing.

Process Dimension

Information on business process changes is unusually sparse. Following the dramatic price decrease of 2014, most upstream companies are stressing specific measures they have or will be taking to reduce cost. There is mention of moving to a "manufacturing mode" which presumably means standardization, cycle time reduction or combinations of both. It is apparent that pursuing high value locations, reducing drilling, completion and operating costs is a priority.

Capital Allocation Process

Oxy appears to be working hard at allocating capital toward the higher value locations in the Permian, while minimizing discretionary spending on the non-core areas: Williston, Libya, Iraq. It is clear from conference call transcripts that they would prefer to sell the Libyan and Iraqi assets as they have those in the Williston. Host governments are either unable or unwilling to redeem these assets in this environment. Thus, Oxy needs to maintain residual value while minimizing cash drain, a difficult balancing act at best.

The big capital spend at al Hosn is nearly complete. However, the challenge of operating such a large complex facility remains. Fortunately, there is plenty of process engineering and project management talent available. Oxy should be able find the people necessary to develop and run the managerial processes required.

EOR spending is a delicate balancing act given the low price environment. It is a credit that Oxy has developed an apparently low cost CO2 delivery and production system. Maintaining these facilities is a challenge as the carbonic acid by-product corrodes all but the most robust stainless steel. Oxy reports about a $20/bbl cash margin. It is not clear from the CFO's comments if that was at $90 or current prices. If that cash margin is before non-cash DD&A, the EOR business may be underwater from a P&L perspective while cash flow positive before sustaining CAPEX.

Capital Deployment Process

Oxy's large Permian inventory should give it the flexibility to sustain activity on the highest quality locations for quite some time. This should allow the company to sustain and possibly increase production and cash flow. Cost reduction will need to be vigorously pursued to protect the dividend and maintain a sustaining capital spending program. The company will need to be very systematic in its capital deployment process to weather the price storm should it continue beyond 2016. A highly systematic approach to capital deployment seems to be a fundamental imperative for the foreseeable future.

Field Operations

The company claims an 18% reduction in non-EOR field operating expenses during 2015. This is similar to other shale operators, but certainly not the most aggressive. It appears there may be further reductions possible.

EOR operating costs are not directly reported, but there is no doubt Oxy is pursuing reductions where possible. Since there are only a few EOR players of any size, and EOR is among the highest cost oil production businesses, we anticipate EOR volumes will likely not grow for in the next few years. However, taking the opportunity to wring cost out of a proprietary asset position would seem to be a good tactic to position for a future higher price regime.

Conclusion

The Challenge

Oxy is well positioned to make the transition to new senior leadership and to weather the current price storm. Despite the somewhat erratic and mercurial decision making of the past, it can be said the company has done a reasonably good job of capital stewardship. One of the two core assets, the Permian Basin shale acreage should be a source of sustained profitability, probably growth and possibly preeminence in the future. The other core area, al Hosn is less certain. A great deal of capital has been invested (2010 estimates suggest between $10 Billion-$12 Billion gross, Oxy net is uncertain and may be proprietary information). Cash flow to Oxy is estimated at $300-$600 million annually. That is a large range for a project that is now online and near full capacity. It can only be said that this represents a significant exposure in a very uncertain market.

The legacy assets from the Hammer-Irani tenures have been significantly written down, probably to the point that future impacts will be minor. The distraction and diversion of talent and time to these assets need to be minimized to allow Oxy to fully exploit its Permian Resources asset base.

The big takeaway is that after years of internal turmoil and questionable decision making, the company is on track to continue its transition to a more professionally run enterprise. Strategic focus and operational discipline should be the prime imperatives for the company to achieve its full potential. Shareholders are supportive of the moves to date awarding the company a generous market premium over the Fair Value of its assets.

Figure 1

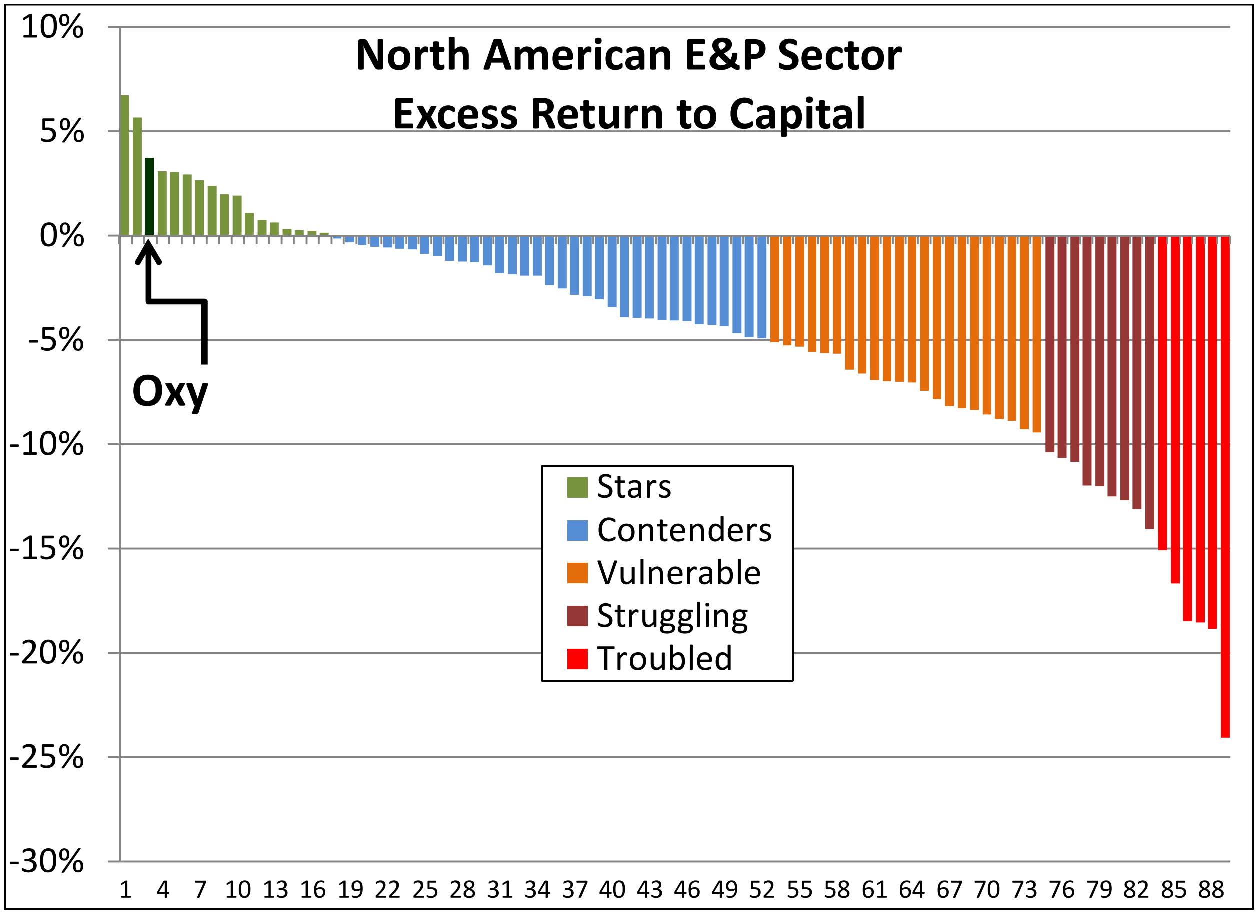
North American E&P Sector
Excess Return to Capital
10%
5%
0%
-5%
-10%
-15%
-20%
-25%
-30%
Oxy
Stars
Contenders
Vulnerable
Struggling
Troubled
1 4 7 10 13 16 19 22 25 28 31 34 37 40 43 46 49 52 55 58 61 64 67 70 73 76 79 82 85 88

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Figure 2

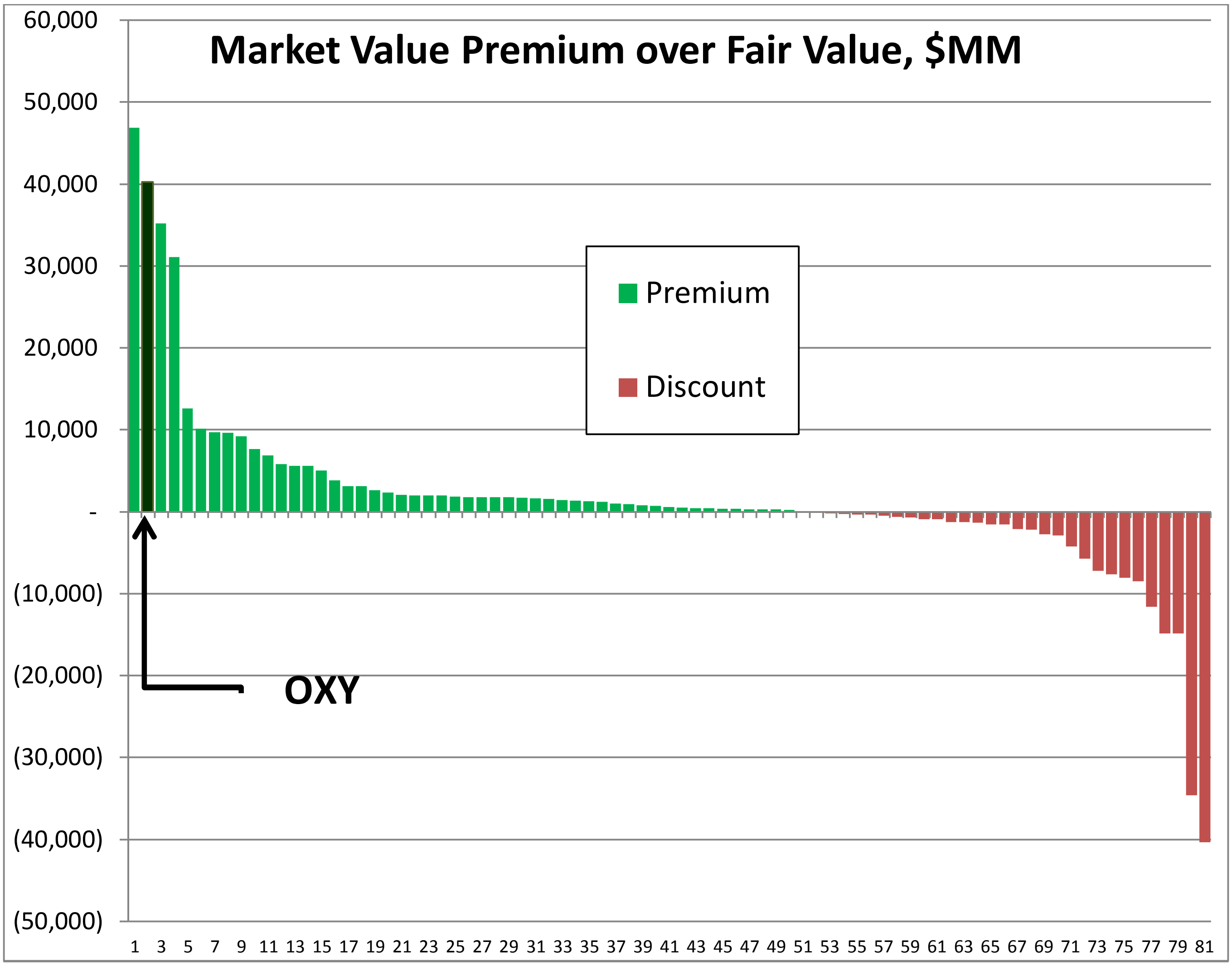
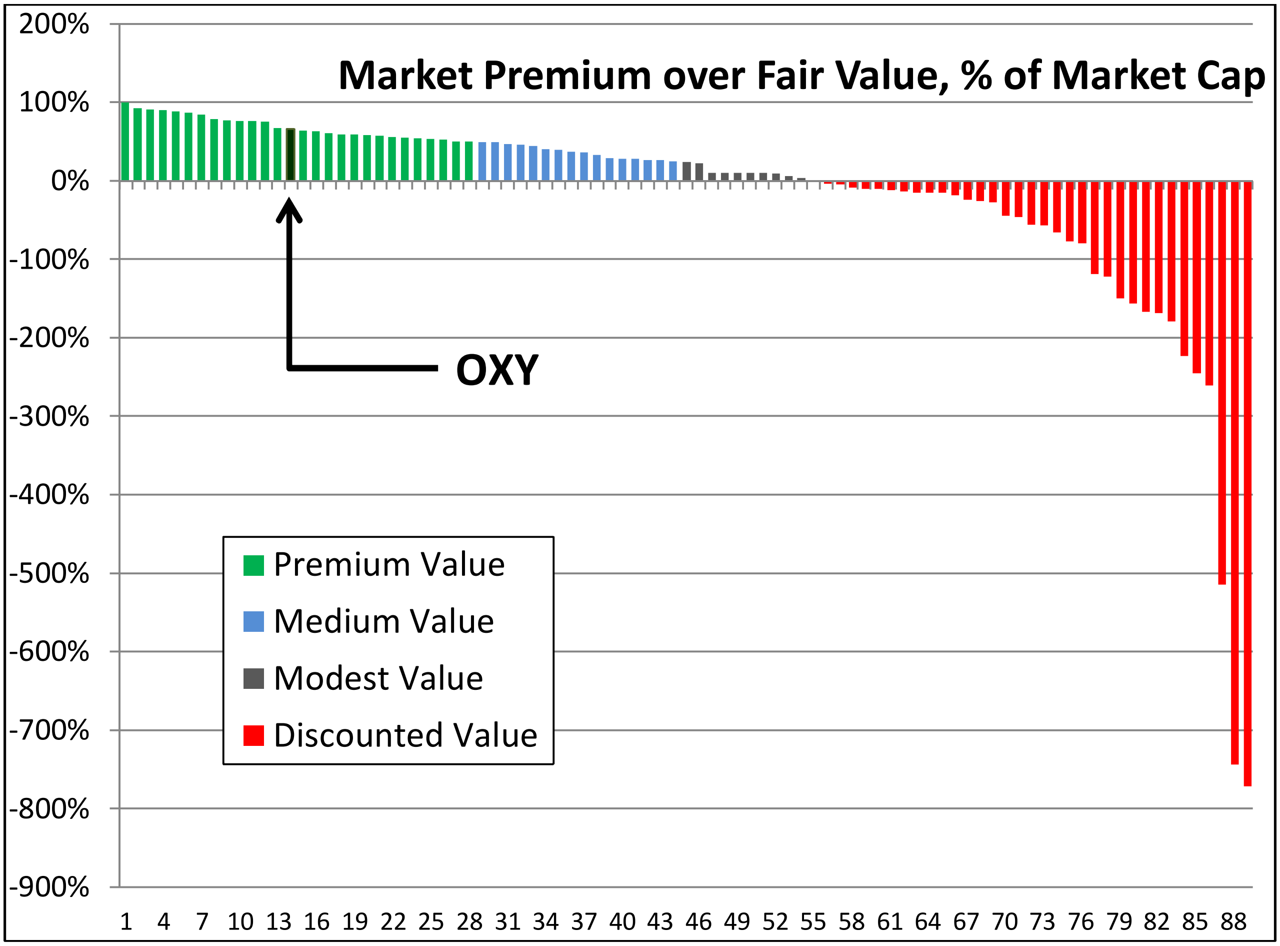


Figure 3


Market Premium over Fair Value, % of Market Cap
200%
100%
0%
-100%
-200%
-300%
-400%
-500%
-600%
-700%
-800%
-900%
OXY
Premium Value
Medium Value
Modest Value
Discounted Value
1 4 7 10 13 16 19 22 25 28 31 34 37 40 43 46 49 52 55 58 61 64 67 70 73 76 79 82 85 88