Devon Energy Third Quarter 2020 Q&A Commentary Transcript

Operator: Welcome to Devon Energy's third quarter 2020 conference call. At this time all participants are in listen-only mode. This call is being recorded. I'd now like to turn the call over to Scott Coody, Vice President of Investor Relations. Sir, you may begin.

Scott Coody, Vice President Investor Relations: Good morning and thank you to everyone for joining us on the call today. Last night we issued an earnings release and presentation that cover our results for the third quarter and updated outlook for the remainder of the year. Throughout the call today, we will make references to our earnings presentation to support our prepared remarks, and these slides can be found on our website at devonenergy.com. Also joining me on the call today are Dave Hager, our President and CEO; David Harris, our executive vice president of exploration and production; Jeff Ritenour, our chief financial officer, and a few other members of our senior management team.

Comments on the call today will include plans, forecasts and estimates that are forward-looking statements under U.S. securities law. These comments are subject to assumptions, risks and uncertainties that could cause actual results to differ from our forward-looking statements. Please take note of the cautionary language and risk factors provided in our SEC filings and earnings materials. With that, I will turn the call over to Dave.

Dave Hager, President and CEO: Thank you, Scott, and good morning. We appreciate everyone taking the time to join us on the call today and for your interest in Devon. For the purpose of today's call, my comments will be centered on **three key points**, our outstanding third-quarter results, our improved outlook for the remainder of the year and the benefits our recently announced merger with WPX.

On **slide 7** of our earnings presentation, I will begin my prepared remarks by covering a few key highlights from our **outstanding third-quarter results**. Across the portfolio, our teams are responding to a challenging operating environment by delivering results that continue to exceed production and capital efficiency targets while successfully driving down per-unit operating costs and maximizing margins. This is evidenced by several noteworthy accomplishments in the quarter, including:

- Oil production exceeding midpoint guidance by 6,000 barrels per day, complimented with capital spending that was once again below forecast.
- Furthermore, we continued to expand margins through improvements in our cost structure, headlined by operating expenses that were 8% below guidance and G&A costs that were reduced 30% year over year.
- With this strong operational performance, we generated $223 million of free cash flow in the quarter.
- And just after quarter end, with the closing of the Barnett transaction, we paid out a $100 million special dividend

All in all, the third quarter was an excellent one, both operationally and financially, as we executed at a very high-level on every single strategic objective that underpins our business model. This strong

performance is a testament to the hard work and dedication of our team, and I want to thank our employees for their continued commitment to excellence.

Moving to **slide 11,** with the strong results our business has delivered year to date, we are **now raising our outlook for the remainder of 2020.** Not surprisingly, this improved outlook is underpinned by the outstanding well performance we are experiencing in the Delaware Basin, and as a result, we are now increasing our full-year oil guidance for the second consecutive quarter. Looking specifically at the upcoming fourth quarter, we now expect our oil production to average 148,000 to 153,000 barrels per day, a 7,000 barrels per day improvement versus prior guidance expectations. Importantly, we are delivering this incremental production with $30 million less capital compared to the revised budget we issued earlier this year.

We also continue to act with a sense of urgency to materially improve our cash cost structure in order to get the most value out of every barrel we produce. With this intense focus, we are on track to reduce LOE and GP&T costs by approximately $0.50 per-unit or 6% compared to our previous expectations. To achieve this step-change improvement in field-level costs, we have meaningfully reduced our recurring LOE expense across several categories including, chemical and disposal costs, compression and contract labor. We have also taken steps to streamline our organization’s corporate cost structure. This is clearly demonstrated by our G&A expense trajectory improving by around $35 million compared to the revised budget and we expect to achieve a $250 million annual G&A run-rate target by year end.

Turning briefly to **slide 13**, the positive impact from higher volumes, better capital efficiency and strong cost discipline is resulting in increasing amounts of free cash flow in 2020. Including the proceeds from the Barnett Shale divestiture that closed on October 1st, we are on pace to generate around $900 million of free cash flow this year. This is a tremendous accomplishment given the incredibly challenging conditions we have faced this year. And importantly, with this excess cash flow, we have rewarded shareholders with higher dividend payments.

Turning your attention back to **slide 3** of our presentation, I would like to cover the **strategic rationale underpinning our recently announced merger with WPX**. This groundbreaking transaction, announced on September 28th, represents the first true merger of equals within the E&P space in nearly two decades. The strategic combination of Devon and WPX is transformational as we unite our complementary assets to create a leading unconventional oil producer in the U.S., with an asset base underpinned by a premium position in the economic core of the Delaware Basin. By bringing together our respective companies, shareholders will benefit from enhanced scale, immediate cost synergies, higher free cash flow and the financial strength to accelerate the return of cash to shareholders through an industry-first "fixed plus variable" dividend strategy. Additionally, the low premium, stock-for-stock combination underscores our confidence that this transaction will allow shareholders of both companies to benefit from synergy realization and the powerful upside potential associated with our financially driven business model.

The path to completing this merger is progressing well. We received HSR clearance last week, the S-4 proxy will be filed within the next few days and both companies plan to hold shareholder votes

around year end to finalize the merger. Integration plans are also underway, led by a transition team comprised of senior leaders from each company. In addition to ensuring a seamless transition, the team is also tasked with capitalizing on the synergies and operational efficiencies that contribute to the significant upside of the combined company.

Moving to **slide 4**, the value of our merger with WPX lies not only in the power of our enhanced scale and strong financial position, but also in how we will manage our company in the future. As I have mentioned many times in the past, with a commodity business such as ours, any successful strategy must be grounded in supply and demand fundamentals. We understand the maturing demand dynamics for our industry and recognize the traditional E&P growth model of the past is not a viable strategy going forward. To win in the next phase of the energy cycle, a successful company must deploy a financially driven business model that prioritizes cash returns directly to shareholders. Devon is an industry leader in this cash-return movement, and, with this highly disciplined strategy, we are absolutely committed to:

- Limiting top-line growth aspirations to 5% or less in times of favorable conditions
- Pursuing margin expansion through operational scale and leaner corporate structure
- Moderating reinvestment rates to 70% to 80% of operating cash flow
- Maintaining extremely low levels of leverage to establish a greater margin of safety and…
- Returning more cash directly to shareholders through quarterly and variable dividends.

I believe these shareholder-friendly initiatives that underpin our cash-return business model will transform Devon from a highly efficient oil and gas operator to a prominent and consistent builder of economic value through the cycle. With the extreme price volatility we have recently experienced, I

do want to provide a few preliminary thoughts on 2021. While it is a bit too early to provide any formal guidance, I want to be clear that our top priorities are to protect our financial strength, aggressively reduce costs and protect our productive capacity. We believe we can accomplish all these objectives in the current operating environment. In fact, with our strong hedging position and pro forma cost structure, we can fund our maintenance capital program at an ultra-low breakeven level of $33 WTI pricing, if not lower with the leading edge results we are achieving in the Delaware. We will provide more formalized guidance for 2021 upon completion of the merger with WPX, but we will remain mindful of commodity prices, nimble with our capital plans and we will invest responsibly to protect shareholder value during this time of high uncertainty.

And finally on **slide 5**, another critically important component of Devon's business model is our commitment to delivering top-tier ESG performance. Doing business the right way has always been a focal point for Devon and predates the growing focus on ESG that has taken off in recent years. We believe that strong performance in the ESG space is essential and impacts every aspect of our business operationally and financially. As with all other aspects of our business, our focus is to control what we can control, while providing energy the world needs and we take pride in fulfilling this need in a reliable and responsible manner. As such, our top environmental priorities include eliminating routine flaring, reducing emissions and advancing water recycling. In addition to these environmental objectives, we strive to cultivate an inclusive and diverse workplace where broad experiences and fresh perspectives can sharpen our competitive edge. From a governance perspective, we are proud that the combined company will have a strong, diverse and independent board, committed to responsible operations to advance the best interests of all stakeholders. The bottom line is we are

committed to these principles, which is underscored by the inclusion of ESG performance as a key measure in our compensation structure.

So in summary…I want to emphasize that the go-forward Devon has all the necessary attributes to successfully navigate and flourish in today's environment and to create value for many years to come. Our shareholder-friendly strategy is designed to result in attractive returns and free cash flow yields that will compete with any sector in the market. The combination of our top-tier asset portfolio, proven leadership team and disciplined business model offers a unique investment proposition in the E&P space.

And with that, I am going to turn the call over to David Harris to cover a few of our operational highlights from the quarter.

David Harris, Executive Vice President, Exploration and Production: Good morning everyone. As Dave touched on, Devon's operations are hitting on all cylinders as we have repeatedly delivered best-in-class results over the past several quarters.

Turning your attention to **slide 8** of our earnings presentation, our world-class Delaware Basin asset is the capital-efficient growth engine driving Devon's operational outperformance in the third quarter. With our capital activity almost exclusively focused in the Delaware, our high-margin production continued to rapidly advance, growing 22 percent on a year-over-year basis. During the third quarter, our operated activity consisted of 9 drilling rigs and 3 dedicated frac crews, resulting in 32 new wells

commencing first production. With most of these completions occurring toward the back half of the quarter, only 14 of these new wells meaningfully impacted production totals in the quarter by attaining peak production rates. Overall, initial 30-day production rates from these 14 wells averaged an impressive 3,900 Boe per day, of which greater than 65% was oil and collectively rank among the very best results we have delivered to date in this world-class basin.

While we had great results across our Delaware Basin acreage position in the quarter, new well activity was headlined by the record-setting well productivity from our Cobra project in Lea County. This 3-mile lateral development, targeting the XY sands in the upper Wolfcamp, achieved average 30-day rates of approximately 7,300 Boe per day, or 475 Boe per thousand feet of lateral. These wells, drilled in the deepest part of the basin, are the longest wells drilled in the history of the Delaware by measured depth and are the highest rate Wolfcamp wells we have brought online to-date at Devon. Importantly, the capital costs for the Cobra project came in nearly 20% below our pre-drill expectations.

Our result at Cobra is another example of the industry-leading performance we have consistently achieved in the Delaware over the past few years. This performance reflects the quality of our acreage and our technical understanding of the subsurface that allows us to identify the best landing zones. Furthermore, with the experience of drilling hundreds of horizontal wells in the basin, our results are aided by understanding parent-child dynamics, appropriate well spacing per development and customized completion designs to optimize results. I am confident that we can continue to deliver this differentiated well productivity in the Delaware going forward. Our large, contiguous,

stacked-pay position in the economic core of the play provides us a multi-decade inventory opportunity and we have a deep inventory of approved federal drilling permits in hand that essentially cover all of our desired activity over the next presidential term.

Turning your attention to the left-hand side of **slide 9**, in addition to strong well productivity, another key highlight for the quarter is the substantially improved drilling and completion cost results we achieved in the Delaware Basin. This is evidenced by our drilled and completed costs reaching $560 per lateral foot in the third quarter, a 40% improvement compared to 2018. These results are absolutely best-in-class among our peers. The key drivers of this performance are the continual optimization of drilling and completion designs along with repetition gains from drilling two-mile Wolfcamp wells, and non-productive time improvements across all phases of the value chain. These are truly special results and I would like to congratulate our operating team for this outstanding accomplishment. However, we are not done improving, and based on leading edge results, we expect our steadily improving cycle times and costs to provide a capital efficiency tailwind heading into 2021.

Shifting your attention to the right-hand portion of the slide, we have also done a lot of good work to expand our margins by lowering per-unit operating costs by 26% since 2018. One of the most meaningful sources of cost improvement is the scalable infrastructure we have proactively built out. We have nearly all of our oil and produced water connected to pipes to avoid the higher expense of trucking and is also a major positive from a safety and environmental perspective. Looking specifically at our water infrastructure, we are fully integrated with 9 recycling facilities, 40 operated saltwater disposal wells and connections to several third-party water systems. This operating scale and

flexibility allow us to source more than 90% of our operational water needs from recycled or brackish water at costs well below market rates. This strategic infrastructure provides the advantage of avoiding the extremely high expense of trucking in the remote desert of southeast New Mexico that can easily exceed a couple dollars per barrel. A few other important contributing factors to our cost improvement in the Delaware are the use of leading-edge data analytics that have reduced controllable downtime in the field by 12% year over year and supply chain initiatives that leverage our purchasing power to secure services at advantaged rates. The bottom line is that the hard work and thoughtful planning from our operations team and supply chain personnel positions us to capture additional savings that many of our competitors cannot.

And with that, I'll turn the call over to Jeff Ritenour for a brief financial review.

Jeff Ritenour, Chief Financial Officer: Thanks, David. My comments today will be focused on a brief review of our financial results for the quarter and the next steps in the execution of our financial strategy.

A good place to start today is by reviewing our financial performance in the quarter, where Devon's earnings and cash flow per share comfortably exceeded consensus estimates. Operating cash flow for the third quarter totaled $427 million, a rebound of nearly 200% compared to last quarter. This level of cash flow fully funded our capital spending requirements and generated $223 million of free cash flow in the quarter. At the end of September, Devon had $4.9 billion of liquidity, consisting of $1.9 billion of cash on hand and $3 billion of undrawn capacity on our unsecured credit facility.

Subsequent to quarter end, on October 1st, our liquidity was further bolstered by the closing of our Barnett Shale divestiture. For those of you not familiar with the transaction, we agreed to sell our Barnett Shale assets for up to $830 million of total proceeds, consisting of $570 million in cash and contingent payments of up to $260 million. After adjusting for purchase price adjustments, which includes a $170 million deposit we received in April and accrued cash flow from the effective date, we received a net cash payment at closing of $320 million. In conjunction with the closing of this transaction, we returned a portion of the proceeds to shareholders by way of a $100 million special dividend. The special dividend was paid on October 1st in the amount of $0.26 per share.

With the excess cash inflows our business is on track to generate in 2020, we expect our cash balances to exceed $2 billion by year end. The top priority for the large amount of cash we have accumulated is the repayment of up to $1.5 billion of outstanding debt between Devon and WPX. This debt reduction plan will provide a nice uplift to the go-forward company's cash flow, resulting in an interest savings of approximately $75 million on an annual run-rate basis. We expect to execute our debt reduction plan throughout 2021 with completion by year-end. We will be mindful of macroeconomic conditions and remain flexible with how we execute the repurchases, which may include both open market transactions and tender offers. Should commodity prices deteriorate from current levels, we will prioritize liquidity and defer debt repurchases to a more appropriate time. Longer-term, it is our fundamental belief that a successful E&P company must maintain extremely low levels of leverage. In accordance with this belief, we will continue to manage toward our stated leverage target of around 1.0 times net debt-to-EBITDA.

Turning your attention to **slide 14**, with our business scaled to consistently generate free cash flow, another key financial priority for Devon is to further accelerate the return of cash to shareholders through higher dividends. However, we believe the traditional dividend growth model deployed by most U.S.-based companies is flawed when applied to a commodities business. The historical practice in the industry of raising the fixed quarterly dividend in times of prosperity and cutting the dividend or underinvesting in the core business during downcycles is not an optimal solution. With these specific challenges in mind, we are implementing an industry-first “fixed plus variable” dividend framework to optimize the return of cash to shareholders through the cycle. This progressive dividend strategy is uniquely designed for our inherently volatile business, whereby a sustainable fixed dividend is paid every quarter and a supplemental variable dividend is also calculated and reviewed every quarter.

More specifically, upon closing of our merger with WPX, Devon’s fixed quarterly dividend will remain unchanged and paid quarterly at a rate of $0.11 per share, with a target payout of approximately 10 percent of operating cash flow, assuming mid-cycle pricing. In addition to the fixed quarterly dividend, up to 50 percent of the excess free cash flow in a given quarter will be distributed to shareholders through the supplemental variable dividend, if certain liquidity, leverage and forward-looking price criteria are met. In conjunction with this more flexible dividend payout strategy, we will also utilize a portion of the combined company’s excess free cash flow to further improve our balance sheet and evaluate opportunistic share repurchases.

And with that, I will now turn the call back over to Scott for Q&A.

Scott Coody, Vice President Investor Relations: Thanks, Jeff. We will now open the call to Q&A. Please limit yourself to one question and a follow-up. This allows us to get to more of your questions on the call today. With that operator, we will take our first question.

Q&A Session

Scott Coody, Vice President Investor Relations: I appreciate everyone's interest in Devon today and, if you have any further questions, please do not hesitate to reach out to the investor relations team at any time, which consists of myself and Chris Carr. Have a good day.