Pioneer Natural Resources Strategy Report

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Executive Summary

Pioneer Natural Resources (PXD) is a large, independent oil and gas exploration and production company headquartered in Irving, Texas. The company was created in 1997 through the merger of Parker & Parsley Petroleum Company and MESA Inc, the energy company founded by T. Boone Pickens. Pioneer quickly embarked on a series of acquisitions that led to the expansion of their operations from West Texas and Kansas into East Texas, the Gulf of Mexico, Canada, Alaska, South Africa, Gabon, Argentina, and Tunisia. In 2006, Pioneer began a multi-year process of divesting non-core assets by selling their stakes in Gulf of Mexico and Argentinian fields. Pioneer Natural Resources currently has operations in Texas, Colorado, Kansas, and Alaska oil and gas fields. Pioneer recently sold a 40% interest in their Wolfcamp Shale holdings in Texas to Sinochem Petroleum USA LLC for $1.7 billion, as part of their strategy to focus on their potentially extremely lucrative land holdings and rapidly expand their oil and gas production capacity. The company operates with a vertical integration model, owning their service equipment and internally operating specialized field services. Pioneer has a current market capitalization of $13.64 billion on 2012 revenue of $2.8 billion.

The main source of competitive pressure in oil and gas exploration and production industry is internal rivalry. There is a high level of existing competition due to the fractured nature of the industry, with numerous large, well-established companies operating alongside smaller, specialized firms and the commodity-based nature of the products. High capital costs to operate at scale and the need for specialized technology ensure that the threat of entry is very low. Neither the suppliers nor the buyers of this industry wield significant power over its participants, with the prices both are able to command largely set by the broader market for energy. The substitutability of the product is low in the short run, but may increase over time as renewable energy sources become more widely used.

Pioneer is currently experiencing a period of rapid expansion as they seek to expand their oil and gas production capacity. To encourage the rapid expansion of revenue, Pioneer should continue to shift their production towards oil, pursue joint ventures with larger companies that allow them to expand production more rapidly than they would be able to internally finance, and encourage the development of U.S. gas export capabilities in an attempt to raise their revenue from gas and the value of their land holdings.

Company Background

Pioneer Natural Resources, a large independent oil and gas company headquartered in Dallas, was formed through the 1997 merger of Parker & Parsley Petroleum Company and MESA Inc., the energy company founded by T. Boone Pickens. These companies followed a strategy of acquiring and exploiting proven oil and gas properties and had established significant operating interests in quality, long-lived fields.

Throughout the years, Pioneer's high-quality land assets have yielded significant oil and gas discoveries for the industry. A solid base of operations and continued drive to increase production and cash flow from existing properties has helped Pioneer become one of the largest operators in the Spraberry/Wolfcamp oil field in West Texas, the gas-rich Raton basin in Southeastern Colorado, the Hugoton gas field in Kansas, and the West Panhandle gas field in the Texas Panhandle. Pioneer is also one of the most active drillers in the South Texas Eagle Ford Shale and was the first independent oil and gas company to produce oil on the North Slope of Alaska.

In its first year after the merger, the company's business expanded into South Africa and Gabon. The firm also acquired Chauvco Resources Ltd.'s assets in Canada and Argentina. In 1998, the firm began exploring several fields in the deepwater Gulf of Mexico and successfully appraised Sable field, 100km off the southern coast of South Africa**.** The firm made its first deepwater Gulf of Mexico discovery in Aconcagua in 1999 and later in the same year filed to acquire Parker & Parsley Limited Partnerships, a firm related to the original Parker & Parsley Petroleum Company.

In the early 2000s, Pioneer expanded and made several major acquisitions and discoveries. In 2000, the firm made a major deepwater discovery at the Devil's Tower field in the Gulf of Mexico. This field was extremely successful and proved to be an important growth opportunity for Pioneer. It appraised well and the firm sold the field for a large profit, one of the new company's first successes. The firm dedicated most of 2000 to expanding its positions in Gulf of Mexico and Canada. From 2000 to 2005, the firm made seven major discoveries, including the first ever oil discovery in South Africa and the first production of oil in Tunisia. In September 2004, Pioneer merged with Evergreen Resources, Inc., creating a new core area of operations in the Rocky Mountains that improved Pioneer's already strong foundation in North America. In addition to this

merger, by the mid-2000s, Pioneer had acquired a dozen major fields with its revenue from a successful series of major discoveries of proven reserves.

The second half of the 2000s built on the firm's success around the world. Pioneer continued to sell major discoveries in Africa, the deepwater Gulf of Mexico, Argentina, and Alaska. The firm successfully completed the first horizontal well in the Eagle Ford Shale field in South Texas, resulting in a liquids-rich discovery of proven reserves. Huge success from the firm's original overseas explorations was not met with a desire to continue to further exploit these foreign assets. By 2010, the firm had divested its Argentinian and Gulf of Mexico assets in order to concentrate on its Alaska and Texas fields.

Since 2011, the firm has also sold off its Tunisian and South Africa businesses, selling the latter to the Petroleum Oil and Gas Corporation of South Africa Ltd. in 2012. In the same year, Pioneer acquired Carmeuse Industrial Sands (now Premier Silica, LLC) to expand its capacity to provide in-house solutions to drilling needs as part of its vertical integration strategy. This year, Pioneer signed a $1.7 billion agreement with Sinochem Petroleum USA LLC to sell 40 percent of its interest in approximately 207 thousand leased acres in the horizontal Wolfcamp Shale play. The sale provided Pioneer with enough capital to begin investments in drilling and mining the remaining share of the field on their own.

Pioneer's current position in the Texas Wolfcamp field signals the firm's plan to focus its capital on its most promising fields and use the capital gained from the sale of overseas holdings to fund investments in its remaining acreage.[1]

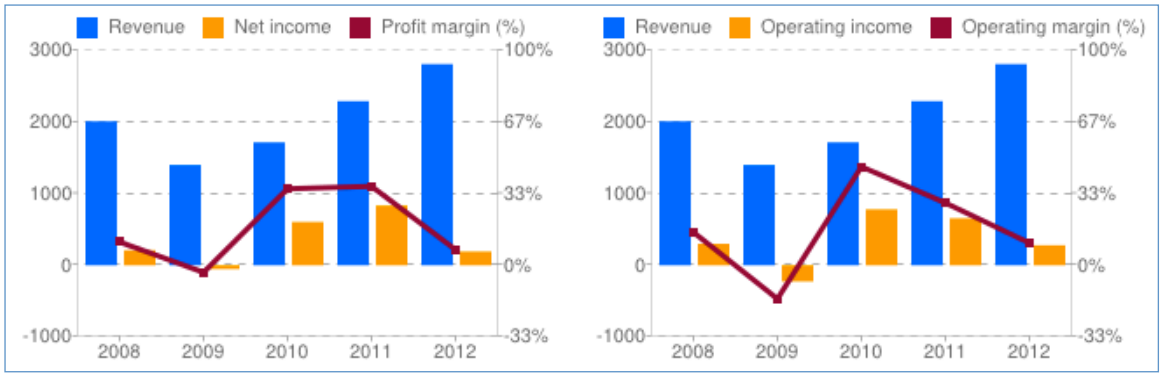
[1] http://www.pxd.com/about/company-history
http://www.fundinguniverse.com/company-histories/pioneer-natural-resources-company-history/
http://www.fundinguniverse.com/company-histories/pioneer-natural-resources-company-history/

Financial Analysis

Revenue, Profitability, & Growth

(in millions of USD)	2012	2011	2010
Revenue	2,811.66	2,294.06	1,718.30
Revenue Growth	22.56%	33.51%	
Operating Income	280.06	656.41	781.57
Operating Income Growth	-57.33%	-16.01%	
Net Income	192.28	834.49	605.21
Net Income Growth	-76.96%	37.88%	

Source: Yahoo Finance



Source: Google Finance

Pioneer Natural Resources has experienced consistent revenue growth in recent years. This is due to an expansion in oil and gas production that should continue into the future as Pioneer Natural Resources focuses on the production side of its business. Revenue growth above 20% for the past two years signals that Pioneer Natural Resources is expanding rapidly, and the decrease in 2012 operating income and net income is a result of that rapid expansion. Oil and gas production equipment is very expensive and due to Pioneer Natural Resources' vertically integrated business model, the company needed to purchase a great deal of this equipment.

In order to focus on oil and gas production in the United States, Pioneer Natural Resources sold off holdings around the world. One piece of property in Tunisia netted a $645 million gain in 2011, but the resulting tax and discontinuation of operations hurt profits in 2012. The $297 million purchase of Premier Silica, a company that produces sand for the fracturing process of oil and gas drilling, also hurt 2012 profits but can be seen as a valuable addition to the vertically integrated business model.

Nevertheless, even as operating revenue increased, profits did decline and that is a worrying trend for Pioneer Natural Resources. Leasing and service costs increased for oil and gas production, and it appears Pioneer Natural Resources increased production will not immediately translate into increased profits. Oil and natural gas prices also fell, and Pioneer Natural Resources' profits are highly sensitive to changes in these commodity prices.

Operating Metrics

Production (daily avg)	2012	2011	2010
Oil (BBLs)	62,645	40,618	28,211
Oil Growth	54.23%	43.98%	
NGLs (BBLs)	29,816	22,487	19,736
NGLs Growth	32.59%	13.94%	
Gas (MCF)	378,369	343,879	335,256
Gas Growth	10.03%	2.57%	

Source: PXD 2012 Annual Report

Pioneer Natural Resources has increased production in all three of its fields: oil, natural gas liquids (NGLs), and gas. The bulk of this increase has occurred in oil, with natural gas liquids also seeing significant growth in 2012. Production of gas has increased, but at a rate slower than Pioneer Natural Resources' total expansion in production.

Prices	2012	2011	2010
Oil	$90.89	$96.60	$90.56
Oil % Change	-5.91%	6.67%	
NGLs	$33.75	$46.27	$38.14
NGLs % Change	-27.06%	21.32%	
Gas	$2.60	$3.84	$4.18
Gas % Change	-32.29%	-8.13%	

Source: PXD 2012 Annual Report

Commodity prices declined in 2012, but not at equal rates across oil, natural gas liquids, and gas. Oil prices fell by just 6%, compared to approximately 30% decreases for natural gas liquids and gas. Gas prices have been hit particularly hard, having also decreased in 2011.

(in millions of USD)	2012	2011	2010
Oil Revenue	2,078.24	1,432.15	932.50
Oil % of Total	74.11%	62.43%	54.27%
NGLs Revenue	367.30	379.77	274.75
NGLs % of Total	13.10%	16.56%	15.99%
Gas Revenue	359.07	481.98	511.50
Gas % of Total	12.80%	21.01%	29.77%

Source: PXD 2012 Annual Report

Over the past three years, the percentage of Pioneer Natural Resources' overall sales coming from oil has increased from 54% to 74%. Natural gas liquids' percentage has stayed approximately the same, while gas is a much smaller part of the sales mix. These changes are partially due to commodity prices, as the price of oil has not dropped since 2010, unlike gas, but they also stem from a strategic decision by Pioneer Natural Resources to focus on the production of oil.

In the future, the production of oil will continue to expand fastest for Pioneer Natural Resources, and taking recent pricing trends into consideration, this appears to be a wise decision and will aid in profit margin. However, as oil becomes a larger percentage of total revenues, Pioneer Natural Resources' profits will be extremely sensitive to the price of oil. If oil prices were to decline,

even increases in the prices of natural gas liquids and gas could likely not counteract the loss in revenue from the oil segment.

Cash Flow & Solvency

Cash Flow (in millions of USD)	2012	2011	2010
Cash from Operating Activities	1,837.58	1,529.71	1,285.02
Cash from Investing Activities	-3,256.41	-1,560.79	-954.86
Cash from Financing Activities	1,110.74	457.4	-246.38
Net Change in Cash	-308.09	426.32	83.79

Source: Google Finance

An increase in overall production has caused Pioneer Natural Resources' cash intake from operating activities to continually expand. 2012 also saw a large increase in cash from financing activities as Pioneer Natural Resources borrowed over $1 billion to help fund its capital expenditures. In order to allow for its expansion in oil and gas production, Pioneer Natural Resources' capital expenditures exceeded $2.75 billion in 2012, far higher than the previous two years and the cause of the company's net decrease in cash.

Despite this decrease in cash, Pioneer Natural Resources' current ratio is still just above 1, a safe value for oil and gas production and exploration firms. The debt to equity ratio has risen to 63.42 due to high capital expenditures, but the most recent annual report notes that banks do not fear this debt, as Pioneer Natural Resources signed a 5-year credit agreement in 2012 to increase its borrowing limit to $1.5 billion. With rising debt, interest expense increased by $23 million to $204 million in 2012, but the average interest rate declined from 7.2% to 6.0%. This indicates that financial institutions do not see Pioneer Natural Resources' debt as a major risk, but rather as a calculated investment that will result in higher production levels in future years.[2]

[2] Pioneer Natural Resources fiscal 2012 form 10-K

DuPont Analysis & Industry Comparison

DuPont Analysis

	Pioneer Natural Resources	Energen Corporation	Apache Corporation
Net Income Margin	6.84%	15.86%	11.72%
Asset Turnover	0.23	0.28	0.30
Leverage Ratio	2.15	2.13	1.80
Return on Equity	3.4%	9.6%	6.4%

*Time period is fiscal 2012, data obtained from the respective companies' fiscal 2012 form 10-K

Pioneer Natural Resources has the lowest return on equity (ROE) amongst its peers, at 3.4% during fiscal 2012.[3] This is substantially lower than both Energen Corporation and Apache Corporation, two of Pioneer's close peers, with ROE of 9.6%[4] and 6.4% respectively. Restoration Hardware's lower ROE is entirely due to having by far the lowest net income margin. This is largely a function of Pioneer currently operating with a much lower operating profit margin of 9.96% than either Energen Corporation or Apache Corporation, with operating profit margins of 28.41% and 29.52%, respectively. This difference is primarily due to substantial capital spending by Pioneer as they work to increase their production capacity. Pioneer's asset turnover ratio is slightly below its peers, which is expected given that much of the company's assets are undeveloped, non-revenue generating land holdings. As Pioneer begins to extract energy from a larger percentage of their holdings, their asset turnover should improve to be more in line with industry averages. Despite the large increase Pioneer's debt in fiscal 2012, the firm has maintained a leverage ratio in line with its competitors.

As Pioneer Natural Resources transitions from primarily an oil and gas exploration company into a firm that focuses on oil and gas production, it must figure out how to improve efficiency and increase its margins. However, given that Pioneer Natural Resources is in a high growth phase and is currently prioritizing overall revenue expansion over profits, the low margins are not as concerning as they would be for a more mature company.

Prior to the 2012 dip in earning stemming from large capital expenditures, Pioneer Natural Resources was in line with industry price to equity (~25) and earnings per share (~3.5) metrics. However, it is now outside industry norms, with a very high P/E ratio of 79.1 and EPS of just 1.5.[5]

[3] Pioneer Natural Resources fiscal 2012 form 10-K
[4] Energen Corporation fiscal 2012 form 10-K and Apache Corporation fiscal 2012 form 10-K
[5] finance.yahoo.com

Stock Performance and Analyst Opinion

Source: Yahoo Finance

With a yearly increase of 8% in comparison to the S&P 500's 11% increase, Pioneer Natural Resources has slightly underperformed the overall stock market. In fact, after hitting a 52-week low of $77.41 in the summer of 2012, the price has risen over 50%. Since hitting its 52-week high in mid-February, however, Pioneer's stock has experienced a substantial pullback, dropping over 17% in the past two months. This chart also shows the high volatility of Pioneer's stock price.

Analyst opinion hovers between a weak buy and a hold for Pioneer Natural Resources. Expected annual growth of 15% over the next five years exceeds S&P 500 expected growth of 9%, and the growth estimates for Pioneer are not significantly different than those for the oil and gas exploration and production industry. Due to expected increases in oil prices and worldwide demand, analysts expect oil and gas exploration and production companies to outperform the broader market. It is not clear, however, that analysts see any particular competitive edge for Pioneer Natural Resources among its peers.[6]

[6] finance.yahoo.com

Competitive Analysis

Internal Rivalry

Pioneer competes with both other independent oil and gas exploration and production companies and global integrated energy companies. Independent operators range in size from companies such as Devon Energy and Apache Corporation that are over twice the size of Pioneer and operate on an international scale to much smaller firms like Diamondback Energy that only operate in one region or, in extreme cases, only one field. Pioneer also competes with international energy conglomerates known as "supermajors", such as ExxonMobil and Royal Dutch Shell, which are engaged in every facet of the energy industry, from new field exploration to selling refined gasoline to consumers. Additionally, while Pioneer does not directly compete with the giant state-owned energy companies, such as Saudi Aramco or Gazprom, since national oil companies control 80% of the world's reserves of oil and natural gas, they are able to assert major pricing pressure on world energy markets.[7] Despite consolidation at the top end of the industry, with the ten largest operators accounting for 54% of proved oil reserves and 48% of proved natural gas reserves in the United States, Pioneer faces stiff competition from both large and small firms due to the lack of economies of scale in oil and gas production. The market is extremely fragmented with over 14,000 firms in the United States operating at least one oil or gas field.[8]

Due to the lack of product differentiation between the many oil and gas production companies, international energy markets set the price of oil and gas. Thus, firms in this industry largely compete on costs to obtain greater profit margins and gain a competitive advantage. One of the main ways companies control costs is vertical integration. This allows firms to control the major cost components of drilling and production activities, such as drilling rigs and specialized sand companies for hydraulic fracturing, rather than farming out those tasks to contractors that take their own profit margin. Companies also attempt to lower land acquisition costs through the use of specialized extraction technology, such as horizontal drilling and hydraulic fracturing, to access unconventional reserves.[9] This allows firms to potentially access previously unavailable oil and gas

[7] http://www.petrostrategies.org/Links/Worlds_Largest_Oil_and_Gas_Companies_Sites.htm
[8] http://www.eia.gov/pub/oil_gas/natural_gas/data_publications/crude_oil_natural_gas_reserves/current/pdf/top100operators.pdf
[9] Pioneer Natural Resources fiscal 2012 form 10-K

on land they already lease or to obtain new holdings for below market value due to their unique ability to access the land's reserves.

Entry & Exit

The threat of entry in the oil and gas exploration and production industry is low. While it is relatively easy for a new firm to enter the market through the purchase of speculative land rights, the high capital costs incurred from exploring and producing at scale, along with the need for specialized equipment and knowledge that is often needed to extract reserves, serve as high barriers to new entrants. While exploration of a new field can be a relatively inexpensive process, an industry wide trend towards lower prices for non-producing fields incentivizes firms to produce promising fields rather than quickly sell them to a larger company. However, oil and gas production at scale is very capital intensive and is difficult for new or smaller firms to achieve without engaging a larger partner. Additionally, the lack of differentiation in the marketplace makes employing well-trained and experienced personnel, with experience in making successful capital investment decisions, extremely important. Given the commodity-based nature of the industry where competitive advantage is gained through cost control, it is difficult for a new entrant without substantial industry experience to survive and acquire the necessary expertise.[10]

Furthermore, the oil and gas industry is bound by a set of complex federal, state and local laws and regulations that vary widely depending on the location of the field. This is an added difficulty that new entrants need to understand and comply with prior to beginning operations.

Substitutes & Complements

The threat of a substitute for oil and gas is low in the short term, but rises to medium over the long term due to potential increases in the efficiency and availability of renewable energy sources. At this time oil and gas are each the main substitute of the other and, in the short term, substitutes for oil and gas are not likely to be readily available at scale. While the cost and availability of renewable energy sources is rapidly expanding, they are not yet able to compete with oil and gas on either front. Together, oil and gas account for approximately 62% of the United States' energy needs. This includes gasoline, heat and power generation, and products derived from petroleum such as rubber

[10] Pioneer Natural Resources fiscal 2012 form 10-K

and plastics.[11] While various renewable energy sources are currently making inroads to displace oil and gas from some of these applications, such as the expansion of wind and solar energy for power generation, they are incapable, for now, of delivering energy at the same scale and cost efficiency due to the current state of technology.

In the medium to long-term, as the manufacturing technology and per unit efficiency of these renewable sources improves, they could prove to be a major threat to oil and gas. Major pushes by large, industrialized countries, to produce a greater percentage of their electricity from renewable sources could accelerate the rate at which these technologies improve. In Germany, for example, the share of electricity produced by renewable energy sources has doubled in the last four years, without any increase in the electricity price for industrial consumers.[12] Germany was only able to accomplish this, however, due to the use of large subsidies for the development of renewable energy.[13] While these subsidies are currently necessary to make up for the large difference in market cost between energy production from fossil fuels, such as oil and gas, and renewable sources, as manufacturing ramps up and the technology improves, these subsidies may become unnecessary. Additionally, environmental concerns about the role carbon dioxide emissions play in global warming may lead to additional taxes or regulations that make it more expensive to produce or use oil and gas.[14] If this happens, the increased cost of producing energy from oil and gas may make renewable sources more competitive.

Right now, the most important complement for oil and gas is power generation in the electricity sector. The increase in gas production in the U.S. has led to an increase in demand for the relatively inexpensive energy produced using natural gas. This, in turn, has sparked an increase in the domestic manufacturing sector, which has grown at a 5% annualized rate since 2009, twice as fast as the overall economy. This increase in the manufacturing base will likely ensure continued demand for gas, as long as the price remains relatively lower than other energy sources, such as coal.[15]

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[11] http://teeic.anl.gov/er/oilgas/restech/uses/
[12] http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&plugin=1&language=en&pcode=ten00114
[13] http://www.reuters.com/article/2013/02/18/energy-power-germany-idUSL5N0BF94820130218
[14] Pioneer Natural Resources fiscal 2012 form 10-K
[15] http://www.npr.org/2013/03/28/175483517/cheap-natural-gas-pumping-new-life-into-u-s-factories

Supplier Power

The primary input for oil and gas exploration and production companies is land holdings with oil or gas reserves. Owners of land potentially holding major oil or gas reserves do not wield as much power as might initially be anticipated. This is largely due to the imprecise nature of estimating the quantity of energy contained in the land and the ability to easily extract it, which cannot be well estimated until a detailed analysis of engineering and geoscience data is conducted. More precise estimates cannot be made until test wells are drilled, and even then there is considerable uncertainty.[16] Due to the lengthy and expensive nature of running these studies, oil and gas exploration firms typically lease the land prior to conducting them. Adding to the lack of supplier power for landholders, the lack of product differentiation means that the price of the oil and gas their land contains is set by the world market. Thus, the value of their land is determined by the broader market and will be set at no greater than the value of the reserves minus expected extraction costs. Additionally, new drilling techniques are opening more and more fields to possible production, flooding the market with potential new sites.

Some oil and gas exploration and production firms also use external specialized field services companies for a broad range of tasks, including pumping services and well services, along with additional ancillary services such as specialized sand for hydraulic fracturing.[17] The supplier power of these field services firms could be large at times, particularly when the price of oil or gas is high leading to increased production rates and greater demand for their specialized services. Despite this, these firms exert little supplier power on the market as a whole. There is no major player that controls this piece of the oil and gas production chain and many larger oil and gas exploration and production companies, such as Pioneer, pursue a strategy of vertical integration to provide these services internally.

Buyer Power

Neither oil and gas exploration and production companies nor their buyers have substantial market power over the other, due to the globalized commodity markets that govern the price of oil and gas.[18] This holds true at all levels of the market; a small, independent producer selling to a distributor

[16] Pioneer Natural Resources fiscal 2012 form 10-K
[17] http://www.pxd.com/operations/vertical-integration
[18] Pioneer Natural Resources fiscal 2012 form 10-K

does not hold considerably less market power than a globally integrated firm, such as Chevron, who sells directly to consumers. This is due to the lack of product differentiation and transparent market pricing, as well as the large numbers of both buyers and sellers in the market. As a result, who a producer sells to or a buyer buys from is often determined by transportation and distribution costs, so buyer power is high only for small or isolated producers.

SWOT

Strengths	Weaknesses
• Vertical Integration • Holdings with Large Resource Potential • Strong Balance Sheet	• Environmental Liabilities • Large Capital Investment Needs • Weak Short-Term Margins
Opportunities	**Threats**
• Joint Ventures • Potential to Sell Unexploited Fields • Gas Exports	• Price Shocks • Regulation • Unproven Reserves Fail to Reach Resource Potential

Strengths

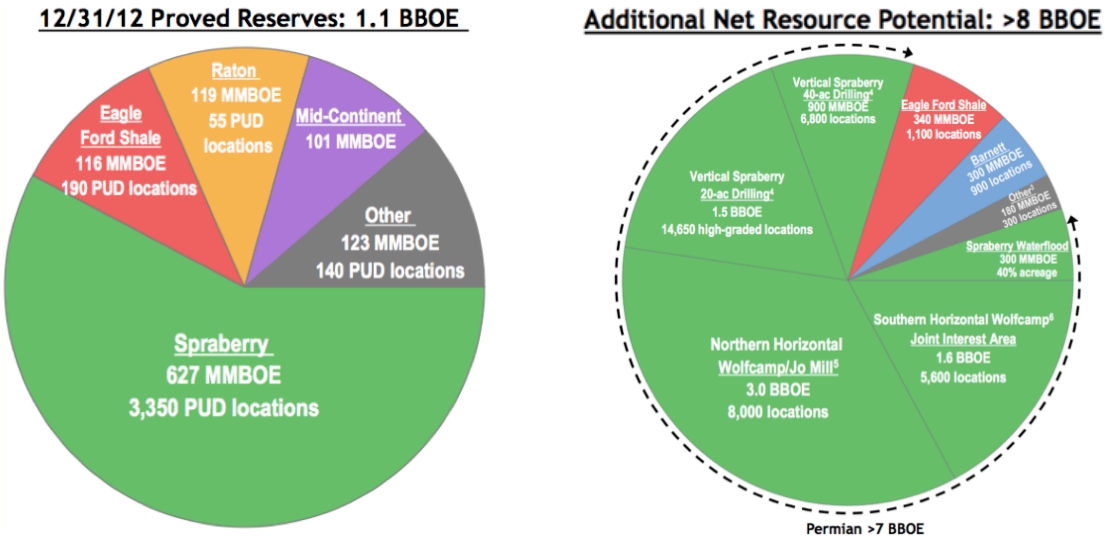
- **Vertical integration**

  Pioneer's business strategy emphasizes providing in-house solutions to drilling needs. As the company has expanded its use of drilling techniques such as hydraulic fracturing and horizontal drilling to access previously inaccessible reserves, the company has acquired firms that provide these specialized drilling services. This allows Pioneer to differentiate themselves from other producers by building up internal expertise in these techniques, rather then relying on external contractors, and to reduce operating costs over the long run.[19]

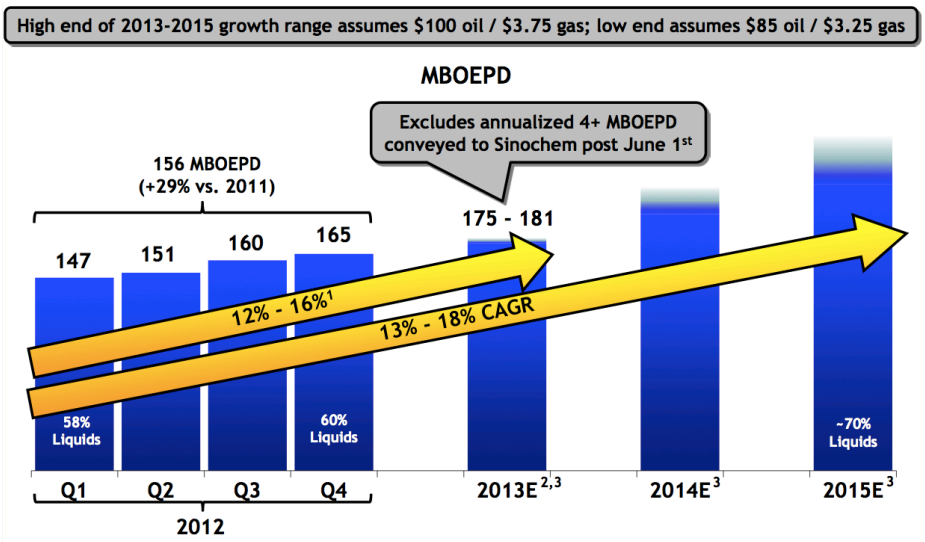
[19] Pioneer Natural Resources fiscal 2012 form 10-K

- **Holdings with large resource potential**

  Pioneer already has substantial proved reserves of 1.1 billion barrels of oil equivalent (BBOE), making them one of the 15 largest oil and gas producers in the United States.[20] The additional energy potential of their land holdings, however, is over 8 BBOE, which could catapult them even higher in the top echelon of U.S. oil and gas producers. Pioneer projects that this combination of proven and potential reserves will allow them to achieve a compound annual growth rate of 13% - 18% from 2013 through 2015.[21]



Historic and Projected Compound Annual Growth Rate (2012 – 2015)



[20] http://www.eia.gov/pub/oil_gas/natural_gas/data_publications/crude_oil_natural_gas_reserves/current/pdf/top100operators.pdf

[21] Pioneer Natural Resources Fourth Quarter 2012 Earnings Presentation, slides 6 and 10

- **Strong balance sheet**

  Pioneer has recently embarked on a multi-year strategy to build up their production capacity in their most promising fields. One of the ways they have financed these capital investments is through increased debt. Pioneer's balance sheet, with a current ration of over 1, has allowed the firm to increase its debt while at the same time decreasing their average interest rate from 7.2% to 6.0%.[22] The ability to take on debt is important during this period of expansion and Pioneer's strong balance sheet has allowed them to do that.

Weaknesses

- **Environmental liabilities**

  The exploration and production of oil and gas products involves many operations risks that could result in substantial losses for Pioneer Natural Resources in the case of an accident or natural disaster. Pioneer's exposure to operational risks has increased as they expand their drilling operations, including hydraulic fracturing which has recently come under greater environmental scrutiny. Although Pioneer is protected from these risks to some degree due to the oil and gas friendly states in which they operate, a substantial accident could result in large civil liabilities or a change in public opinion that forces legislatures to increase regulatory oversight.

- **Large capital investment needs**

  Pioneer Natural Resources operates in an extremely capital intensive industry and the firms' capital investment costs have risen dramatically over the past several years as they have transitioned to focus on increasing production of their current land holdings. Recently, Pioneer has found creative ways to fund their capital costs, such as holding a secondary offering, increasing long-term debt by $1.2 billion in 2012, and joint ventures.[23] However, if Pioneer cannot continue to find ways to fund their investment needs, particularly during this period of rapid expansion, they will be unable to continue their current strategic realignment towards production.

[22] Pioneer Natural Resources fiscal 2012 form 10-K
[23] Pioneer Natural Resources fiscal 2012 form 10-K

- **Weak short-term margins**

  In 2012, Pioneer's operating margin and a net profit margin dropped significantly from the year before, to just 9.96% and 6.84%, respectively. This was primarily due to a large increase in capital expenditures to develop Pioneer's fields and up their production capacity. Even in the short-term, this appears to have been successful, with Pioneer achieving revenue growth of over 20%. However, given the increase in debt and negative cash flow that accompanied this increase in development, Pioneer will not be able to continue operating as is with low margins indefinitely and will be forced to sell off holdings or stop expansion if this continues. Due to Pioneer's historically demonstrated ability to operate with higher margins, this appears to be a short-term issue, rather than a long-term trend.[24]

Opportunities

- **Joint ventures**

  Pioneer has entered several joint ventures agreements in the past, selling a portion of their interest in a field in exchange for cash and other considerations, including paying a substantial portion of Pioneer's drilling costs. In these arrangements, Pioneer continues to operate the field as normal, while allowing the company to share the capital costs associated with increasing production. Recently, Pioneer sold 40% of their interest in the Wolfcamp Shale to Sinochem in exchange for $522 million in cash and an agreement to fund 85% of future drilling and facilities costs (their 40% of costs plus 75% of Pioneer's 60% of costs). These agreements allow Pioneer to expand their production at a much faster rate than they would be able to if the company had to fund all capital expenditures internally.

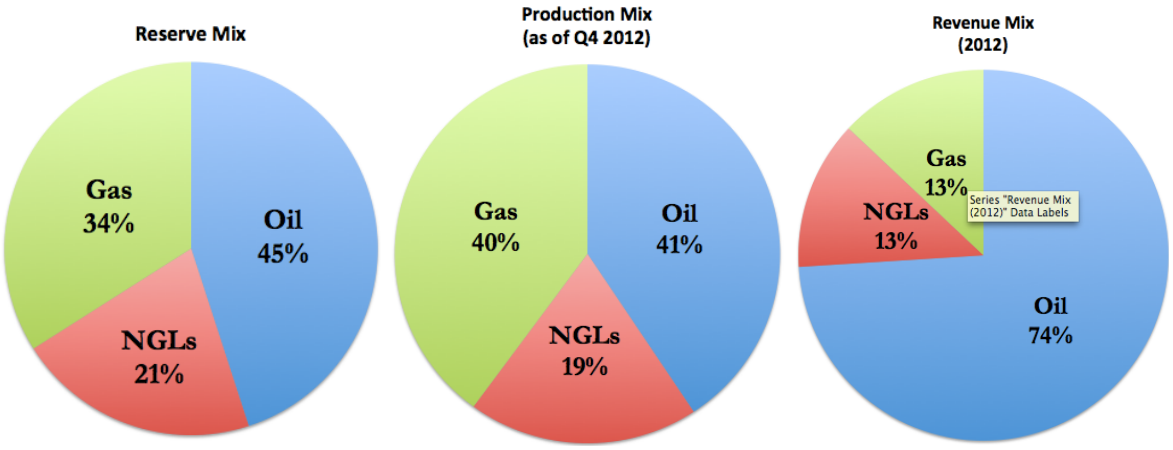
- **Potential to sell unexploited fields**

  Pioneer has significant land holdings on which they have not yet started to produce at scale. Recently, the company solicited offers for their holdings in the Barnett Shale, but decided not to sell after the offers received were deemed too low by management. Currently, market prices for unproven fields are relatively low, however, this may not persist over the long-term and Pioneer has a proven history of being able to sell off unexploited fields to fund future exploration and production operations.

[24] Pioneer Natural Resources fiscal 2012 form 10-K

- **Gas exports**

  Although only 26% of Pioneer's revenue in 2012 came from NGLs and gas,[25] they comprise approximately 60% of the firm's production and 55% of its reserve mix.[26] This is due to the record gas inventories driving prices extremely low. However, recent developments in storing liquid natural gas (LNG) on cargo ships now make it economically feasible to transport gas across oceans, enabling the export of gas to more profitable foreign markets. This has led to a massive shift in LNG export terminal planning and construction in the U.S. with 13 LNG export terminals under construction or formally proposed to the Federal Energy Regulatory Commission.[27] After these export terminals come on line, U.S. gas producers can begin exports to countries places where gas prices are much higher. The average price of gas in the United States was $2.77 per MMBtu in 2012,[28] while the average import price of gas was $11.47 per MMBtu in the European Union and $16.55 in Japan.[29] Even if Pioneer does not actually export any of their own gas to foreign markets, the decrease in the domestic gas supply that these exports would cause should lead to an increase in the price of gas in the U.S. and to substantial increases in revenue for Pioneer.



[25] Pioneer Natural Resources fiscal 2012 form 10-K
[26] Pioneer Natural Resources Fourth Quarter 2012 Earnings Presentation, slides 26 and 30
[27] http://ferc.gov/industries/gas/indus-act/lng.asp
[28] http://www.eia.gov/todayinenergy/detail.cfm?id=9490
[29] http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0,,contentMDK:21574907~menuPK:7859231~pagePK:64165401~piPK:64165026~theSitePK:476883,00.html

Threats

- **Price shocks**

  The recent major expansion of gas production in the United States has driven prices lower and led to a negative price shock for Pioneer, directly leading to decreases in their revenue. Additionally, much of Pioneer's reserve mix is made up of gas and the company's worth is largely determined by the estimated value of deposits in the land that it leases. If gas prices remain low, or further decline, it will lead to a substantial drop in the value of Pioneer's holdings. In 2012, Pioneer had impairment costs of $532.6 million, almost 20% of revenue, due to reductions in management's longer-term price outlooks leading to a substantial revision to the fair value of the company's Barnett Shale holdings.[30]

- **Regulation**

  Pioneer is vulnerable to regulations that would increase costs or limit exploration and production. Recently, concerns about air quality near drilling sites in the Barnett Shale led to the Texas Commission on Environmental Quality adopting new air emissions limitations and permitting requirements for oil and gas facilities in the state, which could increase the cost and time associated with drilling wells in the area. Additionally, hydraulic fracturing, which Pioneer routinely uses in the majority of its drilling to stimulate oil and gas production, has recently come under increased scrutiny on the basis of groundwater contamination and potential seismic hazards. As a result, Pioneer may face increased costs or regulatory requirement, or even decreased production, if the government passes strict rules on the use of hydraulic fracturing.[31]

- **Unproven reserves fail to reach resource potential**

  A significant amount of Pioneer's projected resource potential is unproven reserves. The company's value will decrease if these unproven reserves, which have not yet been accurately estimated, are less than currently estimated. There is a great deal of uncertainty as to the quantity of and the ability for the company to economically extract unproved reserves.[32]

[30] Pioneer Natural Resources fiscal 2012 form 10-K
[31] Pioneer Natural Resources fiscal 2012 form 10-K
[32] Pioneer Natural Resources fiscal 2012 form 10-K

Strategic Recommendations

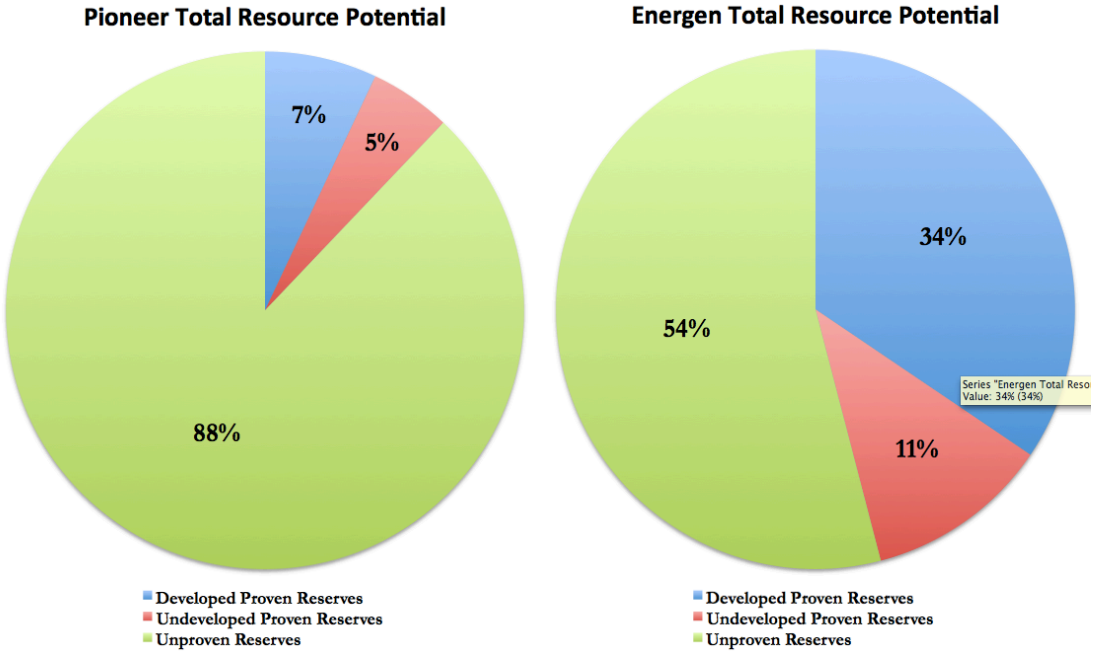
Continue to Shift Production Towards Oil

Over the last three years, as Pioneer has shifted towards production, they have rapidly increased their production of oil, more than doubling daily output from 2010 to 2012. During this period, production of gas increased as well, but at a much slower rate than oil. Much of this was due to Pioneer's investment in expanding production in the oil rich Eagle Ford Shale. Pioneer's management made a smart decision to focus on oil production, as the price of oil stayed relatively stable, while the price of gas plunged. Although gas prices have already risen from the near record lows they reached in 2012, the phenomenal growth in U.S. production of gas in recent years has caused a structural shift in the supply of gas that will likely cause prices to stay relatively low. Oil currently only accounts for 40% of Pioneer's production, even though it accounts for 74.11% of their revenue. Given that it is doubtful the price of gas will rebound in the short-term, Pioneer should continue to focus on increasing production in its fields with the highest percentage of oil, such as Spraberry, the Eagle Ford Shale, and Alaska.

Continue to Pursue Joint Ventures with Larger Companies

Currently Pioneer Natural Resources has only developed 58% of their 1.1 BBOE. When Pioneer's additional unproven resource potential is also considered, the firm is currently producing oil and gas on only 7% of their 9.1 BBOE total resource potential. Additionally, only 12% of their total resource potential is comprised of proven reserves.[33] This stands in stark contrast to one of their competitors, Energen Corporation, another fast growing independent oil and gas exploration and production company. Of Energen's total resource potential of 753 MMBOE, 46% is proved reserves.[34] Additionally, Energen has already developed 75% of their proved reserves.[35]

[33] Pioneer Natural Resources Fourth Quarter 2012 Earnings Presentation, slides 10 and 26
[34] Energen 2012 Annual Report Summary, pages 6 and 7
[35] Energen fiscal 2012 form 10-K



Pioneer does not currently have the funds to internally finance the capital investments needed to either develop the remainder of their proven reserves or to prove a substantial portion of their unproven reserves. Additionally, weak net margins stemming from their current capital investments to increase production limit Pioneer's ability to generate sufficient cash in the near term to internally fund a major expansion. In the past, Pioneer has divested fields that they did not consider core assets in order to generate cash needed to fund exploration or production investments. However, Pioneer's recent inability to sell their holdings in the Barnett Shale for a price that management felt represented the field's fair value shows that selling unproven fields is not economically advantageous at this time.

In the past, Pioneer has also turned to equity and debt markets to fund their capital investment needs. However, Pioneer's stock has dropped 17% over the last two months after hitting its 52-week high in mid-February and has underperformed both the S&P 500 and Vanguard Energy ETF over the past year.[36] As a result, now is not the right time for Pioneer to hold another equity offering to raise capital. In fiscal 2012, Pioneer increased their long-term debt by over $1 billion. They were able to do this while both keeping their current ratio above 1 and lowering the average

[36] finance.google.com

interest payment on their debt. However, in order to fund the level of production expansion they are in a position to pursue, Pioneer would likely need to raise more debt then their creditors would be willing to offer.

Pioneer Natural Resources should instead look to fund rapid development of their proved reserves through additional joint ventures with larger, cash rich companies. Pioneer has a history of successful joint ventures. In June 2010, Pioneer entered into a $1.15 billion joint venture with Reliance Industries Limited. In exchange for a 45% interest in Pioneer's Eagle Ford Shale holdings, Reliance paid Pioneer $266 million in cash and covered 75% (representing $886.8 million) of the Company's exploration, drilling and completion costs in that field through the end of 2012.[37] During this period, Pioneer dramatically increased its share of Eagle Ford Shale production from less than 2 MBOEPD in 2010[38] to 35 MBOEPD in the fourth quarter of 2012.[39]

More recently, in January 2013, Pioneer signed an agreement with Sinochem Petroleum USA LLC. to sell 40% of their interest in the horizontal Wolfcamp Shale field, representing just 10% of Pioneer's total Wolfcamp/Spraberry acreage position, for $1.7 billion. As part of this agreement, Sinochem will pay Pioneer $500 million in cash and will cover 75% of Pioneer's portion of drilling and facilities costs in the field, up to $1.2 billion. As a result of this deal, Pioneer expects to increase the number of operational wells in the field by more than 10 times, from 39 at the end of 2012 to 410 at the end of 2015.[40] This should allow Pioneer to greatly increase their production in this field and to confirm approximately 3 BBOE, which would almost quadruple their proved reserves.[41]

Even after the Sinochem deal, Pioneer will still have approximately 5 BBOE of unproved reserves, 4 BBOE of which is in the same Wolfcamp/Spraberry field. Pioneer should quickly move to secure similar additional joint ventures that allow the company to increase production of their proved reserves and confirm the resource potential of unproved reserves in the Spraberry field. This is also in line with the initial recommendation that Pioneer focus expansion efforts on fields with the

[37] http://investors.pxd.com/phoenix.zhtml?c=90959&p=irol-newsArticle&ID=1441226&highlight=
[38] http://www.pxd.com/operations/south-texas/eagle-ford-shale
[39] Pioneer Natural Resources Fourth Quarter 2012 Earnings Presentation, slide 18
[40] http://investors.pxd.com/phoenix.zhtml?c=90959&p=irol-newsArticle&ID=1779291&highlight=
[41] Pioneer Natural Resources Fourth Quarter 2012 Earnings Presentation, slide 14

highest percentage of oil. By focusing on finding partners for joint ventures in the Spraberry field, Pioneer will be able to quickly expand production and confirm additional proved reserves in their most oil rich holding. Additionally, even though they won't be helped by economies of scale, by focusing on this large field Pioneer will be able to leverage their existing relationships with distributers and buyers to rapidly expand with minimal friction.

Encourage the development of U.S. gas export capabilities

Finally, Pioneer should work to encourage liquid natural gas (LNG) exports from the U.S. to minimize the excess supply now flooding the domestic market and driving down their revenues from gas. As previously stated, the price disparity between the U.S. market and European and Japanese markets for gas has grown extremely wide and makes it economically feasible for U.S. producers to export gas to those countries. For Pioneer, whether or not they actually export any of the gas they produce, decreasing the domestic supply of gas should lead to higher prices and both an increase in revenue and the value of Pioneer's land holdings.

There is currently only one operating LNG export terminal in the U.S., in Nikiski, Alaska, far from the continental U.S. where gas production is booming. However, Cheniere Energy received a permit from the U.S. Department of Energy (DOE) to export natural gas to non-free trade agreement countries and is constructing an LNG export terminal in Sabine, Louisiana that it expects to come online as soon as 2015.[42] Although 12 additional export terminals have been officially proposed to the Federal Energy Regulatory Commission,[43] no additional permits have been granted as the DOE halted issuances while it studies the economic impact of exporting natural gas.[44] Despite releasing a study at the end of 2012 showing the U.S. stands to "realize a significant economic boost from exporting a large portion of its domestic gas production to…Europe and Asia," the DOE has not yet started issuing new export permits. Gas exports are opposed by both environmental groups and large manufacturers. Environmental groups, such as the Sierra Club, oppose exports because they want to limit the use of fossil fuels, in general, and hydraulic fracturing, specifically. Many manufacturing companies who use natural gas in their production processes have benefited from low gas prices and opposed exports since they would lead to higher price. In January 2013, a number

[42] http://online.wsj.com/article/SB10001424127887324789504578382472643241056.html
[43] http://ferc.gov/industries/gas/indus-act/lng/lng-proposed-potential.pdf
[44] http://online.wsj.com/article/SB10001424127887324789504578382472643241056.html

of these manufactures, including Dow Chemical and Alcoa, formed America's Energy Advantage to lobby against gas exports.[45]

As one of the largest oil and gas producers in the U.S., Pioneer Natural Resources should work with its peers to form a similar group, the "Energy Freedom Council," to lobby specifically in favor of gas exports, which would benefit the entire industry. Companies in the Energy Freedom Council could work together and pool resources and expertise to lobby lawmakers and regulators in Washington to resume issuing LNG export permits, as well as educate the public on the benefits of allowing gas exports. Once the DOE begins to issue permits again, the Energy Freedom Council could work to encourage the rapid production of LNG export terminals. The group could invest together to develop the infrastructure necessary to deliver gas to export terminals, work with potential facilities to find major foreign buyers willing to sign long-term contract to purchase exported gas to lessen the risk of building an export terminal, or enter into joint ventures with developers to lower the upfront cost. While gas is not likely to overtake oil as a percentage of Pioneer Natural Resources revenue, encouraging gas exports is an easy way to increase medium and long-term gas revenue and the value of the company's land holdings.

[45] http://www.nationaljournal.com/house-energy-commerce-committee/companies-battle-with-gas-prices-at-stake-20130417