

# Planting Seeds in the Permian Basin

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A man came across a tree farmer in an open field one day and asked the farmer what he was doing.

The farmer replied that he was planting seedlings for Spruce Fir trees, that in 100 years will be cut down and used to build houses. “One hundred years?” replied the man. “You will be long dead by then, so you will see no benefit and will receive no value from your work. You are a crazy man!”

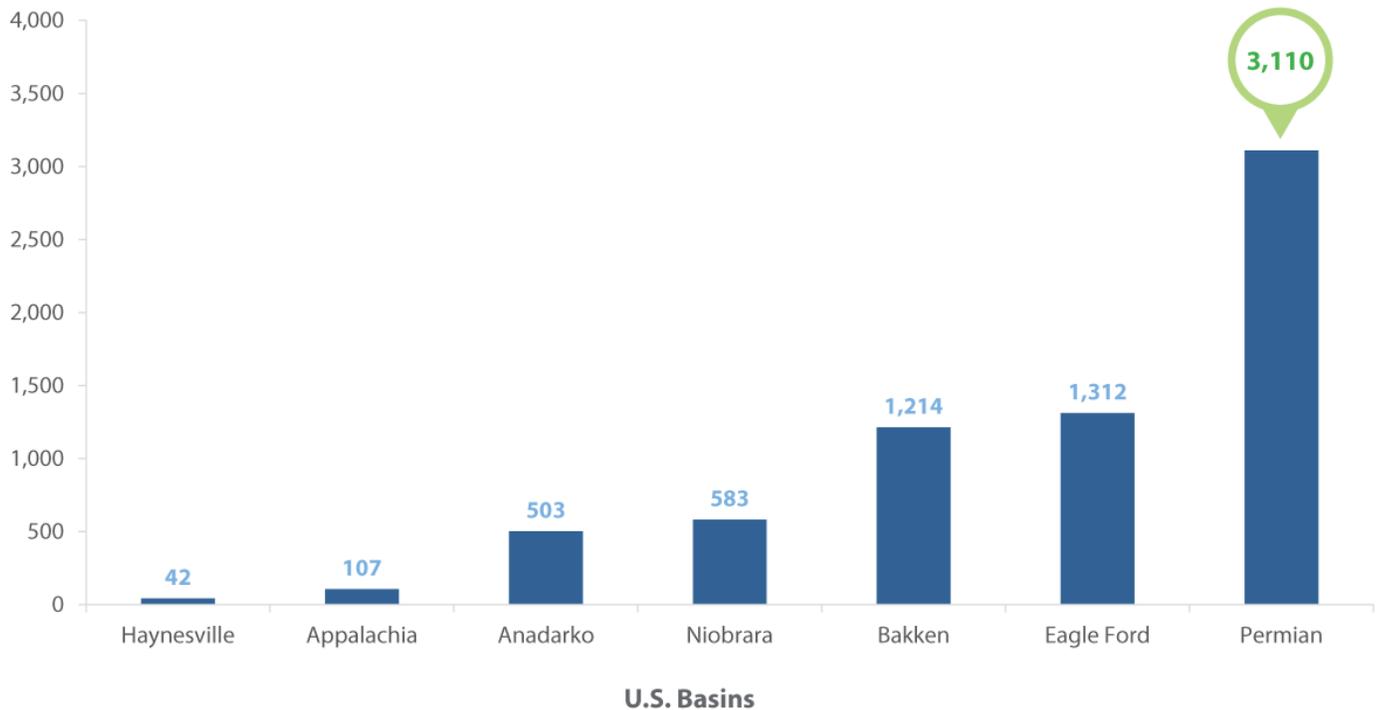
“Quite to the contrary, sir,” said the farmer. “In three years, these saplings will have grown to 2 feet high and will be worth more than they are today. In 10 years, they may be 8 feet high and will be worth even more. In 20 years, the trees may be 20 feet high and worth still more if I decided to sell the land. In 50 years, they will be worth even far more. So, who is the crazy man here?”

Much like this tree anecdote, there may be some great opportunities in the energy sector these days due to the crude pipeline shortage in the Permian Basin in West Texas. A mile beneath the surface of West Texas, the Permian Basin shale deposits hold 75 billion barrels of oil. The Permian now employs 55 percent of all U.S. oil rigs in its fields, and since April 2016, Permian oil production has increased 55 percent.

Due to the advances in technology for methods of recovering energy supplies, the amount of oil being produced in the Permian Basin (3.1 million barrels per day or bpd) will soon be higher than the transportation and pipeline capacity to get that oil to market (3.2 million bpd).

## Permian Basin Crude Oil Production

Thousand barrels per day



Source: Forbes, EIA'S DPR

Current expectations for production growth (to a planned 5.3 million bpd by the end of 2020) compound concerns over oil transportation and available pipelines. New pipeline capacity of 2.4 million bpd is under construction, but this additional takeaway capacity will not be available until the end of 2019 to meet the growing production volumes. As a result of this shortage in capacity, energy producers with a heavy concentration of revenue coming from the Permian Basin have corrected sharply over the past year, and the valuations of these stocks relative to earnings are historically low at about four times earnings. Breakeven cost levels are below \$40 a barrel for oil pumped from the Permian, so these companies could be even more profitable once new pipeline capacity comes online at current oil prices.

Given the recent stock weakness, however, investors appear to have exited their Permian positions with plans to return when the pipeline capacity problems have been alleviated. Like the farmer, every day that we get closer to additional pipeline capacity being available in the Permian, the stock prices of these currently cheap Permian stocks should theoretically rise in value. No one will ring a bell on New Year's Day 2020 to announce that the Permian stocks should now trade at a more normal eight times earnings.

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