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Sanchez Energy: A Big Bet On Making American Oil Great Again

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'The commodity downturn has been a huge benefit for America's drillers,' says Tony Sanchez. 'The industry has learned to become efficient in ways we never thought were possible.'

A couple years ago America's domestic oil supply maxxed out at 9.6 million barrels per day. Then as oil prices plunged, so did drilling. And without new drilling, output declined, bottoming out last August at 8.5 million bpd. But then, even with oil prices still languishing, a tech-driven reversal began. "In a way, the commodity downturn has been a huge benefit for America's drillers," says Tony Sanchez, CEO of publicly traded Sanchez Energy, "because the industry has learned to become efficient in ways we never thought were possible."

Indeed, America's drillers have started back to work, and now oil flows are edging up again to a current 8.8 million. Most of the new action has been in the Permian basin of west Texas, where innovations in drilling and fracking has unlocked tens of billions of barrels of reserves profitable even at $40 oil.

But there are plenty of other American oil fields just waiting to be made great again. Which is where Sanchez comes in. The company is teaming up with Blackstone Energy Partners on a $3.2 billion deal to acquire hundreds of thousands of acres of leases from Anadarko Petroleum in the Eagle Ford shale.

The Eagle Ford is a 200-foot-thick zone of oil-bearing rock that sits about a mile underground, and can be found in a crescent-shaped swath curving from Laredo, on the Texas border with Mexico, up towards Austin. From just a trickle in 2009, by 2015 oil flows from the field had boomed to 1.7 million barrels per day — a fifth of domestic oil supply — a remarkable achievement. But then drillers cooled on the Eagle Ford, and flows dried up to 1 million bpd. The conventional wisdom was that most of the good spots had been drilled up.

Sanchez, 42, intends to help make the Eagle Ford great again. The deal is potentially transformative for the company, as the Anadarko acreage is adjacent to a 100,000 acre block that Sanchez acquired from Royal Dutch Shell in 2014 for $560 million. "I've always liked the acreage," says CEO Tony Sanchez, III. "It just bolts on." All together, Sanchez and partners will control nearly 600,000 acres in one of America's biggest oil fields.

Anadarko mothballed drilling rigs when oil prices began falling in 2014. They haven't drilled another Eagle Ford well since — instead focusing investment in the lower-cost Permian. Sanchez is convinced a lot more oil can be gleaned there. He's seen the breakthroughs first-hand. When Sanchez took over the Catarina Ranch from Shell, their average well cost was $9 million, and much of the 100,000 acres looked like a write-off. "We thought the western part would work and and we put no value on anything else." The area in the middle of the ranch appeared so devoid of oil that "we used to call it the donut hole."

Two years later, it's become the motherlode. "Our understanding of the rock has changed very significantly," says Sanchez. They realized that there are three or four distinct oil-bearing layers of rock in the thicker zone known as the Eagle Ford. In west Texas there are ares with 10 oil layers stacked on top of each other. Sanchez says in his acreage, there are three or four. "It was a pleasant surprise," he says. "Now the best part is where we didn't think it was going to work." Well costs are down to $3 million, believed to be the lowest among Eagle Ford operators.

The key to making good wells is being able to steer the drillbit into just the right spots, a mile underground. From each drilling site, Sanchez will bore 15 wells tapping into the different Eagle Ford layers like so many roots from a tree. With the addition of the Anadarko acreage, "we could drill 200 wells a year and still be here in 20 years drilling." Recent wells in that area have come online at an impressive 1,600 barrels per day (roughly 50/50 oil to natural gas). Break even is at $35 a barrel. At $50 oil Sanchez says well investments reach payback in about a year. “We can make it work now.” The company projects growing its net production volumes from 53,000 barrels of oil (and equivalent gas) per day to about 80,000 bpd at the end of this year.

The Sanchez family has deep roots in south Texas; father Tony Sanchez, Jr., started Sanchez Oil & Gas in 1972 and scratched out a living drilling wells around the region. Breakthroughs in drilling led to the discovery of the Eagle Ford shale around 2010, and in 2011 Sanchez Energy went public in an IPO. Before becoming CEO, Sanchez III. was a banker at JPMorgan and earned a Harvard MBA. Sanchez family members own about 15% of Sanchez Energy as well as about 15% of the common units of the master limited partnership Sanchez Production Partners.

Leveraging those roots, Sanchez has been pushing to vertically integrate their oilfield operations. Instead of relying on margin-creaming middlemen, Sanchez now buys its own sand and chemicals direct from mines and manufacturers. It and handles its own logistics, including 250 truckloads of sand that get blasted down into each well, where the grains prop open tiny cracks and fissures in the rock, allowing the oil to escape. All told, Sanchez will need more than 3 billion pounds of sand every year.

Gone are the days of oil wildcatting — drilling holes on a hunch. Today the Sanchez drilling teams know what they’re going to find. The challenge is in getting that next well done faster and cheaper than the last. “We have a factory here,” says Sanchez, “We’re solely looking at this as a manufacturing process at this point.”

The nationwide oil and gas rig count bottomed at 366 in May 2016, according to Cowen & Co. The count is up 322 since then, with 55% of the additions in the Permian basin. After a 47% decline in 2016, oilfield spending is expected to increase about 30% in 2017. Analysts forecast oilfield service costs to climb 15% over the next 18 months. Sanchez plans on adding about 5 rigs (about 1.5 rigs net to the company’s interest), but figures its procurement efforts will help hold their cost inflation to half of industry averages. Total company capex for 2017 will be on the order of $450 million.

When Sanchez first started pursuing the deal, more than six months ago, conditions were bleak. Shares of Sanchez Energy bottomed out at $2.06 last February. To get it financed Sanchez teamed with Blackstone Energy Partners on the equity. GSO Capital Partners, a Blackstone affiliate, paid in $500 million for preferred stock, while JPMorgan and Citi funded a $250 million revolver — all collateralized by about $40 million a year in cash flows from the Anadarko acreage. Sanchez shares have surged to closed Tuesday at $13.64.

The relationship with Blackstone gives Sanchez options. “We’re not looking for a quick flip,” says Sanchez. “We are the likely buyer of their interest” years from now. Other big players with plots nearby include Chesapeake Energy and Noble Energy. But let’s not get ahead of ourselves. “We’re not out of the woods,” says Sanchez. Oil’s at $50. His stock, at $13.50, is a third of its 2014 peak. “It feels better, but there’s not any fewer challenges. This is when the real work starts.”

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