

January 2010 CGI Growth & Value Focus Special Report

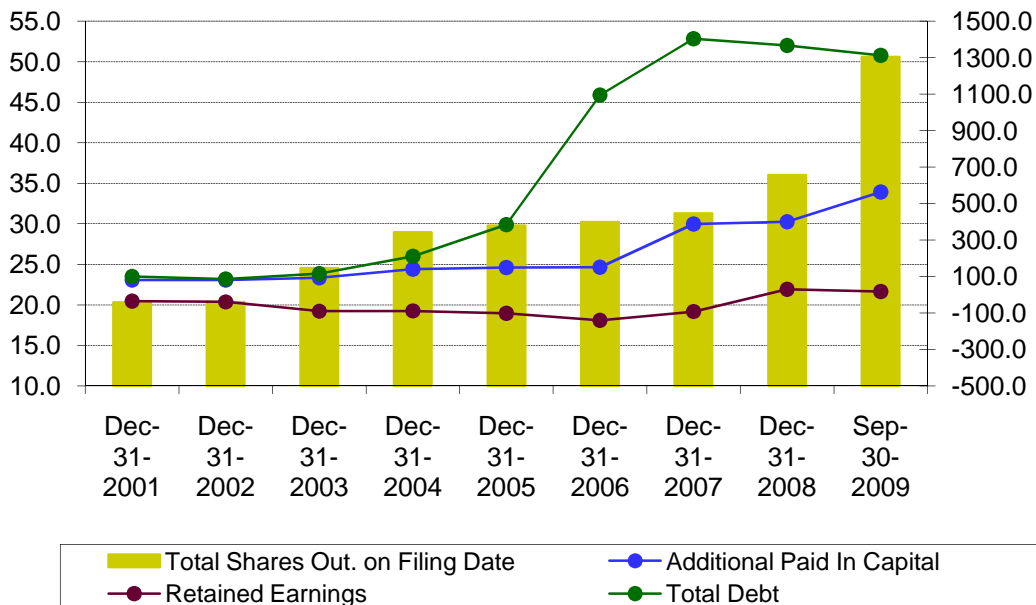
Energy: Two Sells and One Buy

by [Jeff Annello](#), Active Value Port Co-Manager

We left our three energy companies out of the Coach's latest portfolio review because new information appeared that required consideration. We have finished digesting and made our choices. Here they are and why we've made them.

Let's look at three charts. Each chart plots, over time, the retained earnings, additional paid in capital, shares outstanding, and total debt for the company represented. I'll withhold the names of each company for now.

Figure 1.



CGI GROWTH & VALUE FOCUS

The patient search for bargains

Figure 2.

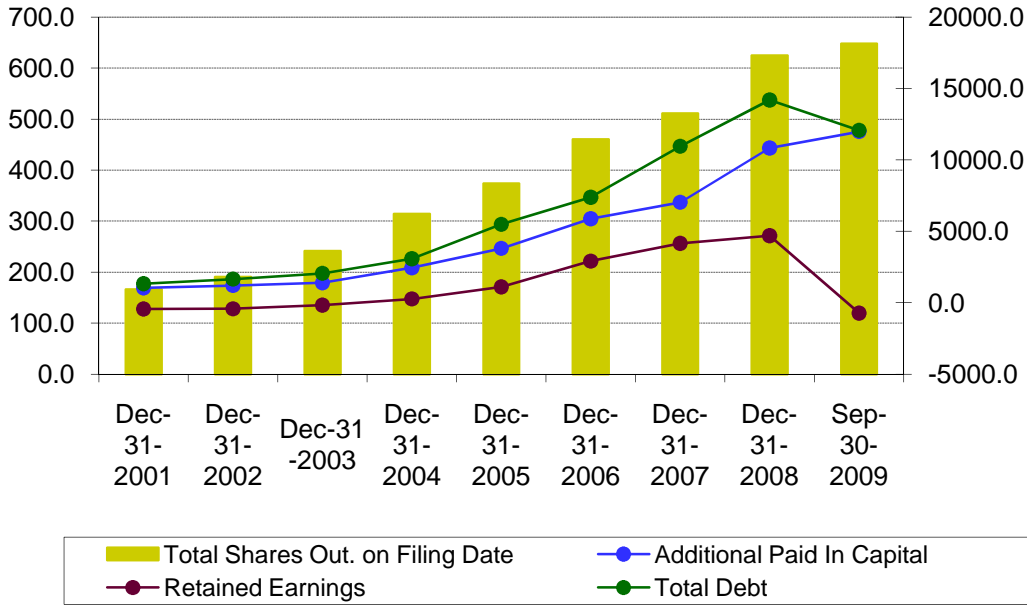
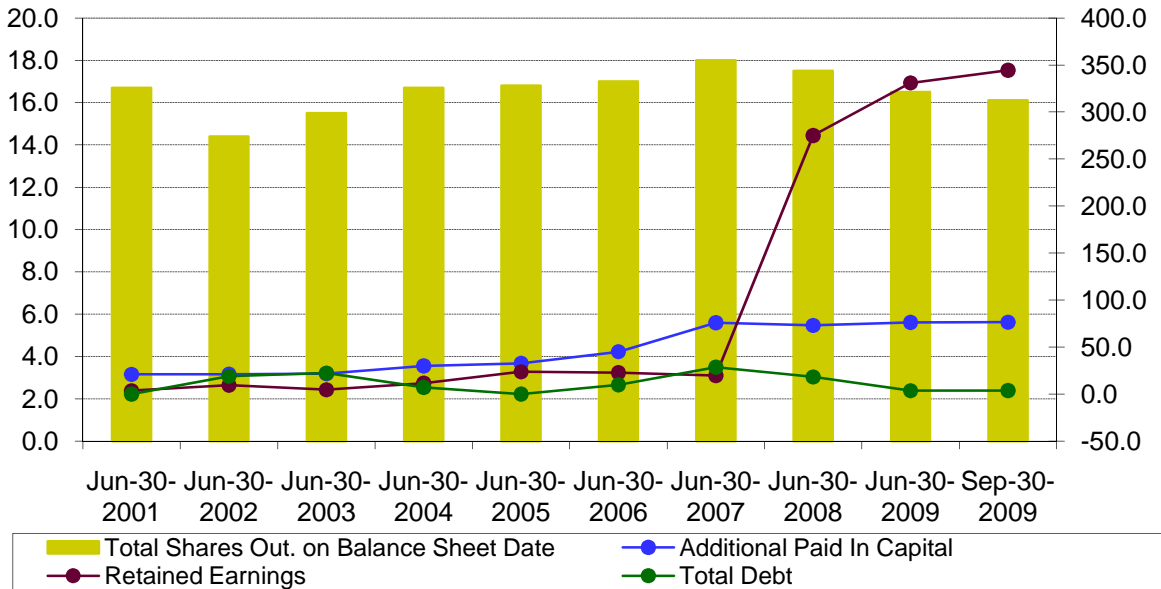


Figure 3.





Figures 1 and 2 show a similar story—huge increases in shares outstanding, total debt, and additional paid in capital, along with a decrease or negligible increase in retained earnings. Figure 3, on the other hand, shows no increase in shares outstanding, no increase in debt, and a small increase in additional paid in capital, along with a gigantic gain in retained earnings.

Now ask yourself, of the three businesses presented above, which would you most like to own? Which one do you think has rewarded shareholders over time?

Yep, you guessed it...

It shouldn't come as surprise that at CGI we own each of the above businesses. Figure 1 represents **ATP Oil & Gas (ATPG)**, Figure 2 **Chesapeake Energy (CHK)**, and Figure 3 **Contango Oil & Gas (MCF)**.

You may now be asking, "Why did we ever own these businesses that constantly raise capital, dilute shareholders, and seem to not compound any internally generated capital over time?"

To answer that question, let's review what the stock market is. The correct analogy for the market was presented years ago by Charlie Munger: a pari-mutuel betting system. If you think about it, betting on horses is a lot like investing in companies. It is often clear which businesses, and which horses, have a large advantage over their peers, but due to constantly shifting *odds*, it is not so clear which way to bet.

Stock market prices can be seen as odds based on the perceived fortunes of each business. Those who beat the track and beat the market over time wait for a mispriced bet they fully understand, and bet only when that occurs.

Thus, we bought ATPG in the single digits and re-bought CHK around \$20 based on our assessment that the *odds* offered did not properly reflect the real probabilities. In each case, the market was telling us that the odds of future prosperity were very low, and we disagreed.

It turns out we were right with ATP and fairly accurate with CHK. However, the odds have shifted today: ATPG sells for a more reasonable \$20 per share and CHK has recently sold for nearly \$30 per share. This necessitates a re-evaluation of the odds versus the probabilities. Remember that this is not a science, but a highly subjective art.

To that end, let's review each holding and our actions in more depth.

ATP Oil & Gas (ATPG) (Jeff)

The list of completed deals and major events at ATP—even in the last six months—is a long one: two equity sales, a deal to sell its Gomez pipeline ownership, a royalty interest sale at Gomez, an improvement in its reserves at the Telemark Hub, and finally, a revision to its credit agreement that loosened financial covenants in exchange for a higher interest rate.

These factors combine to tell a much different ATP story than when we originally purchased it back in 2008. At the time, we had a company struggling to meet its debt covenants, whose very existence was in doubt. We disagreed and were ultimately rewarded with a large gain in the stock.

Today, ATP is in better financial standing and has a fairly bright future. Before long, ATP should report its first production numbers at the Telemark Hub in the Gulf of Mexico, which is set



to double its production rate by the end of 2010 and into 2011.

But as always, the main risk facing ATP is the continued need for cash. We are now becoming wary of staying at this party too long. At some point, ATP needs to let cash flow to the bottom line and to start curtailing its spending habits if *long-term* shareholder wealth is to be built. A company can only outspend its cash inflows for so long.

Since 2001, ATP has raised a net of \$1.9 billion in capital through equity, preferred stock, and debt, minus amounts repaid. Yet, entering 2010, shareholders are holding only \$950 million in wealth, and debt holders have another \$1 billion, net. So where exactly is the value creation?

One answer is that the equity is too cheap, and the market is not yet recognizing the creation of value. There is also merit to another thesis: that the market sees ATP as a money pit—it keeps pouring capital in and it isn't getting anything in return. We think both views have merit.

At this price, which way to bet is no longer clear to us. While ATP's net asset value clearly exceeds today's stock price, there's no guarantee of the future creation of stockholder wealth. As Figure 1 shows, ATP has consistently diluted shareholders over the years, often at nonsensical prices.

While the rationale in each instance seems fair—"debt is too expensive," "we need a cash cushion," "we can purchase an attractive asset,"—the overall trend causes concern. Along with the equity raises, ATP's management team leveraged the company to the hilt in a period of rising commodity prices, and shareholders paid the ultimate price when the tide went out.

While I believe that ATP would be a fairly sure bet from here if I had faith that management would return future cash flows to shareholders, I don't. Drilling expenditures will remain very high for years and the company will continue to use up cash. Its record for value creation is just not enviable; shareholders who bought ATP around the time it went public are sitting on about a 40% total return in 10 years. We can do better.

We will **sell** our entire ATP Oil & Gas stake. At a far lower price, we could overlook business issues—as we did—but not at today's. I am not saying ATP will be an unsatisfactory investment going forward. I am merely saying that given the odds, I'm no longer sure enough to bet on the outcome. As Warren Buffett likes to say, this is a "no strikes called" game. So our decision as value investors is clear.

Chesapeake Energy (CHK) (Tom, Jeff)

The rationale for our decision at Chesapeake Energy is similar to that of ATP Oil & Gas. Over the past decade, shares outstanding have increased more than 300%, \$23 billion in net capital has been raised, and yet Chesapeake shareholders have \$18 billion in wealth and debt holders another \$12 billion.

This equals not much value creation over a decade of much self-flagellation by Aubrey McClendon. Chesapeake's stock price is the same today as it was *14 years ago* when McClendon leveraged the company to participate in the Austin Chalk play in Texas. Both then and now, shareholders almost suffered their demise because of excessive debt.

Chesapeake continues to monetize its assets at a surprising rate, selling big shares to big international energy companies. Most recently, Total SA said it would pay \$2.25 billion for 25% of



Chesapeake's Barnett Shale assets: \$800 million in cash and the rest in kind. According to its presentations, Chesapeake is planning on \$7+ natural gas for the foreseeable future. While we did like to see the press release showing hedging increased to 50% of next year's production, its "production update" was cause for concern.

One would logically think that after selling of 25% of its Barnett Shale gas, Chesapeake would have lowered production guidance for next year. But magically, McClendon pulled a rabbit out of his hat in the form of increased production forecasts in the shale, which kept the updated production guidance remarkably similar to the guidance issued *before* the Total deal.

This reminds us of analysts who, upon seeing news that causes their earnings estimates to be clearly wrong, simply tweak a few other variables in their spreadsheet to arrive at the same target stock price as before.

Another [dubious honor](#)—Worst Footnote of 2009—was bestowed by the well-regarded blog Footnoted, for Chesapeake's purchase of McClendon's art collection for a whopping \$12 million. Considering his massive loss of wealth after buying Chesapeake shares on margin, we're not sure the company's intentions were pure.

Thus, assessing the specious capital allocation record and the games McClendon seems to be playing at Chesapeake, we've decided to **sell** our position. As with ATP, we're not sure what the future holds for shareholders, and we're not going to stick around to find out. Over the long term, one does not make sure money by partnering with iffy people.

We do not stick with a position just because we have it. When we rethink, and if our thinking changes, we sell.

Contango Oil & Gas (MCF) (Jeff)

On the other end of the spectrum is our holding in Contango Oil & Gas. While ATP uses lots of debt, focuses on producing reserves, and avoids any drilling for unknown reserves, MCF does the opposite. It uses almost no leverage, concentrates its capital on wildcat drilling for new natural gas, and usually sells, or tries to sell, its reserves rather than produce them.

Since 1999, Contango has issued no net debt and only \$60 million in stock. Today, shareholders have \$750 million in wealth and \$64 million in cash. In the meantime, Contango spent \$65 million repurchasing stock, reducing the count by 500,000. These sound capital allocation policies are unmatched in the energy business for sure, and nearly so in other industries too.

For now, Contango continues to produce its reserves at least until natural gas prices bounce back to a level attractive enough for CEO Ken Peak to sell the entire company. That might take awhile. In a recent [press release](#), Peak lamented the aggregate stupidity of natural gas producers who seem intent on drilling natural gas prices back down to late 2008 levels—\$2–\$4/mcf at the Henry Hub.

Mostly, he blames the shale players like Chesapeake. While drilling in many areas has declined, the spout of new gas coming from the shale has kept supplies fairly abundant, and most natural gas CEOs don't seem intent on reducing their drilling or production next year. Case in point is Chesapeake, who will spend \$4 billion drilling next year versus closer to \$3 billion this year. Gigantic production increases at newer

shale plays seem to be outweighing the 50% rig count decreases that Tom and I pointed out last year.

However, even if natural gas prices do dip in the near term, Contango is still a great long-term investment as a smart, low-cost, and unleveraged operator. Economically, natural gas cannot stay at \$3–\$4/mcf levels for any extended period due to the costs of production in the shale and elsewhere, which are currently running around \$5.50/mcf and higher. And whereas many natural gas producers are chronically unprofitable with natural gas at these levels, Contango is making money hand over fist.

Its average natural gas sales price was \$3.40/mcf in the third quarter of 2009, yet they generated a healthy \$21 million in operating cash flow. At today's prices, Contango is generating over \$100 million in annualized cash flow. Sharply lower natural gas prices will only help Contango in the long term, shaking out leveraged operators and attracting energy users to natural gas, eventually driving the price back up. Any short- or long-term increase in natural gas prices is pure upside for shareholders.

Based on its current production profile and at today's prices, Contango is worth at least \$75–\$80 per share, which means we could—and will—buy more shares at a healthy discount. In addition, Contango is spending up to \$120 million next year on various drilling projects, each of offering extremely attractive rates of return.

Where companies with \$6.00/mcf cost structures are unwise to drill today, Contango's costs are less than half of that, and select opportunities make sense. Given its successful history of exploration, there's no other company who we

feel more comfortable watching spend its cash. Drilling success is another pure upside for shareholders.

We recommend going to Contango's website and reviewing its recent presentations. They provide a lot of insight into to why Contango is such a well-managed company.

We'll reinvest \$6,000 of the proceeds from our Chesapeake sale into shares of Contango. If natural gas does rise, we'll benefit with Contango. If it falls, Contango's stock will also fall, but the company won't be at risk, so we'll probably load up on more stock.

The remaining cash and the proceeds from the ATP sale will bring our total cash to over \$51,000 and about 30% of the Active Value Portfolio. Our cash hoard has never been this high, but we know two things with certainty: other juicy opportunities for good businesses at cheap prices are never too far out of reach, and we won't accept anything less.

In sum, after this alert issues to members, we will:

1. SELL 370 **Chesapeake Energy** (CHK), raising about \$10,360 in cash.
2. SELL 800 **ATP Oil & Gas** (ATPG), for \$15,000.
3. BUY 120 additional **Contango Oil & Gas** (MCF), using \$6,000.

If you have any questions, join us on the [Member Forum](#) and thank you so much for being a *Growth & Value Focus* member.

Best wishes,
Jeff Anello, Co-Manager
Active Value Portfolio
CGI Growth & Value Focus:
The patient search for bargains



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