# Aspera Bulletin

Intelligent, Independent Investment Management

## Oil Stocks: Calamity and Opportunity

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Before anyone calls asking if I've lost my mind, I thought I'd send a Bulletin out discussing our recent activity in the energy space. Let's dispel any emotionally-charged, slanderous assumptions straight away. Yes, I do pay close attention to the news. Yes, I am well aware that one of BP's deepwater Gulf of Mexico wells has blown out and is gushing oil at a healthy rate. Yes, I realize that this is not a bullish development for the company or industry. Yes, I understand that BP will be putting food on the tables of hundreds of lawyers for many years. Yes, I realize that the President has instituted a 6-month ban on deepwater drilling in the Gulf. Yes, I understand that this will cost the company more than the GDP of many countries. And no, I have not personally suffered a catastrophic blowout.

**<u>Brief Market Commentary</u>**

Given the recent volatility in the global financial markets, a brief update is warranted. Nothing that is occurring in the global economy or markets should be surprising if you've been reading these Bulletins and Quarterly Reviews. For some time now, we've been discussing the massive global debt overhang, the likelihood of a slowdown in China, the problems facing the Euro community, the over-valuation of financial markets, the dependency of the "recovery" on government stimulus, and the underlying weakness, fragility, and manipulation of the U.S. equity market. What we've seen of late is simply recognition by the broader investment community that these issues and challenges do exist and are substantial.

Of particular note is the reality that each successive stimulus attempt is failing more quickly. The fact that a nearly $1 trillion bailout of the Euro community provided support for all of one day is extraordinary. The fact that it failed isn't the news. The significant point is that the market recognized the futility of the desperate maneuver so quickly. Market participants seem to be waking up to the fact that the solution to massive debt and structural issues does not lie in the issuance of even more debt or the printing of money.

This by no means is meant to suggest that our fearless leaders will throw in the towel. I expect them to redouble their efforts once it becomes clear that their measures to date have failed and that global growth is again slowing (which it is). To do nothing would be tantamount to admitting their personal failure. The next round of stimulus will likely be centered on the outright printing of money (more quantitative easing). It is the only substantial lever that remains, but it is also ultimately doomed to fail. We can't rule out additional fiscal stimulus, but we are at last seeing some seriously indebted countries (mainly in Europe) taking some preliminary steps to get their deficits under control.

As I've said throughout this rally, I believe that we're still in a secular bear market. The ingredients for a substantial leg down are in place, but predicting short-term market movements is a silly exercise best left to those who are enamored by the sound of their own voice. The markets will likely remain volatile, but our strategy will not change. We will increase risk at the portfolio level only when we're being paid to do so – when risk is cheap.

Should the markets continue to roll over, you should expect to see us gradually reduce our hedge (protection) positions and add to our risk positions. Our bias on the long side is likely to remain with energy, commodity, and precious metals names for the time being. In our more conservative accounts, we hope to be able to add more positions with strong balance sheets and solid dividends. As always, we'll move incrementally as opportunities present themselves. In the meantime, our focus on wealth preservation is proving effective in protecting our portfolios during this recent decline.

With that, let's turn our attention to the catastrophe, misery, and destruction that we now refer to as our oil industry.

**Energy: The Macondo Prospect and Industry Implications**

Let me begin by once again stating how fortunate I am to work with such terrific clients. The fact that I can buy a (small) position in the world's most hated company without a single word (at least not to my face) of dissent, condemnation, anger, or ridicule does make my job much easier. The other possibility is that you just haven't been looking at your trade confirmations. Either one works for me.

As we all know, the oil industry has been under attack of late given the disastrous blowout of BP's Macondo well in 5,000 feet of water 52 miles off the coast of Louisiana. I'm not going to defend BP. I don't really care to be the idiot offering excuses for Genghis Khan as he burns my village and steals my livestock. "He's just misunderstood. He had a rough day. I was thinking of becoming a vegetarian anyway." However, it is important to evaluate events with an open mind as opportunities tend to surface when emotion has co-opted calm deliberation.

As the evidence trickles in, it appears that there is plenty of blame to go around for the Macondo blowout. BP certainly deserves a majority share, but it's also clear that our government did a horrendous job of enforcing the regulations already on the book. Arguably, a stricter enforcement of these existing regulations would have prevented this disaster from occurring. This by no means absolves BP, but it should help to put the outrage being expressed by our government into some context. The degree to which the rig operator, blowout preventer manufacturer, and cement servicer also share blame will be determined in the courts.

What is occurring in the Gulf of Mexico is horrendous and will have long-lasting ramifications that are unlikely to be fully understood for years. At the same time, it's important to recognize that this type of drilling at extreme depths, pressures, and temperatures is truly cutting edge and extraordinarily challenging. There is a bit of an art to it which means that there is always room for second guessing and a difference of opinions. Whether shortcuts were taken may be difficult to prove, but it should be obvious that no company wants to find itself in BP's current situation, facing an enormous liability and the ire of the entire world.

Let's also remember that firms are drilling in the deepwater because our world still runs on oil, and much of the world's easily accessible oil was found decades ago. These deepwater wells are terribly expensive with no assurance of success. However risky and dangerous these drilling programs were assumed to be two months ago, that assessment has changed dramatically since then.

Not too surprisingly, Obama has instituted a six-month ban on deepwater drilling. Our job is to look ahead and position ourselves to take advantage of any opportunities that may be arising from recent events. Here are a few of the predictions that are guiding our recent activity:

- Deepwater drilling in the U.S. will return. We are simply too dependent on oil in the intermediate term to completely abandon one of the most promising regions of exploration.
- The ban on drilling will impact oil supply negatively at the margin, and this will push oil prices higher than they otherwise would have been.
- We will see increased pressure from the Gulf states themselves to restore drilling as many jobs and much tax revenue depend on it. We're already hearing rumblings from Louisiana's governor along these lines.
- We should expect increased regulation when it comes to deepwater drilling.
- Oil companies drilling in the deepwater will significantly increase their safety and disaster response measures regardless of what happens on the regulatory front. It's an intelligent investment on their part.
- The lessons learned from this calamity will help to prevent and mitigate future disasters. We will have a better idea as to how to address such a blowout in the future, and more resources will be devoted to disaster mitigation plans.
- Rig companies will be upgrading their assets with increased safety measures.
- The offshore rig market is bound to experience softness in the near-term due to the drilling ban. Day rates will fall and costs will increase for the industry. New orders for rigs will evaporate, and we may see further consolidation in the industry. Eventually though, these rigs will be reabsorbed and put back to work.
- Should Obama prolong the ban, the deepwater rigs will leave the Gulf and move to more friendly jurisdictions. This will happen to some degree even with the current 6-month ban.

The most likely eventual outcome is that the Macondo well will be plugged during the late summer, and cooler heads will prevail. Shallow water drilling in the Gulf is certainly much safer, but it has also been thoroughly explored. The promise of substantial U.S. reserves lies in the riskier deeper waters. The oil industry is very powerful and has deep pockets. At the end of the day, the politicians will claim to be tough on Big Oil by demanding stricter regulations and oversight, but the oil industry will again be able to drill in the deepwater of the Gulf.

Let's look at some of our recent trading activity in the energy space.

## Atlas Pipeline: Derisking

We sold our position in APL before the Macondo well blew. APL was one of our more speculative holdings during the past 15 months. The more debt any company had and the closer it was to bankruptcy at the beginning of last year, the better it has performed since. APL was a beneficiary of this investor love affair with the nearly departed.

APL carries a hefty debt load, but they've made some solid strides in stabilizing their business. Still, the company will need to refinance quite a bit of debt in the next few years. With the bond market once again paying some attention to balance sheets, my comfort with the name has decreased.

This stock outperformed on the way up, and it will underperform on the way down. In the worst case situation, the company could fail if it isn't able to refinance its debt at affordable terms or at all. Given our concern about highly-leveraged balance sheets and the prospects of a weakening demand environment, we sold our position.

**BP: Beelzlebub Petroleum or Big Polluter**

You can earn very attractive long-term returns by being smart/willing/brave/naive enough to tread where others fear. Uncertainty is the breeding ground of opportunity. Investors hate uncertainty, and BP is an uncertain stock with an uncertain problem with an uncertain cost in an uncertain stock market. This is precisely why the value of the company has fallen by $70 billion in the past 6 weeks.

Emotions are high, and portfolio managers aren't keen to show BP as one of their holdings come quarter-end. If the stock is sold before June 30th, the portfolio manager then won't have to field questions such as:

1. Why didn't you sell the stock when the blowout first occurred?
2. Why did you ride the stock all the way down?
3. Why do we own shares in such an evil company?
4. Is there any inbreeding in your family history?

Furthermore, some fundholders are so outraged by this disaster that they will sell any fund that owns BP shares simply out of principle. Why give them the excuse? Life would be so much simpler for portfolio managers if they sold their BP shares and rid themselves of the headache.

And life would be simpler for me as well if I had simply ignored the stock altogether. If the investment pans out, some of you may still be disappointed that I bought it. If it doesn't work out well, the failure will seem pre-ordained and my judgment suspect. I can already feel a new tension in just the past few days since our purchase. My Starbucks barista is skimping on my mocha, and my dogs seem a little less eager to go out for a walk with me in public. So, before I proffer my investment rationale, please keep in mind that I'm well aware of the risks being taken with this purchase, in terms of the stock itself, your view of my judgment, and my social standing. I trust that you will embrace my boldness rather than ridicule my folly.


Disaster can translate into opportunity. Of course, disaster can also translate into…disaster. Essentially, there is a range of possible outcomes for BP, and each has some probability of occurrence. Is there a possibility that BP will have to file bankruptcy and that shareholders will be wiped out? Absolutely. Do I view it as likely? No. Is it possible that BP will kill the well soon and that cleanup and liability costs will be <u>relatively</u> modest? Of course. Do I view it as likely? No.

My eyes are wide open. I'm not exactly expecting a rosy scenario for BP. Specifically, I expect:

- The well most likely won't be killed until later this summer once the well hole is intersected by one of the two offset drilling programs underway. Keep in mind that they're trying to intersect a one foot diameter hole with another one foot diameter hole from miles away. It will take a number of stabs until they get it, but this should work.

- The cleanup cost and the legal liability will be massive. I wouldn't be surprised to see this figure in the $30-40 billion range or more.
- There is a strong likelihood that BP's dividend will be substantially cut or eliminated altogether for some time as reserves are built up to cover costs.
- There will be long-lasting reputational damage, and the bad press will continue for some time.

What's not to like!? The point I'm trying to make is that BP stock is an interesting investment at these levels despite these risks. Consider:

- $70 billion in company value has already been erased from the company. The stock is already discounting significant clean-up costs and legal liability.
- There is talk of the government taking over BP or shutting the company down. This makes no sense. The government and all claimants need BP to survive and keep generating cash in order to fund their liabilities. BP is worth more alive than dead.
- BP is generating billions in cash each quarter, and that will continue. BP generated $6 billion in income in the first quarter of this year alone.
- The total cost of the spill isn't due today. It will be spread over many years.
- BP has nearly $5 billion in cash on hand today.
- I suspect we'll see BP ease up on its capital spending near-term to preserve cash.
- BP could increase its debt to raise additional funds.
- If you avoid a BP pump and BP sells less gasoline at the retail level, then other firms are selling more. If nothing else, those firms will have to buy product from BP to meet their increased demand. Oil/gas demand isn't falling because of this spill, and BP will find markets for its products whether you frequent their pumps or not.
- Another avenue available to BP is the sale of certain assets to generate additional cash. This would help allay fears as to whether the company can afford the liability, but it would also impair future earnings power.
- Should the value of the company fall too much more, there is a chance that the company could become a takeover candidate. One or more firms may try to acquire the company once there is more clarity on the ultimate liability. Assuming a total liability in the range now generally being discussed, it's hard to imagine BP fetching significantly less than its current value.
- Ironically, the ban on offshore drilling will serve to support oil prices due to less supply being produced at the margin. This actually helps BP's revenue.

Shareholders (including us) would prefer to see the dividend maintained, but public and government pressure may prove too hard to resist. This bothers me much less than it bothers most analysts. It would help resolve the issue sooner and temper public outrage. The company would eventually restore the dividend once the dust has settled. If BP can digest its future liability, as I suspect it can, the company can eventually return to distributing its cash flow to shareholders via a dividend. At our purchase price, that would imply a 9% yield.

Essentially, the pertinent investment issue is whether the uncertainty (risk) is more than adequately priced into the stock at current levels. We bought BP because we are getting compensated for the risk in the stock at the current price. This in no way guarantees that the stock will ultimately be a winner for us or that the company will even survive this calamity. It simply means that there is a very good chance that the stock is now discounting a future for the company that is worse than what will likely be realized. We have taken a very modest position in recognition of the risks inherent in the stock and will, of course, monitor events and add to or eliminate the position should our expectations change significantly.

**Diamond Offshore: A Diamond Getting Roughed**

Transocean Ltd (RIG) is the company which owns the rig which BP was using to drill the Macondo well. It should come as no surprise that RIG has taken a beating since the blowout due to the uncertainty as to its ultimate liability, but it isn't only RIG which has been dumped of late. The entire offshore drilling industry has taken a pounding. Obama's 6-month ban on drilling and the uncertainty surrounding the future of offshore drilling is severely impacting even those companies not directly exposed to the Macondo blowout. One such company is Diamond Offshore (DO).

Diamond is in the same business as Transocean. They are both offshore contract drillers. They own the big rigs that the oil and gas companies of the world lease in order to drill wells. Diamond, like Transocean, has a strong presence in deepwater drilling. Diamond, however, is not at all involved in the Macondo well blow out and therefore has no liability to it. Despite this, Diamond's share price has declined nearly as much as Transocean's.


All of the deepwater rig operators will likely suffer in the near-term as contracts are cancelled (force majeure is declared) by some of the oil and gas companies currently leasing the rigs for deepwater Gulf of Mexico programs. The rig owners will surely also face the added costs of improving the safety of their rigs (improved blowout preventers, for instance).

This, however, will eventually pass. The odds favor deepwater drilling again being allowed in the Gulf of Mexico, but even if such drilling were permanently banned, these rigs would eventually be put back to work internationally in more friendly jurisdictions. This will take time and margins will suffer in the interim as an excess supply of rigs depresses the rates these owners can charge, but balance will eventually be restored.

Diamond had nearly $1 billion in cash and investments on its balance sheet as of March 31st versus $1.5 billion in long-term debt. $500 million of the debt isn't due until 2019 and another $500 million comes due in 2039, so the company's balance sheet is in solid shape. DO management has done a fine job in allocating its cash flow over the years. When business softens, the company uses its financial resources to buy assets on the cheap. When such opportunities aren't available, the company has issued special dividends to its shareholders. Management has proven to be responsible stewards of company funds and shareholder value.

**Summary**

Although I'm still not constructive on the general equity or fixed income markets, recent events have presented us with an opportunity to add some new risk exposure. Many energy names have been destroyed in just the past 6 weeks and are back to trading at levels last seen when the market bottomed in March of 2009. I've been patiently waiting to increase our exposure to the energy space for some time, but valuation and economic concerns have kept me sidelined. It's unfortunate that it has taken a disaster such as we're experiencing in the Gulf to provide an attractive entry point.

These new positions were purchased because of their longer term prospects, not in anticipation of an imminent rally. Emotion as well as political and market uncertainty can certainly drive these stocks even lower. For that reason, we have simply stuck our toe in the water with BP and DO.

Peak oil is real as there is no cheaply and easily accessible oil of any size left. The price of oil will continue to fluctuate significantly, but the trend will be higher. The demand for oil and the services provided by energy service firms will remain strong for many years still. Should this sector continue to be punished, you should expect to see our exposure increase further. Regardless of where these stocks go in the short term, let's hope that cooler heads do prevail, that the environmental impact of the blowout is less than feared, and that the industry learns from its mistakes and adopts measures to more effectively curtail the impact of future disasters.

Best,

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