A Search for Global Value TRAPS!

Grant's Spring 2012 Conference
April 11, 2012

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Value Stocks: Definitive Traits

- Predictable, consistent cash flow
- Defensive and/or defensible business
- Not dependent on superior management
- Low/reasonable valuation
- Margin of safety using many metrics
- Reliable, transparent financial statements
Value Traps: Some Common Characteristics

- Cyclical and/or overly dependent on one product
- Hindsight drives expectations
- Marquis management and/or famous investor(s)
- Appears cheap using management's metric
- Accounting issues
Current Value Traps

- U.S. Shale Explosion
- National Oil Company
- Mobile Computing Revolution
- Digital Distribution
- Troubled National Balance Sheet
- Iron Ore Rush
U.S. Shale Explosion: Cheap Gas at Coal’s Expense

- Shale is a game-changer: U.S. is now 75% energy independent
- The rapid expansion of shale gas production capacity has led to record low prices
  - Henry Hub natural gas price around $2/mmBtu
    - Down over 50% YoY
    - Over 75% lower than five years ago
  - Gas inventories are at record levels
- Shale production economics imply even lower natural gas prices
  - Cash operating costs of production are extremely low (less than $1.50/mmBtu in some cases)
  - At current natural gas prices, there is still little incentive to cut production
- Cheap natural gas leading to substitution from coal-fired power generation:
  - January 2012 coal-fired electricity was down 25% YoY
  - January 2012 gas-fired electricity was up 23% YoY
- Coal industry is feeling the heat
  - Domestic coal prices down 20-32% YoY
  - Coal train car loads down 18% YoY

Sources: Bloomberg; EIA; AAR
US Shale Explosion: Cheap Gas at Coal’s Expense

Natural Gas Price (Henry Hub $/mmBtu)

Thermal Coal Price (Northern Appalachia $/ton)

Source: Bloomberg
CONSOL Energy (NYSE: CNX)

Source: Bloomberg
CONSOL Energy (NYSE: CNX)

The “value” story
- Stock is down over 30% YoY
- Earnings stream is diversified
- Assets are low cost relative to peers

CONSOL’s businesses face headwinds
- Thermal coal, 45% of 2011 gross profit
  - Pressure from coal-to-gas substitution
- Metallurgical coal, 38% of 2011 gross profit
  - Uncertain Chinese steel demand
- Shale gas, 17% of 2011 gross profit
  - Ongoing domestic overinvestment

High cost assets relative to international peers
- Thermal coal exports are competing with low-cost exporters from Australia, Indonesia, South Africa, Colombia
- Metallurgical coal exports pressured as Australia returns to normalized levels

Shale gas capital allocation raises concerns: over half of 2012 growth expenditures

Sources: Bloomberg; Company Filings; Note: gross contribution excludes freight, non-owned coal and other
From China to Brazil, quasi-public is the new model for national oil companies
  
  - Step 1: Retain a majority stake
  - Step 2: Push ambitious and costly investment strategy
  - Step 3: Keep pump prices low to appease citizens

China shows how it's done
  
  - Big three oil companies are theoretically public
  - Overpaying for overseas reserves
  - Downstream margins often negative

Petrobras seen as a LatAm model
  
  - In Mexican election, politicians calling to IPO Pemex along similar lines

Brazil remains a troubling prospect for outside investors
  
  - Chevron and Transocean face an $11B federal lawsuit and criminal charges for a tiny 3,000 barrel spill in Nov 2011
  - Infrastructure is ~2% of GDP barely covering depreciation
  - Prosperity has bred complacency and reform has slowed
Petrobras (NYSE: PBR)

Source: Bloomberg
Petrobras (NYSE: PBR)

Å The “value” story
  • Forward P/E of 7.6x, forward EV/EBITDA of 5.4x
  • Stock price is down nearly 40% over the past 2 years
  • Pre-salt offshore oil discovery: the biggest find in Americas in a generation

Å Huge capex program
  • $225B over 2011-15
  • Requires $14B of divestments and $86B in additional leverage

Å Government intervention reduces inherent value
  • Push for local services:
    - PBR must incorporate 65% of content from local services industry
    - Brazil must construct a high-end shipbuilding industry from scratch
  • Downstream: Domestic fuel prices capped
  • Government domination of PBR

Å Social engineering generates poor results
  • Upstream: production growth of 1.4% per year from 2006-11
  • Downstream: $6.6B EBITDA loss in 2011
  • $13B FCF outflow after dividends in 2011
**Mobile Computing Revolution: Death of the PC?**

- The proliferation of mobile devices pressures PC demand
  - Mobile devices have same key capabilities as PCs
  - Apple shipped more iPads in 1Q12 than the largest vendor shipped PCs
  - Shipments of mobile products increased by 79% YoY in 2011
  - Shipments of PCs increased by 2.9%

- Proliferation of mobile devices pressures PC margins
  - iPad bill of materials is ~40% lower than average PC
  - Tablets/smart-phones have no hard-drives, no keyboards, and no Wintel

- Cloud services allow consumers to be device-agnostic
  - Eliminates need for PC as a mass storage device
  - Functionality migrating to the Cloud

Sources: Barclays, IDC, Gartner
Mobile Computing Revolution: Death of the PC?

Source: IDC via Bloomberg
Dell (NASDAQ: DELL)

Source: Bloomberg
Dell (NASDAQ: DELL)

- **The “value” story**
  - Forward P/E of 7.6x, forward EV / EBIT of 4.9x
  - FCF yield of 16.7% using LTM FCF before share-buybacks and acquisitions
  - $2.7B in share-buybacks in 2011, equal to 56% of FCF, up from 23% of FCF last year

- **Dell still a PC company**
  - Desktops and notebooks are a majority of the business (55% of revenue in FY12)
  - PC software & peripherals are also significant part of the business (17% of revenue in FY12)

- **Margins at near all-time highs appear unsustainable**
  - Gross margin last year was 22.3%. Average gross margin in 2005-2010 was 18.1%
  - Margins were boosted by low component prices, moderate pricing environment, and extension of financing
  - Recent supply chain consolidation/disruption increasing cost pressure

- **Dell Financial Services contribution**
  - Portfolio up 7% to $5B in FY12
  - 68% of Dell Financial Services consumers have FICO scores of less than 660

- **Dell using M&A to transform itself**
  - $2.6B spent on acquisitions in FY12
  - Announced 5 acquisitions so far this year
Digital Distribution: Physical Media an Endangered Species?

- Twilight of the Gatekeepers
- Physical media retailers are being disaggregated
  - HMV, the last song
    - Unsuccessful diversification attempts to offset music declines
    - Shares at £0.04, down from 2005 peak of £2.73
  - Blockbuster, last of the chains
    - Unsuccessfully competed against DVD-by-mail service and online digital distribution
    - Bankruptcy filing September 2010
    - Continuously shrinking number of stores

- Video is undergoing digital transition
  - Proliferation of digital video distribution outlets, including over-the-top video on demand and streaming services like iTunes and Netflix
  - Proliferation of internet-ready televisions and mobile devices (e.g., tablets and smart phones) are accelerating the shift to digital video consumption
Digital Distribution: Physical Media an Endangered Species?

Source: The Digital Entertainment Group
Coinstar (NASDAQ: CSTR)

Source: Bloomberg
Coinstar (NASDAQ: CSTR)

- The value story
  - Forward EV/EBITDA 4.7x versus 7.0x average over last 5 years
  - Over $7.50 TTM FCF/share in FY11
  - Redbox has been Coinstar’s growth engine

- Reaching saturation point in 4Q11
  - Installed kiosk growth rate slowed to 2.9% QoQ, down from an average of 8.4% QoQ in the prior 10 quarters
  - Redbox DVDs rented fell 0.7% QoQ, the first ever sequential decline

- Coinstar resorts to unconventional ways to support Redbox growth
  - Recently raised rental DVD prices by 20% to $1.20/night
  - Announced a digital joint venture with Verizon
  - Pending acquisition of NCR’s ~10,000 DVD kiosks

- Redbox business model under pressure
  - Movie studios have implemented more onerous distribution windows
  - Implementation of credit card interchange fees will impact Redbox’s transaction-heavy business

- Coinstar is exploring creative kiosk concepts to offset potential Redbox slowdown
Troubled National Balance Sheet: Banking on Spain

Å Spain’s fiscal house is in disarray
   - Unemployment rate at 23% continues to rise (youth unemployment at 50.5%)
   - Fiscal debt greater than consensus view
   - Austerity won’t solve Spain’s on-going economic woes

Å Over-reliance on LTRO and ECB funding kicks can down the road
   - €152B in ECB funding as of February 2012 (47% of total ECB lending)
   - Spanish banks purchased at least €68B in Spanish debt since November 2011
   - Regional government borrowings continue to climb (€140B at year-end 2011)

Å Caja collapse adds to problem
   - Problematic loans forcing industry consolidation
   - Government guarantees and incentives required to complete consolidations

Å Spanish real estate bubble still on the books
   - €323B of commercial and property developer loans still outstanding
   - €50B of increased provisions only 15% of total required coverage
Troubled National Balance Sheet: Banking on Spain

Spain’s Debt/GDP +90%, all in – not 60%

Spain 5-Y CDS: Back at pre-LTRO levels

* Other central, regional and local public enterprises
** Other public enterprise debt as of 3Q11; govt.-backed bank debt as of April 10, 2012

Note: FADE = Fondo de Amortización del Deficit Electrico;
FROB = Fondo de Reestructuracion Ordenada Bancaria;
AIF = Administrador de Infraestructuras

Source: Bank of Spain, Bloomberg

Source: Bloomberg
Banco Santander (SAN SM)

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Banco Santander (SAN SM)

The "value" story
- Trading at P/TBV of 0.9x, P/E of 7.2x
- Attractive exposure to Brazil

Significant real estate exposure in Spain
- Equates to 172% of TBV
- 29% of commercial real estate loans are classified as NPLs as of year-end 2011
- Residential mortgage NPLs at 2.7% of portfolio and rising

Brazil exposure a headwind, not a panacea
- Increasing lending, even as local competitors pull back
- Credit quality a question mark

Capital remains an issue
- Core Tier 1 capital ratio of 10% doesn't reflect leverage of 26x TBV
- Listed local bank structure traps capital
Iron Ore Rush: Fuel for China’s Bubble

- leveraged to Chinese growth
  - Growth in iron ore demand is driven by China’s fixed asset investment boom
  - China’s share of global iron ore consumption is 66% (2011) up from 51% (2007) \(^1\)

- China’s credit-driven fixed-asset economy not sustainable
  - Recent signs of a slow down
  - Negative implications for Chinese steel consumption
  - Recent BHP comments consistent: Steel growth rates will flatten and they have flattened. \(^2\) Ian Ashby, President of BHP Iron Ore, March 20, 2012

- Iron ore extraction becoming more costly
  - Enormous investment in rail, port and energy facilities required
  - Steel, energy and labor cost inflation in key mining regions
  - Governments targeting the industry as a source of revenue and taxes

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\(^1\) Macquarie
\(^2\) AJM Global Iron Ore & Steel Conference (March 20, 2012)
Iron Ore Rush: Fuel for China’s Bubble

Iron Ore Price (2012 $/dry metric ton)

Source: Global Financial Data
Fortescue (ASX: FMG)

• The "value" story
  ‒ High operating cash flow margins (38% in 2011)
  ‒ Key assets near the bottom of the industry cost curve
  ‒ Plans to increase production capacity to 155Mtpa from 55Mtpa by June 2013

• A highly leveraged bet on continued fixed asset investment growth in China
  ‒ 98% of sales from China
  ‒ High level of debt ($6.4B) exposes company to iron ore price declines

• Cost inflation endemic in Western Australia’s Pilbara region
  ‒ Shortages in labor, accommodation and transportation driving up costs
  ‒ Increasing overburden removal required at existing mines
  ‒ Cost inflation in dollar terms exacerbated by strong AUD currency

• Significant planned volume growth may create oversupply in the iron ore market
  ‒ The four major iron ore producers are all pursuing significant expansions at a time when Chinese demand growth is flattening
  ‒ Increases risk to Fortescue debt-financed expansion

Sources: Bloomberg; Company Filings
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