

# A Search for Global Value ð TRAPS!

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James Chanos  
Kynikos Associates

# 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

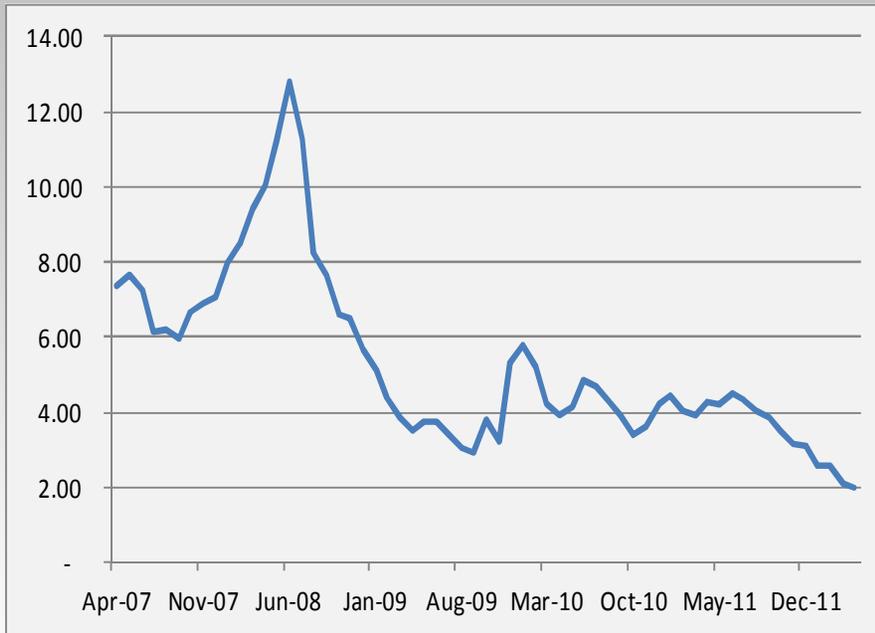
- “ U.S. Shale Explosion
- “ National Oil Company
- “ Mobile Computing Revolution
- “ Digital Distribution
- “ Troubled National Balance Sheet
- “ Iron Ore Rush

# U.S. Shale Explosion: Cheap Gas at Coal's Expense

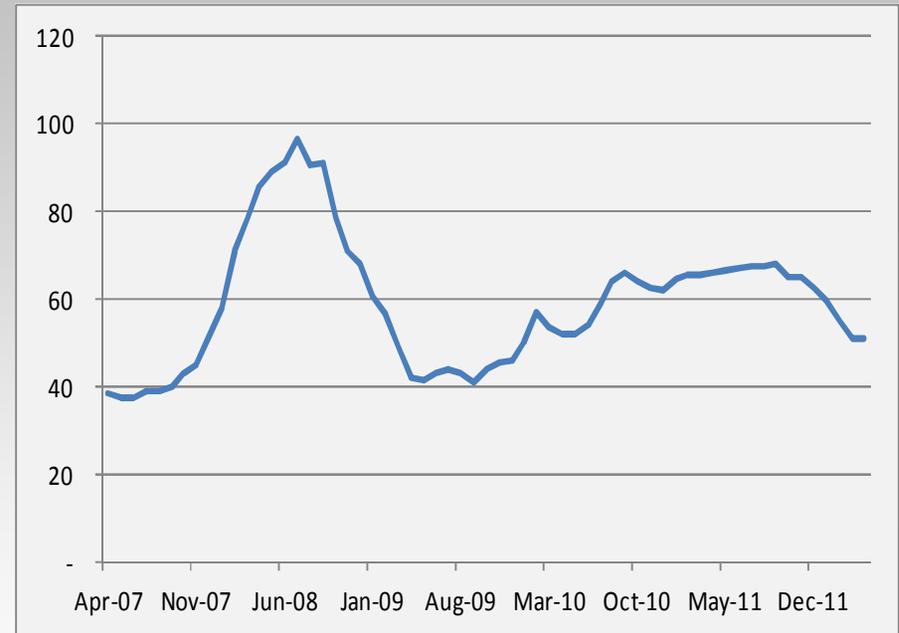
- “ Shale is a game-changer: U.S. is now 75% energy independent
- “ The rapid expansion of shale gas production capacity has led to record low prices
  - . Henry Hub natural gas price around \$2/mmBtu
    - “ Down over 50% YoY
    - “ Over 75% lower than five years ago
  - . Gas inventories are at record 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

# US Shale Explosion: Cheap Gas at Coal 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

# National Oil Company: For the Benefit of the State?

- “ 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

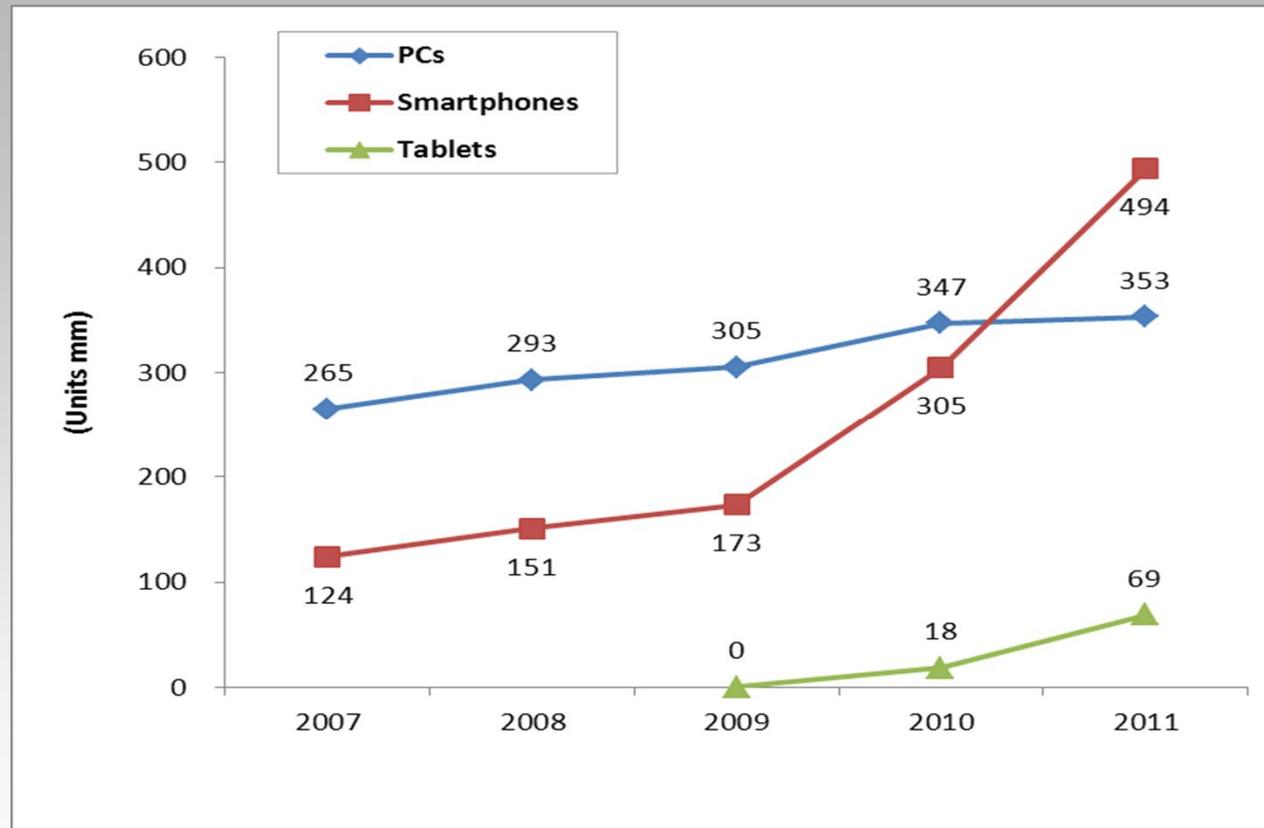
# Petrobras (NYSE: PBR)

- “ 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
- “ Huge capex program
  - . \$225B over 2011-15
  - . Requires \$14B of divestments and \$86B in additional leverage
- “ 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
- “ 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

# Mobile Computing Revolution: Death of the PC?



Source: IDC via Bloomberg

# Dell (NASDAQ: DELL)



Source: Bloomberg

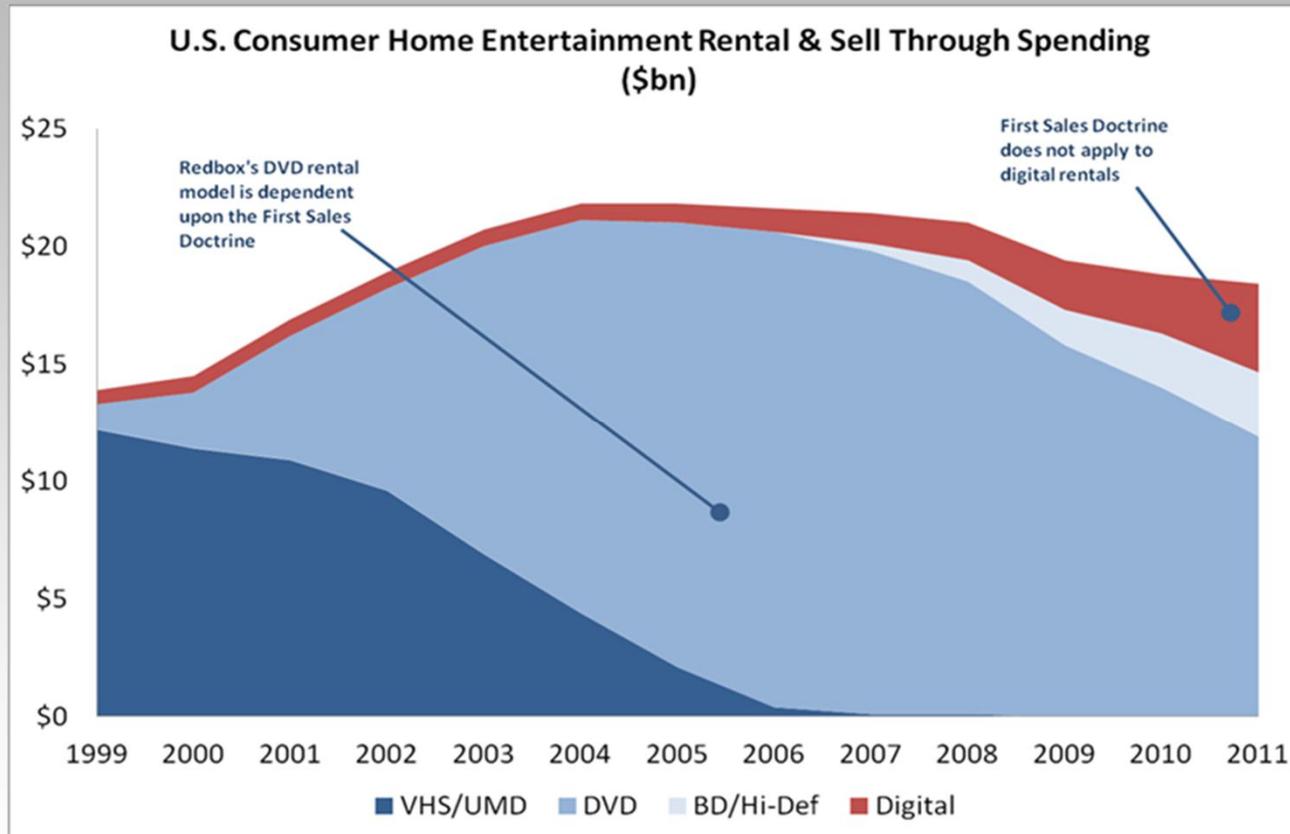
# Dell (NASDAQ: DELL)

- “ 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 . %cheap+throughout decline
    - 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
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# Digital Distribution: Physical Media an Endangered Species?



Source: The Digital Entertainment Group

# Coinstar (NASDAQ: CSTR)



Source: Bloomberg

# Coinstar (NASDAQ: CSTR)

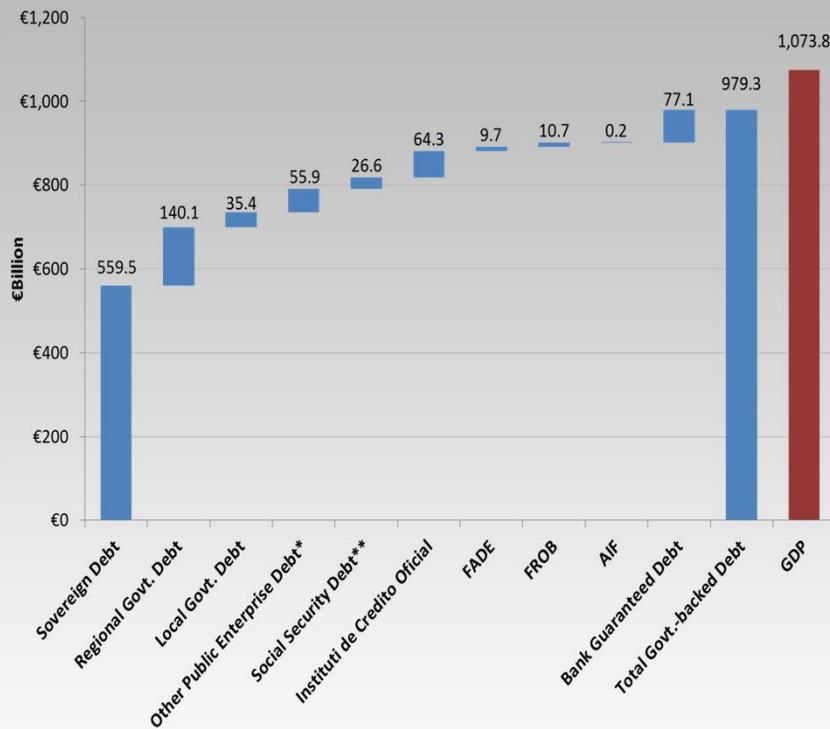
- “ The value story
    - . Forward EV/EBITDA 4.7x versus 7.0x average over last 5 years
    - . Over \$7.50 TTM FCF/share in FY11
    - . Redbox has been Coinstar's growth engine
  - “ Reaching saturation point in 4Q11
    - . Installed kiosk growth rate slowed to 2.9% QoQ, down from an average of 8.4% 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
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# Troubled National Balance Sheet: Banking on Spain

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



\* Other central, regional and local public enterprises

\*\* Other public enterprise debt as of 3Q11; govt.-backed bank debt as of April 10, 2012

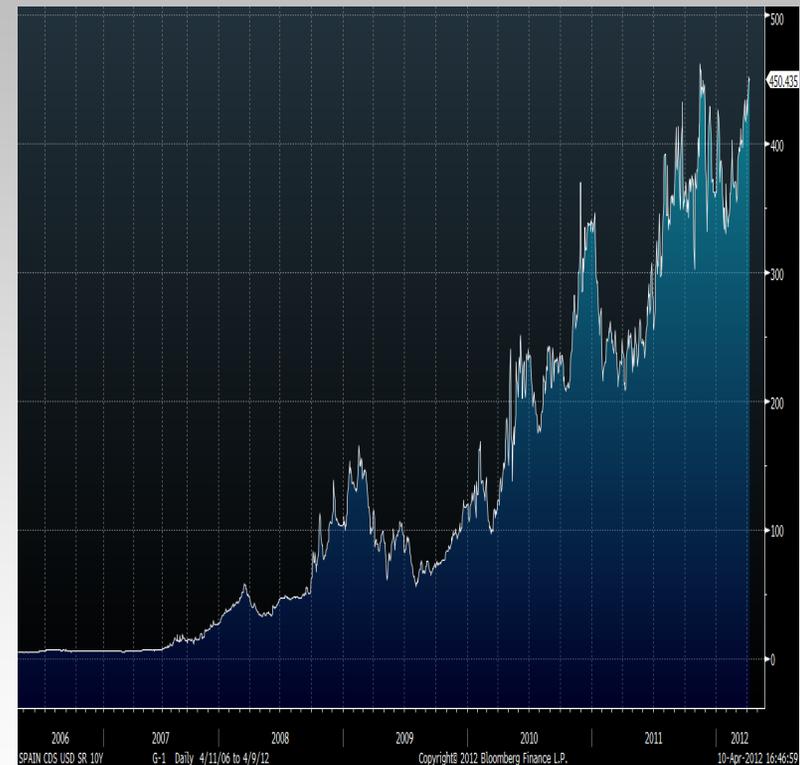
Note: FADE = Fondo de Amortizacion del Deficit Electrico;

FROB = Fondo de Reestructuracion Ordenada Bancaria;

AIF = Administrador de Infraestructuras

Source: Bank of Spain, Bloomberg

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



Source: Bloomberg

# Banco Santander (SAN SM)



Source: Bloomberg

# 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

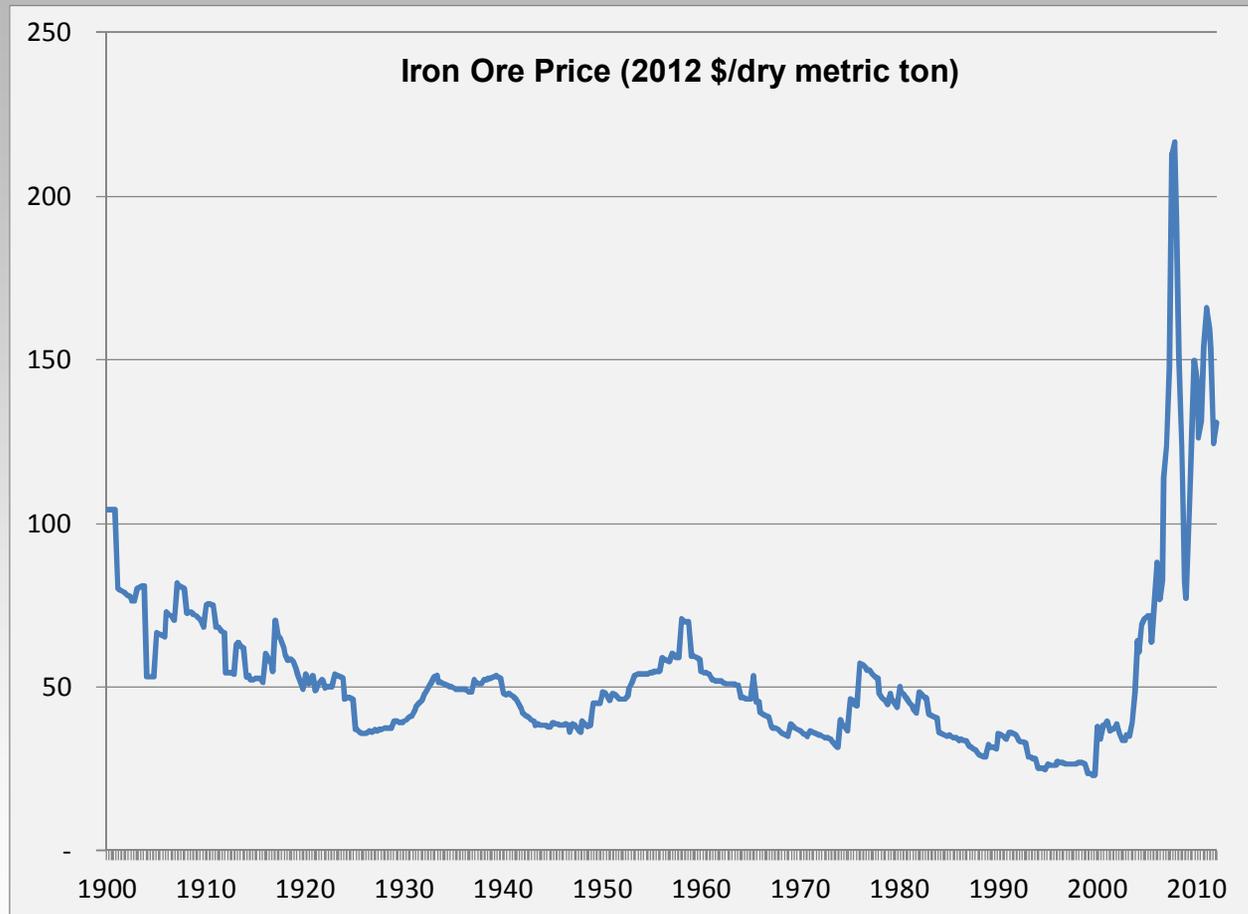
- “ Leveraged to Chinese growth
  - Growth in iron ore demand is driven by China's fixed asset investment boom
  - China's share of global iron ore consumption is 66% (2011) up from 51% (2007) <sup>1</sup>
- “ China's credit-driven fixed-asset economy not sustainable
  - Recent signs of a slow down
  - Negative implications for Chinese steel consumption
  - Recent BHP comments consistent: %Steel growth rates will flatten and they have flattened.+ *Ian Ashby, President of BHP Iron Ore, March 20, 2012* <sup>2</sup>
- “ 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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<sup>1</sup> Macquarie

<sup>2</sup> AJM Global Iron Ore & Steel Conference (March 20, 2012)

# Iron Ore Rush: Fuel for China's Bubble



Source: Global Financial Data

# Fortescue (ASX: FMG)



Source: Bloomberg

# 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

**Thank You to the  
Grant's Spring 2012 Conference**

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