GRANT'S

INTEREST RATE OBSERVER®

Vol. 33, No. 04b | Two Wall Street, New York, New York 10005 • www.grantspub.com | FEBRUARY 20 2015

Mistaken identity

Either the great lake of redundant crude oil points to long-term oversupply in fossil fuels, or it doesn't. The price of oil hangs in the balance. Not so—by rights, we're about to contend—the price of a share of Vancouver-based Methanex Corp. (MEOH on the Nasdaq, MX on the Toronto Stock Exchange). On Methanex, we're bullish, let the oil price do what it will—within reason, that is.

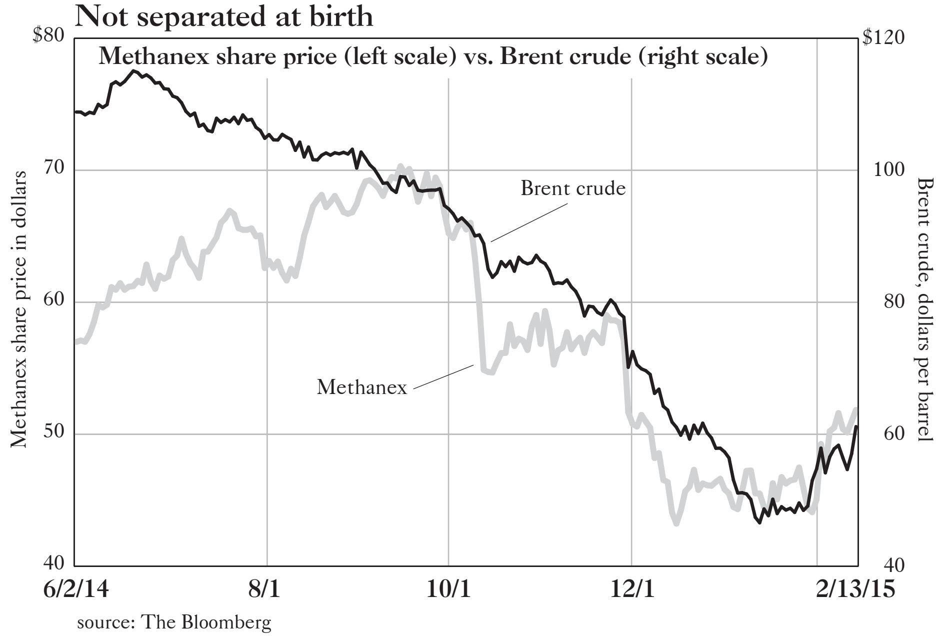
Methanol, familiarly and inexactly known as wood alcohol, is Methanex's stock in trade. Crude oil is not. Methanol is clear and free pouring, oil is black and viscous. Methanol mixes readily with water, oil doesn't. Methanol rapidly biodegrades, crude doesn't.There's really no confusing one chemical with the other. Yet Methanex shares have shadowed the price of crude since late last summer.

You can understand the source of the confusion. Energy-related applications absorb 40% of the 59 million tons of methanol that change hands each year. Industrial applications consume the rest. Methanol makes gasoline more efficient. It substitutes for naphtha as the feedstock to produce olefins, the basic building blocks of plastic. It goes into the manufacture of formaldehyde and acetic acid. To make methanol these days, you need natural gas, or—when in China—coal. In any case, not wood.

With Methanex, what you see—starting with the eponymous corporate name—is what you get. It's a pure play on methanol production, sales and logistics. The company is the world's largest methanol merchant, with over 15% of the global market share. It owns methanol-producing plants in Canada, the United States, Trinidad, Chile, Egypt and New Zealand. It manages a fleet of 18 ocean-going vessels to transport methanol. It owns or leases storage and terminals on four continents. "We are the only company that posts our own prices around the world," Methanex CEO John Floren reminded investors at a Scotiabank conference on Sept. 23. By dint of scale and depth of knowledge, Methanex is the first choice for anyone in search of a methanol joint-venture partner. It's the company to which you turn to implement a bright idea for new methanol applications. In the full year 2014, Methanex sold 8.5 million tons of methanol, of which Methanex-owned facilities accounted for 4.9 million tons.

A complicating element in the Methanex narrative is the People's Republic of China. By far the largest methanol end-market, China accounts for 43% of global methanol consumption. Concerning China's debt-crazed development schemes, this publication is perennially critical. As to the topic at hand, we relate without editorial comment the fact that Beijing has mandated methanol fuel blending. It has built methanol-to-olefin plants and invested in other methanol- related infrastructure to reduce Chinese dependence on imported oil. Long on coal and short on natural gas, China feeds its methanol industry with coal, not gas. For this reason—because gas is the cheaper alternative in methanol production—the People's Republic sits atop the methanol cost curve.

Not separated at birth



source: The Bloomberg

As China is a net importer of methanol, high-cost Chinese producers provide a bit of a pricing umbrella for more efficient producers. The methanol spot price in China, according to Bloomberg, is $250 per ton. "We believe the shutdown of marginal production in China is required to bring prices back to cost-curve levels, which we estimate to be in the range of $260 per metric ton to $280 per metric ton," Floren said on the Jan. 29 earnings call. "We are uncertain at this time how long the high-cost producers will sustain operations. As we head into the Chinese New Year [on Feb. 19], we would expect some marginal-cost producers, who use coal as a feedstock, to shut down."

It has happened before. When worldwide methanol prices slumped to $213 a ton in the dark days of 2009, lots of higher-cost capacity, particularly in China and Europe, went dark.

Probably every good investment begins with a misconception. The better-informed side of the trade sees something that the other side fails to grasp. In the case at hand, the value-enhancing error (so we say) concerns the sensitivity of Methanex's earnings to a high and rising price for crude oil. It's not as if there were no correlation. It's rather that the market exaggerates it.

"If oil prices stay low," a close observer of the methanol industry tells colleague Evan Lorenz, "then that [energy-related] demand may not grow to the same extent as was originally forecast. That is probably why you are seeing that response [in the share price]. Yet it's true that there is a whole pile of demand out there that is not correlated to oil at all and that is what forms the heart of our industry."

Before the crude-oil market slipped and fell, methanol makers worried about a looming supply deficit. Compare and contrast projected growth in supply and demand in the three years to 2017, the Methanex CEO told the Scotiabank audience in September: "You can see here there's a gap of around 10 million tons to 12 million tons of methanol demand versus supply," Floren said. "We think this is going to be filled by two occurrences. You may see some higher-cost capacity, mainly inside China, continuing to run or run at higher rates, as well there probably will be some substitution demands, substitution for some of the energy applications depending on their relative affordability of the substitute product. So it will depend, as we get more demand coming, on who can afford to pay more for methanol. And that's what will keep the world balance."

At current prices, methanol remains competitive in the manufacture of a pair of critical energy-related end products. It shows well against crude in the making of dimethyl ether (DME) and methanol-to-olefins (MTO) at a ratio of oil to gas prices of at least 15:1. Thus, with natural gas trading at $2.78 in the U.S., oil would have to fall below $41.69 before methanol became uncompetitive.

Nothing says that a new leg down in the bear market for crude is impossible. Just the other day, Citicorp analysts were musing on the possibility of a plunge to $20 a barrel. "But, if you have a two-to-three year view," an anonymity-seeking bull pitches Lorenz, "you are receiving a stock that has something like a mid-single-digit to high-single-digit free cash flow yield, with the option of strong double-digit free cash flow yield if energy prices go back up in the future."

The bullish case rests on what the company can control, i.e. its production, and not what it can't control, i.e. the price that production fetches in the market. By the looks of things, production is on the upswing. How Methanex has dealt with logistical snags in South America tell part of the tale.

As long ago as 2006, the company's Chilean operations delivered 3.2 million tons of methanol; in 2014, production there dwindled to just 165,000 tons. Inadequate supplies of natural gas bear the blame.

Methanex—"the power of agility" is the corporate slogan—is moving to solve the problem by relocating at least two of its four Chilean plants to Geismar, La. The company began producing methanol from the first Geismar plant on Jan. 24. Louisiana facility No. 2 is expected to become operational in the first quarter 2016. The pair is expected to add two million tons per year to Methanex's capacity and, given the bountiful supplies of U.S. natural gas, near two million tons in actual annual production.

While the company is mum on plant-by-plant profitability, it's fair to conjecture that the stockholders won't regret the decision to build in Geismar. In the

Methanex Corp. Financials
(All figures in $ millions, unless otherwise indicated)

	2014	2013	2012	2011	2010	2009
Total methanol sales (mns. tons)	8.5	8.0	7.5	7.5	6.9	5.9
Company produced sales (mns. tons)	4.9	4.3	4.0	3.9	3.5	3.8
Avg. realized price ($ / ton)	$437	$441	$382	$374	$306	$225
Revenue	3223	3024	2543	2608	1967	1198
Operating income	655	523	303	344	135	24
Earnings from associates	9	31	0	0	0	0
Net interest expense	44	52	60	60	29	27
Non-operational items	42	(59)	(362)	0	22	0
Profit before taxes	662	443	(119)	284	128	(3)
Taxes	155	66	(85)	56	34	(4)
Profit after tax	506	377	(34)	228	94	1
Minority interests	52	48	34	27	(2)	0
Net income	455	329	(68)	201	96	1
Diluted shares outsanding (mns.)	96.2	95.3	93.8	93.0	92.2	92.1
EPS	$4.55	$3.41	($0.73)	$2.06	$1.03	$0.01
Cash	952	733	727	351	194	170
Minority interest	267	248	188	197	156	133
Debt	1722	1168	1194	966	1026	914
Net debt	1037	683	655	812	989	878

source: The Bloomberg, company reports

American methanol market, relatively high-cost Asian producers deliver the marginal tons—just to ship methanol to the U.S. Gulf Coast from Asia costs about $100 a ton. In consequence, U.S. methanol prices tend to be much higher than those outside the 48 contiguous states. At last word from the Methanex Website, the non-discounted reference price for North America averaged $416 per ton vs. $315 per ton for Asia Pacific.

"Once Geismar 2 becomes fully operational," Lorenz relates, "Methanex's production should increase by two-fifths vs. the production level in 2014. The question before the house is what price methanol will command. In the fourth quarter, the company realized an average $390 per ton worldwide vs. $437 in full-year 2014, $441 in 2013 and $382 in 2012. Then, too, the February reference prices for North America, Europe and Asia Pacific are down 14%, 14%, and 26%, respectively, from the average reference rates in the fourth quarter. Methanex management and my own sources concur that prices in China need to be around $300 per ton in order for Chinese producers to be profitable – add $50 in freight for differences around the world, and that implies a global price closer to $350 per ton to keep the industry in the black."

As to what Methanex might earn, Lorenz asked his bull-without-a-name. "At a $300 per ton global price," our source replied, "I get free-cash-flow per share once the second Geismar plant comes on of about $4.25. At $350 it's over $6. At $400 it's about $8. That's assuming no more share repurchases and they just reloaded on their new share authorization." Based on the current share price, that would imply a free-cash-flow yield between 8% and 15%.

A continued rally in oil prices would certainly do the Methanex bottom line no harm; at higher crude prices, methanol would be in a position to claim more energy-related market share. As for the possibility of a pratfall in crude, Methanex is not without protection. For one thing, it tends to make good margins at all points in the cycle. The reason has to do with a kind of natural hedge. Except for the Medicine Hat plant in Canada, long-term gas contracts link to the price of methanol. Methanex shares a portion of the upside in methanol pricing with its gas suppliers, who symmetrically bear a portion of the downside risk. So it was that even in the first and second quarters of 2009, when the realized methanol price averaged just $213 per ton, Methanex managed to generate positive cash flow (albeit not enough to cover capital expenditures).

The same sensible-shoes management style is stamped on the company balance sheet. At year-end 2014, debt, net of cash, amounted to 1.2 times EBITDA, i.e., earnings before interest, taxes, depreciation and amortization. In the fourth quarter, operating earnings covered interest expense by a factor of more than 21 times.

Maybe the Methanex governing councils will choose to sell the two Geismar plants to a master limited partnership; a decision on that potentially shareholder-pleasing step is expected this year. Or perhaps they will choose to disassemble the remaining Chilean methanol plants and ship them, too, to Louisiana. Or maybe they will elect to build a second methanol plant at Medicine Hat, Canada.

"Methanex has a superb track record of allocating capital efficiently and rewarding shareholders," Lorenz points out. "From year-end 2000 to the end of last month, the company repurchased 81.3 million shares, reducing the share count to 91.8 million from 173.1 million. Another 3.8 million shares are destined for erasure under a new buyback program unveiled in January. There's nothing inherently value-accretive about share repurchases, of course. They deliver the goods only when management doesn't overpay. On this score, Methanex's management earns high marks. It paid prices of less than $20 a share on most of the shares that it repurchased over the past 15 years—a price that compares very nicely to the one prevailing as we go to press, $52.54. From the end of the Great Recession until just last year, Methanex had held back from large-scale share buybacks. The new share-repurchase initiative may be signaling a bullish change in management's informed view about the company's future (though let the record show that these shrewd investors have lately done no buying for their own accounts)."

The Methanex share price values the company at just half the replacement cost of the assets, Floren told dialers-in on the January earnings call. The CEO added that the future is an open book, nobody can predict it and prudence is the watchword. With respect to buybacks, he pledged to go slow.

The Methanex front office behaves as if it were dedicated to solvency, growth and the return of excess cash to the shareholders, in that time-honored order. Completion of the second Geismar plant is known to be a high corporate priority. Expansion at Medicine Hat and—perhaps—an exit from Chile are also on the table. The dividend occupies a place of some importance, too. First put in place in 2002, it has moved up every year except during the Great Recession, when it remained flat. Management is known to be averse to any policy that might lead to the future necessity of a reduction in the dividend (such as might be forced upon it by a sustained period of low methanol prices).

Methanex changes hands at 12.8 times trailing earnings and 15 times expected 2015 earnings; the dividend yield stands at 1.9%. Bay Street and Wall Street are each favorably disposed, with the analysts weighing in 10 to 2 on the bullish side of the story. Management incentives are aligned with shareholders' interests: John Floren is under contract to hold five times his salary in Methanex shares (he in fact owns stock equivalent to 6.6 times his 2013 cash compensation), five other senior executives must own three times their salary in stock and another 50 members of the management team are required to hold shares equal to their salary. It would be nice, as mentioned, if management were buying stock in these difficult days—in February, four insiders sold a total of 17,582 shares. Your move, Mr. Floren!

•