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Just in case

"We are all losing our shirts today. You know, we're making no money. It's all in the red."

The speaker was Rex Tillerson, chief executive officer of Exxon Mobil, the date was June 27 and the price of natural gas on the day he spoke was around $2.50 per thousand cubic feet. "What I can tell you," Tillerson informed an audience at the Council on Foreign Relations in New York, "is the cost to supply is not $2.50."

Now begins an exploration of the speculative possibilities of higher energy prices. We introduce a pair of orphaned equities and revisit an issue of cast-off bonds. And we preface the analysis with what may or may not be a bullish straw in the wind. Late last month, Petronas, Malaysia's state-owned oil and gas company, paid a 77% premium to buy Calgary-based Progress Energy Resources. It wasn't lost on Petronas that LNG (liquefied natural gas) has commanded six times the price in Asia that ordinary gas does in North America. E&P investors, hard-hit this year, briefly dried their tears on receipt of the news of the C$5.5 billion transaction.

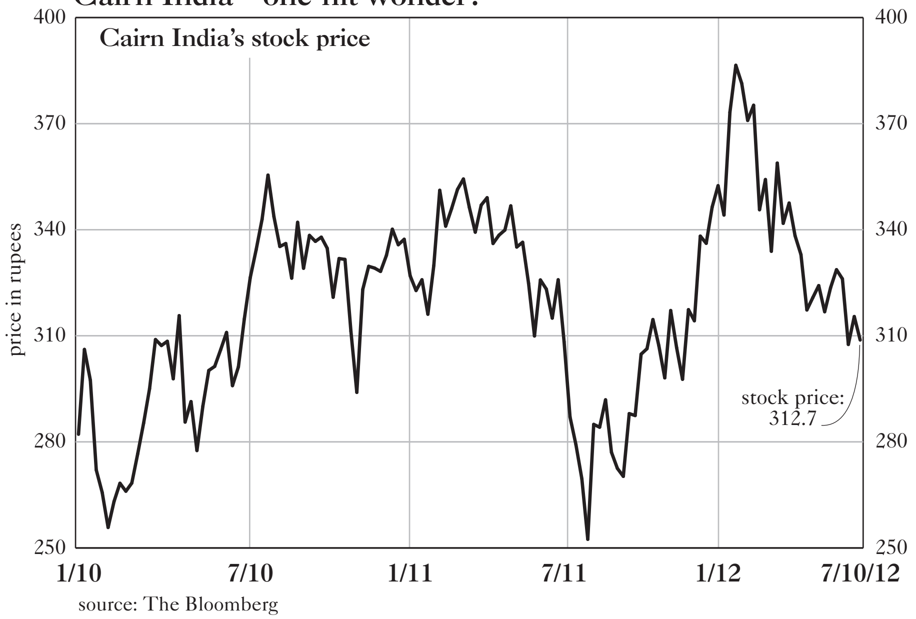
First up is Cairn Energy (CNE on the London Stock Exchange), a £1.66 billion ($2.57 billion), Edinburgh-based exploration and development company that the market loves to hate. Cairn's principal asset is an 18.3% stake in Cairn India Ltd. (CAIR IN on Bloomberg), which alone is worth almost $2 billion. There are days—June 27 was one of them—when Cairn trades at a discount even to this, its top but by no means only, asset.

Insofar as Mr. Market has given the matter his due consideration, he has put down Cairn as a one-hit wonder. The company had a huge success in India, discovering, in the Mangala field in 2004, the potential source of 30% of India's current oil production. Having hit this jackpot, Cairn returned cash to its owners. Completing the sale of a 40% stake in the Indian crown jewel in December, management distributed $3.5 billion in a special dividend in February.

But Cairn did not liquidate. With the cash that remained, it bought Agora Oil & Gas, an exploration outfit with assets in the North Sea. Cost: $453 million. And it has bid for Nautical Petroleum, another E&P company with North Sea interests. Value of the Nautical bid: £414 million. Earlier, Cairn had acquired exploration acreage in Greenland equivalent to one-half the size of the U.K. Cost to date of its Greenland effort: around $1 billion.

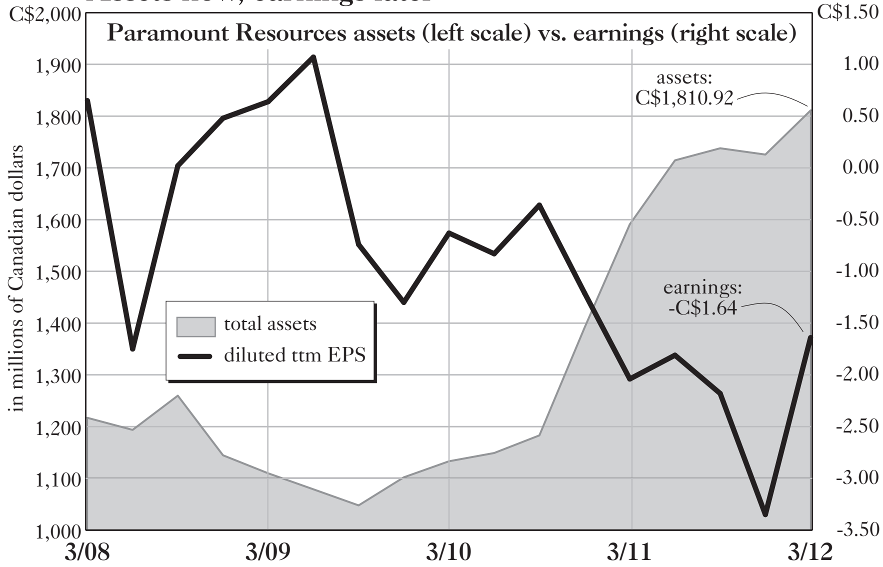
"Let's look at valuation," colleague David Peligal proposes. "At current values for commodity prices and exchange rates, Cairn India is worth almost $2 billion. Let's assume that the Nautical Petroleum acquisition goes through. At the end of this year, Cairn Energy would have a little less than $200 million of cash plus another $360 million that came in from the most recent disposition of Cairn India shares in late June (it has no debt). Adding the value of the remaining Cairn India position to pro forma year-end cash gives an amount roughly equal to Cairn En-

Cairn India—one-hit wonder?



source: The Bloomberg

Assets now, earnings later



source: The Bloomberg

ergy's current market cap. Consider the free options. True, the Greenland effort has so far yielded nothing but dry holes, but, as the geologists say, there's just a lot of potential stuff up there. Two, there are some exploration blocks in offshore Spain. Third, we've got Agora and Nautical, the latter trading slightly above Cairn's bid price as if to suggest that someone thinks it has value."

There are, of course, risks, but the market seems to have overlooked the potential rewards. "Should their failure thus far in Greenland render their success in India meaningless as an indicator of future exploration potential?" asks Jeremy Mindich, managing member of Scopia Capital and a Cairn Energy holder. "We don't think so."

Like Cairn Energy, Paramount Resources Ltd. (POU on the Toronto Stock Exchange), a Calgary-based oil and natural gas development and production company with operations in western Canada, is a sum-of-the-parts story. Earnings may not be much, the narrative goes, but the undervalued assets will sooner or later validate the foresight of the management and the patience of the investors.

At 85.6 million shares outstanding times a C$24.17 share price, the Paramount market cap weighs in at C$2.07 billion. The company boasts, among other things, a new oil sands subsidiary headed by Will Roach, former president and CEO of UTS Energy Corp. (*Grant's*, Sept. 19, 2009). Cavalier Energy is its name, and it's the recent proud acquirer of 36 square miles of land encompassing a prospect called Eagle's Nest: "We bought that out of bankruptcy from Oilsands Quest earlier this year," Roach tells Peligal. Then there's the promising Paramount tract in the Liard Basin, a relatively unexplored area of northeastern British Columbia. Eric S. Stein, founder of ESS Capital Management, paid-up subscriber to *Grant's* and owner of Paramount shares, has some thoughts on the Liard Basin property.

"The biggest recent development," Stein tells Peligal, "which I think is one of the keys to the company's intrinsic value and that nobody is really focusing on right now, is that Apache Corp., at their investor day last month, announced that they had discovered 48 trillion cubic feet of recoverable gas. Apache thinks this is the best unconventional shale reservoir in North America. The initial production rates are off the charts, and they've said that this play, because the production rates are so strong, is probably economic at $2.57 per mcf, which is where Henry Hub gas was priced just a few weeks ago. My view is that it doesn't really matter, because Liard is about 60 miles from the Horn River Basin. And the Horn River is being talked about as the big gas supply field for the LNG facilities in Canada. Obviously, Asian LNG is between $14 and $16 per mcf. Paramount believes they have about 15 trillion cubic feet of recoverable gas in the Liard Basin, which is not in anyone's sum-of-the-parts models. My view is that if you assume that they bring in a JV partner, which is what a lot of these operations have done up in the Liard and Horn River basins, their recoverable gas, net to them, goes from 15 tcf to 7.5 tcf. If you value that resource in the ground at about $0.20 per mcf, that's worth about $1.5 billion, or C$17 per share to Paramount. And that's just one of their assets."

Paramount's management team and ownership interest constitute another corporate asset. Clay Riddell, chairman and CEO, founded Paramount in

Not fearing Chapter 11

source: The Bloomberg

1974. Jim Riddell, his son, is president and chief operating officer. The Riddells own half of the stock and run the company with refreshing indifference to quarterly results. "They run it like a private company," Burt Ahrens, president of Edgehill Corp., an investor in energy stocks, tells Peligal. "When Paramount has a new area that really seems prospective, they invest in the infrastructure as well as drilling the wells. This may have a negative impact on earnings per share, but it pays off handsomely when they go into production."

As of the March 31 reporting date, Paramount showed net debt of C$474 million, and its public investments are worth C$625.6 million today. The investments can be seen as a source of cash with which to finance exploration and development outlays. These may run to C$475 million in 2012, management reckons. Besides the aforementioned long-lived assets in Liard Basin and Cavalier, Paramount is producing 25,000 barrels of oil (or oil equivalents) a day; 2012 revenues may come in at C$250 million. Analysts forecast a loss of C$0.80 a share.

"So, net-net," Peligal sums up, "this is what Paramount offers: valuable resources in the Liard Basin that might feed a future Asian LNG export trade. You have those public investments and a smart and well-respected management team that is investing alongside you. And you have the likes of Will Roach at Cavalier whose track record of success preceded him at Paramount."

Now for a postscript on ATP Oil & Gas Corp. Concerning its 11 7/8s second-lien notes due May 2015. *Grant's* had bullish things to say in the issue dated July 23, 2010. Quoted at 72 when we wrote, they fetch 47 today. They're rated Caa2/CCC-minus.

Peligal has surveyed holders of the ATP notes. He has appraised the value of the ATP assets and taken the measure of the unstellar ATP management team (whose latest misadventure featured the resignation of a new CEO exactly one week after that executive, Matt McCarroll, reported for duty). And what we conclude is that, if ATP did file for bankruptcy, the price of the notes probably wouldn't fall by much and could, in fact, appreciate a little, since management, bankruptcy-bound, would be making fewer new dubious commitments. For ourselves, who misjudged two years ago, we don't see much upside, and we don't see much downside. We are neither bullish nor bearish but chagrined.

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