GRANT'S
INTEREST RATE OBSERVER®

Vol. 31, No. 10c | Two Wall Street, New York, New York 10005 • www.grantspub.com | MAY 17, 2013

Puts on Ph.D.s

Interest-rate crushing and money printing remain 21st-century crowd pleasers to judge by the evident suspension of the laws of financial gravity. But let's say that the agents of financial repression misplay their hands and print the fatal redundant unit of scrip. Come the day of disillusionment, plenty will change, including, perhaps, the prices of the following handpicked trio of corporate equities.

The list comprises a development-stage gold mining company, an energy exploration and development outfit and a wood-flooring retail chain. We present the stocks as options on the Federal Reserve and its works. Each option, in its way, stands to benefit when the current monetary regime—the Ph.D. standard, as we know it in these pages—comes a cropper. Someone may know the timing of the denouement, but that someone isn't us.

First up is NovaGold Resources (NG on the NYSE-MKT), 50% owner with Barrick Gold of the world's largest known, undeveloped gold deposit, some 40 million ounces and counting. From 50 cents to $20 or thereabouts and back to 50 cents, with a thud, is the well-worn price track of the company's shares.

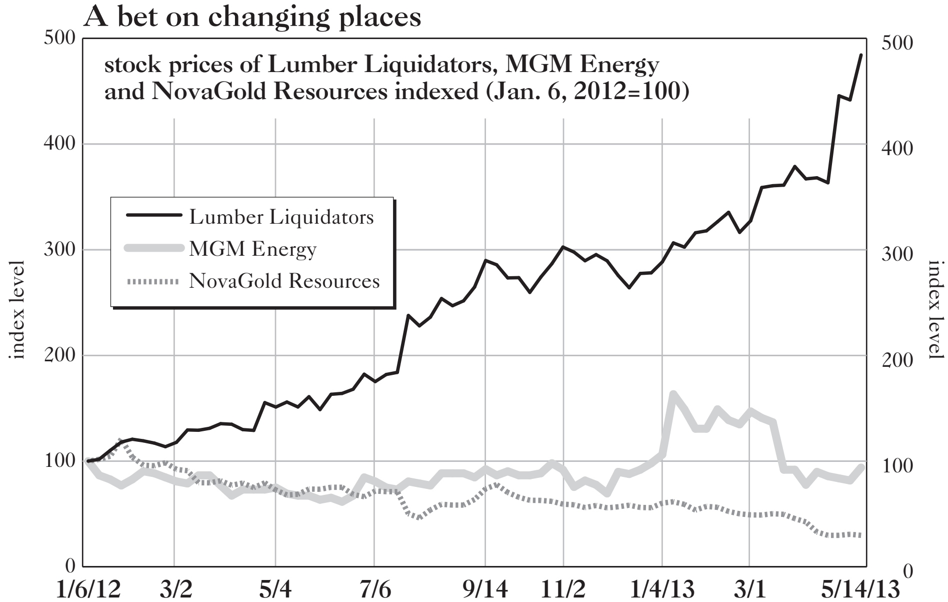
NG is nature's own hyper-leveraged option on a much higher gold value expressed in terms of Federal Reserve notes. Donlin, as the property is called, is situated smack dab in the middle of the Alaskan nowhere. The project is in its formative permitting phase. Capital spending on the order of $6.7 billion, or perhaps much more, may begin in 2016, but not at the current gold price. Only a value on the order of $2,000 an ounce would justify the projected outlays, John Doody, editor of the *Gold Stock Analyst*, advises. Production would start in 2019. "Jam today," therefore, NovaGold is definitely not.

"I don't believe that the bull market has even begun," pronounces Tom Kaplan, referring to gold. He is the owner of 84.6 million NovaGold shares, or 26.7% of the outstanding, and he bought low in one of NG's recurrent sinking spells. In 2006, Barrick had offered $1.6 billion for NovaGold, or $16 a share, based solely on Donlin, when gold was a mere $600 an ounce and when Donlin's reserves were a fraction of what they're cracked up to be now. That $1.6 billion is a little more than twice NovaGold's current stock market capitalization.

Spurned, Barrick backed off—as did the price of NG, all the way down to $1 a share or less, when Kaplan appeared as a white knight. "NovaGold—Donlin—was my Holy Grail," the bull of bulls tells colleague David Peligal. "It had everything I was looking for. It had the size, it had the jurisdiction, the grade, everything about it to me was perfectly aligned to create a unique way to be able to get leveraged into gold where time would be on our side. . . ."

Which side of the argument time favors is exactly the question. Barrick Gold, NovaGold's partner in Donlin, is struggling with an over-encumbered

A bet on changing places



source: The Bloomberg

balance sheet and an underachieving share price. Seymour Schulich, the superstar Canadian resources investor, tells Peligal that (*a*) he has just bought five million shares of Barrick, and (*b*) he hopes Barrick will not—repeat, not—go ahead with Donlin. Pierre Lassonde, with whom Schulich has often partnered, tells Peligal that it may cost $10 billion, not $6.7 billion, to bring Donlin into production. "It's a great call on gold at $5,000!" Lassonde adds.

Besides Donlin, NovaGold owns a 50% interest in Galore Creek, a copper-gold-silver deposit in northwestern British Columbia. Given that Teck Resources, NovaGold's partner in Galore Creek, has invested $400 million in the undertaking for a total assumed value of $800 million, let's credit the NovaGold balance sheet with $400 million. As against net cash of $200 million, NovaGold is spending, for now, at the rate of $40 million a year.

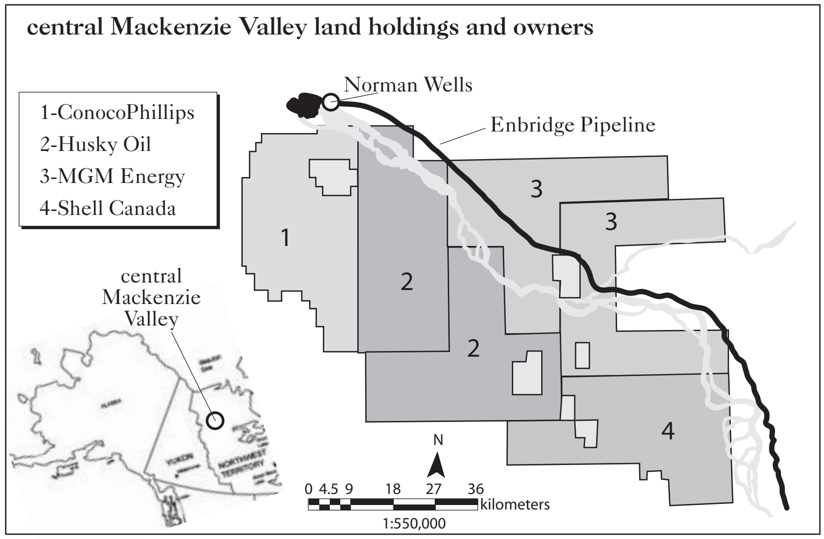
From which it follows, Peligal reasons, "investors are paying $200 million for 20 million ounces of gold in the U.S., or about $10 of equity market cap per ounce of gold resource. Companies have paid many multiples of that to acquire gold resources in emerging markets."

"Let's put it like this," says Kaplan, that most interested party: "That 40 million ounces [of which 20 million belong to NovaGold] come from only part of a three-kilometer section of an eight-kilometer strike length, which is all mineralized. So we're expecting this to be a mine that starts out at 27 years, but very likely could go on for a multiple of that. And the grade is extraordinary. The only other place in the world where there's a large project that has this kind of grade is in the Congo. And we're not in the Congo."

When mining equities have their next upswing—it's not a question of "if," Kaplan insists—there will be a "gravitation towards jurisdictional safety," he says. "The last couple of years have really taken almost all jurisdictions other than North America out of the safety equation. That's why … I think people will want to be in a place where the rule of law isn't a novelty." As for the timing of the payoff, Kaplan brushes it off: "[I]f you're trying to make 100 times on your money, whether or not you're right within 24 or 60 months, it doesn't matter."

On, now, to MGM Energy Corp. (MGX on the Toronto Stock Exchange), a sporadically trading, loss-making, thinly financed, C$0.23 per-share exploration and development company that operates near the Arctic Circle in Canada's Northwest Territories. "With MGM," relates Peligal, "you have a significant land position in the emerging central Mackenzie Valley Canol shale oil play. You have a gas resource base in the Mackenzie Delta that totals 778 billion cubic feet of contingent and prospective gas resources. And as with NovaGold, the public punter is speculating alongside a rich principal, in this case Clay Riddell, founder of Paramount Resources; Riddell and Paramount together own 45% of MGM shares." (As for Paramount, see the issue of *Grant's* dated July 13, 2012.)

Location, location, location



source: MGM Energy Corp.

MGM came into the world with higher hopes than might seem to be justified today. It was spun out from Paramount (POU in Toronto) in January 2007 and began trading at C$5 a share. The founders visualized the construction of a new pipeline to deliver MGM's gas to TransCanada's system in northern Alberta. But with the surprise arrival of the "shale gale," the pipeline turned into a pipe dream (the price tag would have been on the order of $16 billion). So it was on to Plan B.

"For MGM," Peligal continues, "the focus shifted to oil prospecting on company lands in the central Mackenzie Valley. Importantly, MGM's assets here are close to the existing oil infrastructure, such as it is. Paved roads, bridges and power lines are rarities in the Northwest Territories, a land mass twice the size of Texas but with a mere 43,000 inhabitants. What remains to be seen is whether any of the shale oil trapped in the rock can be produced in a cost-effective manner."

On this score, MGM's front office and the stock market have apparently agreed to disagree. "We are very excited. . . ," said the president of MGM, Henry Sykes, in March at news of the results from the one vertical well that's been dug on company land in the Canol. As Sykes was extolling, however, the share price was sinking by 12 cents, or 35%, to slightly less than one-quarter of a dollar, where it sits today.

MGM, with stockholders' equity of C$74.6 million and net cash of C$12 million, is not about to develop its own interest in the Canol. "Perhaps," Peligal speculates, "management is banking on its deep-pocketed neighbors in that area, Husky Energy and ConocoPhillips, for that. If you wonder why MGM just doesn't put itself up for auction now, you must remember that the Riddell interests are in charge, and they seem to be holding out for something bigger and better than what the market would bring today.

"During the first quarter of 2011," Peligal notes, "MGM sold 20% of its stake in the Umiak gas reserves, one of its properties in the Mackenzie Delta, for C$30 million to Korea Gas Corp., a transaction that values MGM's remaining 40% interest in the Umiak field at C$60 million. The gas resource is there, but not the pipeline. So when you think about MGM's C$90 million market cap, you are either getting 778 bcf of gas for under $0.12 per mcf and MGM's leases in the Canol shale for free, or you're paying nothing for the stranded gas and paying C$90 million for the potential value of the land in the Canol.

"Here's one way of thinking about that C$90 million," Peligal continues. "In March 2012, as gas prices headed towards $2 per mcf, unconventional gas reserves were acquired in the Barnett Shale in Texas for $0.69 per mcf. Using this distressed deal as a benchmark, MGM's gas reserves seem attractively priced. Remember, MGM's gas assets are conventional so they are much cheaper to develop since fewer wells need to be drilled and the decline rates are much more gradual. Furthermore, if we assume success for the Canol shale, the numbers become silly. On their leases, MGM believes it has a resource base of over 5.2 billion barrels of net oil in place. If we assume a 5% to 10% recovery factor for shale oil, which is a conservative estimate, MGM's net recoverable oil could range from 250 million to 500 million barrels. Recent oil M&A has valued proved reserves at $10 to $20 per barrel. If we discount this 90% to account for the remote operating environment and value the potential resource at $1 to $2 per barrel, the Canol shale could be worth up to $250 million to $1 billion."

Needless to say, much higher nominal energy prices brought about by heavy-handed work on the monetary pumps wouldn't be unwelcome, either.

Idea No. 3 is a short position in Lumber Liquidators Holdings (LL on the Big Board), the biggest specialty retailer of hardwood flooring in North America. Let us first acknowledge that we are picking on a marketing juggernaut and a stock-price momentum rocket ship. Sales and earnings per share are on a roll, and operating margins have been widening—to 11% in the first quarter of 2013 from 7.1% in the like period of 2012. The balance sheet shows $72.7 million in net cash. Hustling to stay bullish enough, sell-side analysts are ratcheting up their price targets even as the latest S&P/Case-Shiller Home Price Index, for February, shows a 9.3% year-over-year gain, the most since May 2006. In short, here is an apparent state of perfection.

But only apparent: "The bullish Lumber Liquidators' story revolves around the potential opportunity for the company to open 600 stores in the United States over the next couple of years and to take market share from independent floor-covering retailers," Peligal relates. "Lumber Liquidators owns a 10.5% market share, management estimates. Other contenders in the American hardwood and laminate market are home centers like Home Depot and Lowe's, with a combined share of 27%, and everybody else with 62%. While one can understand the bullish thesis, it's interesting to note that LL's sales per store are flattish over the past couple of years.

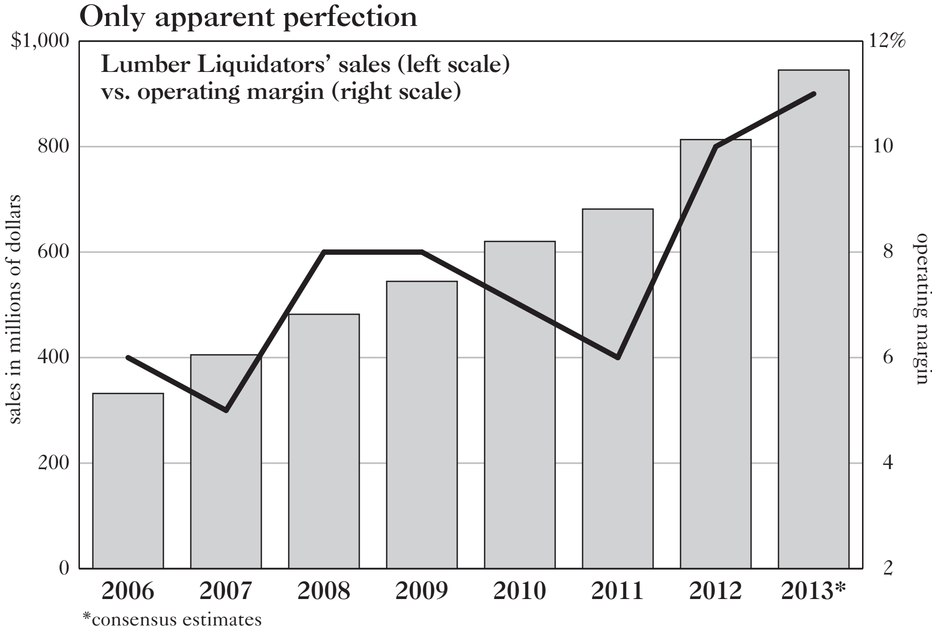
"Now it's true," Peligal continues, "that new stores cannibalize old stores, but let's make the generous assumption that a mature LL store can generate $3.5 million of revenues per year. Furthermore, assume LL can open a total of 600 stores, and that total revenue at some point in the future will be $2.1 billion (600 stores times $3.5 million per store). Say, in addition, that LL can take share from independent retailers and that operating margin climbs to 14%. You would then have $294 million in earnings before interest and taxes ($2.1 billion in future revenues times a 14% margin). Because, at this indeterminate point in the future, LL will have become a mature retail concept, apply a multiple of 14. You get about $2.6 billion of value, or perhaps $2.4 billion, as the stores don't just build themselves. And that is essentially where the stock is valued today. If you put any kind of discount rate on it, the share price would immediately sink, because it might take six or eight years to finish the construction. Thus, at these levels, LL is a different kind of lottery ticket. In a way, you're buying a low-cost put on housing. If a surprise outbreak of inflation pushed up mortgage rates, or a surprise outbreak of deflation pushed down house prices, the price of a share of LL could come down from the ceiling to a spot much nearer the floor."

Peligal got on the phone to check with some of the independent flooring retailers on whose market share Lumber Liquidators will ostensibly feast. "What is their name?" a New Jersey merchant rhetorically asked in reply to Peligal's question. "Lumber Liquidators," he answered himself. "You know what liquidators means? It's the stuff nobody else wants."

The man from the Garden State asked to remain anonymous. So did a retailer from Maryland. "I'm the general manager of this company, and I've been in the industry for 26 years now," our informant said. "The reputation of Lumber Liquidators is that they are the dumpster of the industry."

The author of a Yelp review of the

Only apparent perfection



*consensus estimates
source: The Bloomberg

Lumber Liquidators' store on E. 18th St. in Manhattan, dated Dec. 10, 2012, was only one-half anonymous. "The wood that they sell you is of poor quality, even if it's Bellawood hardwood," wrote Sarah F. "The planks are not the same width across their length, and they are not durable at all. I've had my floor for less than six months and it looks awful already."

The Web site Reseller Ratings posts 63 customer reviews of Lumber Liquidators. On a 10-point scale, LL scores 3.61 for pricing and services, 0.63 for shipping and packaging and 0.56 for customer service. "Save yourself a major headache by running as quickly [as possible] in the other direction as if your hair was on fire!" writes customer Kate Olen, of Kissimmee, Fla. Evidence that not every single Internet commentator is angry are the reviews posted on Reseller Ratings for True Hardwoods of Calhoun, Ga. Here, the scores run 9.62 for product and service, 9.81 for shipping and packaging and a perfect 10 for customer service; 39 customers contributed.

Reached for comment, the LL investor-relations contact replied that the majority of her company's products are first quality, with odd lots and second-quality goods accounting for only 5% of volume. As for hardwood, she said, it's a natural product, and people have unreasonably high expectations about the uniformity of the wood. "Well," she explains, "that's how the trees grow."

Notably, the short sellers in LL are not the only sellers. Thomas Sullivan, founder and chairman of Lumber Liquidators, has been a consistent seller over the past two years, including 200,000 shares between May 3 and May 6 at prices in the low $80s (which leaves him 708,998 shares). Follow the leader, we say.

•