GRANT'S
INTEREST RATE OBSERVER®

Vol. 31, No. 20b Two Wall Street, New York, New York 10005 • www.grantspub.com OCTOBER 18, 2013

Investing in Yellen

By the looks of things, the post-Bernanke Federal Reserve will be much like the Bernanke Federal Reserve, except, perhaps, more openhanded. The ideal hedge against the possible consequences of an overly aggressive monetary policy would be a value-laden equity that could prosper in any macroeconomic setting but could shine in an inflationary one. Eni S.p.A. (ENI on the Italian bourse), the principal subject at hand, conforms to that description, it seems to us, while Pretium Resources (PVG in both New York and Toronto), a *Grant's* problem child and the second topic under discussion, fills another monetary hedging need.

We start with Eni and a question: What would you pay, gentle paid-up subscriber, for an oil refinery in Italy? The market is weak now—demand for refined product is down by 26% from levels in 2008—but Italy's economy will recover some day. Based on an analysis of Eni, the price tag on that Mediterranean refinery is negative: The market will pay you.

We arrive at this conclusion with a little help from the SEC, which requires companies engaged in oil and gas extraction to estimate their production from proved (not probable or possible) reserves. Eni is engaged in the oil and gas extraction business, among others. It owns oil refineries, petrochemical plants, a gas marketing and distribution business and shares in a number of public companies. The Italian government owns 30.3% of Eni's stock.

Now, then, an analyst in receipt of company-estimated production data can make some assumption-intensive guesses about the future. By comparing future revenue streams (one must guess about energy prices) with future costs, including royalties and income taxes (more guesswork required), he or she may derive a revenue forecast. Next, the analyst discounts the estimated future revenues to solve for a present value. Because 10% is the industry-accepted discount rate, the calculation is known as "PV10."

"Critically," observes colleague Evan Lorenz, "no assumptions are allowed about growth in proven reserves; they are what they were at the start of the analysis. Owing to this convention, most companies trade at a premium to PV10. Exxon Mobil Corp., whose production has flat-lined for a decade, has an enterprise value that is 179% of its PV10. The next five largest U.S. energy companies by market cap trade at an average of 229% of EV to PV10. Lukoil OAO (*Grant's*, Sept. 6), which operates in Vladimir Putin's Russia, has an enterprise value that is only 80% of its PV10. Eni's enterprise value of €80.2 billion is 125% of the company's estimated €64.2 billion PV10.

"Comparing securities based on their PV10 valuations can lead to some interesting results, by the way," Lorenz adds. "BP Prudhoe Bay Royalty Trust (BPT on the New York Stock Exchange) trades at 150% of its PV10, while BP PLC (BP on the NYSE) trades at 126%. In other words, the income trust with a finite life is priced for higher growth than the living company that can invest in new fields."

Part of what makes Eni attractive is that the sum of its subsidiary parts is greater than the corporate whole. They are greater than the €64 billion equity

Eni S.p.A.
(in € millions, except per-share data)

	12 mo. thru 6/30/2013	2012	2011	2010	2009
Revenue	€123,293	€127,220	€109,589	€98,523	€83,227
Operating profit	11,002	15,026	17,435	16,111	12,055
Int. expense	940	980	922	766	753
Net income	5,762	7,788	6,860	6,318	4,367
EPS	€ 1.59	€ 2.15	€ 1.89	€ 1.74	€1.21
Diluted shares	3,623	3,623	3,623	3,622	3,622
Cash	8,063	8,000	1,762	1,931	1,956
Debt	24,575	24,463	29,597	27,783	24,800
Min. interests	2,868	3,514	4,921	4,522	3,978
Net debt	19,380	19,977	32,756	30,374	26,822
Net debt / EBITDA	0.9	0.8	1.3	1.2	1.3
Op. profit / int. expense	11.7	15.3	18.9	21.0	16.0

Source: The Bloomberg

market cap as well as the €80.2 billion enterprise value (EV being defined as equity market cap plus debt at par minus cash). Eni's stakes in Galp Energia, SGPS, S.A., a Portuguese energy company, and Saipem S.p.A, an Italian construction and energy services company, are worth €4.6 billion at today's prices. (Management views these holdings as non-core and is looking to divest them.) Eni also owns a 50% interest in a fertile natural gas exploration block off the coast of Mozambique. In March, the China National Petroleum Corp. paid $4.2 billion for a 20% interest in this underwater formation. Early tests hint that the deposit may hold 87 trillion cubic feet of natural gas, but, because these possible reserves have yet to be proved, they do not show up in Eni's PV10. "I think that this is a game changer for the company," an anonymous Eni holder tells Lorenz. "Mozambique will increase Eni's reserves from 7.2 billion barrels at the end of 2012 to 15 to 16 billion barrels." Using the valuation CNPC bought in at would value Eni's stake—which amounts to 50%—at €7.8 billion, or $10.5 billion.

"Eni has expanded its production by 1.5% a year over the last decade and, based on projects under construction, the company estimates that it will grow production by over 4% a year between 2012 and the close of 2016," Lorenz reports. "This projected growth excludes any contribution from Mozambique, which is not expected to begin production until at least 2018. While Eni's growth beats Exxon's, Eni operates in some less-than-stable countries, including Libya (15% of 2012 production volume) and Nigeria (9%). Production of 1.6 million barrels in the first half of 2013 has disappointed some, partly because trouble in Libya and Nigeria cost 20,000 barrels per day of production. For the sake of our valuation experiment, we will value Eni's oil business at one times its PV10.

"Adding the value of the Mozambique claim to Eni's public holdings and €64.2 billion PV10 valuation yields an overall valuation of €76.6 billion," Lorenz goes on. "For accounting purposes, Eni consolidates Saipem's figures. Eni's enterprise value, ex-debt and minority interests attributable to Saipem, is €72.9 billion, i.e., the market prices Eni's refining, petrochemical and gas businesses at a negative €3.7 billion."

Unwanted, these businesses may be. And while they generated operating losses of €5.1 billion over the past 12 months, they managed to earn operating profits of €2.9 billion in the not-so-spectacular year 2010 and €4.9 billion in 2007. Eni's top management—which, let the record show, personally owns not a lot of stock—says it's taking steps to turn things around even in the absence of any economic growth. The gas and marketing business has been dealt a knock both by America's shale gas revolution and by Europe's adoption of renewable energy. Before the Great Slump, Eni signed long-term take-or-pay gas contracts linked to the price of oil with the likes of Gazprom and Sonatrach. Spot prices have fallen well below Eni's contract prices, driving this division into operating losses of €3.2 billion in 2012 vs. operating profits of €1.8 billion and €2.9 billion in 2011 and 2010. The company has renegotiated most of its supply contracts, which—it is hoped—may lubricate a return to profitability.

Eni's refining business lost €1.3 billion in 2012 and was in the red for four of the last five years. Management is on a cost-cutting program that it estimates will leave the division at break-even by 2014, even at 2012 depressed demand levels. Eni's petrochemical business, which manufactures everything from olefins to elastomers, lost €683 million in 2012 and has been in the red every year for the last five years. This business is perhaps the most troubled in the Eni stable. Management is trying to move it out of commodity ethylene and into higher value-added products like elastomers and environmentally friendly chemicals. Break-even is the goal by 2016.

"But," Lorenz winds up, "even with these dud divisions dragging down the bottom line, Eni is cheap at 12.3 times expected 2013 earnings and a 6.2% dividend yield. The company has many levers to boost the share price, including a €6 billion share-buyback authorization."

As for Pretium Resources, we, the bulls, are destined either to be very wrong or very right. If very right, it will be in the context of having been very wrong, as the share price has crumbled. It fell out of bed on Oct. 9 on news of the resignation of one of two independent consultants who had been performing a gold-sampling program at the Brucejack deposit, Pretium's crown jewel, in northern British Columbia. For background to the Pretium story, please see the issues of *Grant's* dated Jan. 25 and July 12. As for the dustup over the departure of Strathcona Mineral Services Ltd., nobody seems to know much. At least, nobody who seems to know much is saying anything. Strathcona declined to say why it quit, though the market was quick to conclude that it was because the consultant had discovered something that was highly un-bullish. Then, again, another consultant, Snowden Mining Industry Consultants, has stayed on the job. Snowden and Strathcona apparently had technical differences over how to test Pretium's ore samples. In any case, the results of the sampling—now performed by the Snowden method—aren't known and won't be available until January.

These days, when gold sneezes, the mining shares wind up in the hospital. Most of all do the junior miners—in effect, long-dated options on a much higher gold price—struggle. Yet with federal default in the foreground and Janet Yellen in the background, we are inclined to favor the short side of the fiat currency story, the long side of the gold story.

"We had working capital of $37.9 million at June 30 and raised $27.3 million in August," Joe Ovsenek, chief development officer at Pretium, advises in an e-mail. "We have the cash to (a) finish up this year's programs at site, (b) mill the bulk sample, (c) file our permit applications and end the year with reasonable working capital. We have not yet worked out our budget for next year, but expect to focus on permitting and production financing."

Herewith, then, a deeply out-of-favor speculation on a monetary outcome that history says is not so unlikely. We remain bullish.

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