Thoughts on the Market August 14, 2012

Volatility (as defined by the VIX) has been trending lower, as the many sources of bad news fail to get any worse and confiscatory interest rates relentlessly push investors into the water. Investors are searching for ways to bet on it rising again – a tricky concept to get right. As investors climb the wall of worry through buying stocks they push down levels of implied volatility in the process.

Bonds are without doubt guaranteed both to return your money and to reduce its purchasing power. It’s a Faustian bargain readily accepted by many, and yet the pessimist would say you can lose money quickly (in stocks) or slowly (in Bonds). Without dismissing such fears, I’d simply say that figuring out how much of the bad news in the the overall level of the market isn’t something that we spend an inordinate amount of time on. Better to focus on companies that can survive the bad things that may come and can prosper if everything turns out not quite so awful.

In our Deep Value Equity Strategy we’ve made a few modest changes over the past couple of weeks. We have net raised a bit of cash, mostly through trimming positions that had grown too big rather than through any darkening top-down view of the world. We reduced our position modestly in Comstock Resources (CRK). We still like the natural gas theme and CRK is making the right moves, repaying their revolver with $300MM of long term debt maturing in 2020 (incurred following their purchase of properties in west Texas) and continuing to shift their capex to oil while natural gas prices remain weak. They also announced a partnership with KKR sharing their development risk in their Eagle Ford shale. About a year ago BHP Billiton acquired Petrohawk (HK), in whom we were invested, at a 60% premium but more recently had to take a

writedown on the shale gas assets then acquired. Floyd Wilson, then Petrohawk's CEO, always said he wanted to sell the company and showed timing of a similar order to Steve Case (AOL to Time Warner) or brother Dan Case (H&Q to JPMorgan) with that move.

But it'll be a while before CRK realizes the value in its portfolio through being acquired, and daily volatility of 5 times or more the equity market caused us to trim this back somewhat. We maintained our energy exposure with an investment in Kinder Morgan Inc., (KMI), which owns most of the GP for Kinder Morgan Partners (KMP).

We invested in Leukadia (LUK), a holding company with a fairly eclectic portfolio of businesses that has been trading at a discount to book value for some time and recently dipped when Knight Trading (KCG) almost bankrupted themselves through a poorly debugged trading program. LUK owns a portion of Jefferies (JEF), and no doubt traded down in sympathy at that time.

We've also invested in Burger King (BKW), which recently started trading in the U.S. following an investment by a UK SPAC called Justice Holdings and controlled by Bill Ackman. BKW is in the midst of a turnaround, and generates about $1.1MM per year from its restaurants, far less than its peers in the Quick Serve Restaurant (QSR) industry such as Wendy's (WEN) at $1.4MM or McDonalds (MCD) at 2.4MM! We also own MCD in our Hedged Dividend Capture strategy.

Finally, we sold some of our position in Kraft (KFT) as it broke through $40. Kraft will split into two in October and we still think it's a good investment but no longer worthy of a maximum position at current prices.

We watched the JCPenney earnings webcast with interest last week. We have around a 4% position in JCP – although we began accumulating the position over a year ago (after CEO Ron

Johnson had joined the company but before he assumed his high profile CEO role). In a spectacularly wrongheaded move earlier this year we neglected to take profits when it reached $40, so convincing was the smooth yet inspiring Ron Johnson in his investor presentation. It was a missed opportunity as the stock proceeded to lose half its value through collapsing sales as the transformation of JCP proceeded not altogether smoothly. We've neither bought or sold JCP for several months, and will likely do nothing for quite a long while. If they can truly pull off the change they're projecting then the company will be worth substantially more, and in the meantime they have enough cash and cash generating capability to provide time. We're going to wait this one out.

Patriot Coal Succumbs to Cheap Natural Gas

The Energy Information Agency (EIA) is a rich source of data on everything related to energy production, consumption and storage in the U.S. This chart caught my attention, showing that coal use for electricity generation continues to fall sharply, with the result that in April for the first time natural gas was used to produce as much power as coal. The price advantage and environmental issues are both helping drive natural gas consumption higher, and the EIA even project that the U.S. will eventually become a natural gas exporter (though that time is 5-10 years away).

Meanwhile, Patriot Coal (PCX) filed for bankruptcy yesterday as the deteriorating economics of the coal industry proved

insurmountable.

We continue to hold positions in three E&P names: Range Resources (RRC), which stands to benefit over the long term from greater natural gas consumption since they have such large potential reserves (50-60 Trillion Cubic Feet Equivalent). Their current market cap of $9.7BN is far less than the cash they can generate if even half of this potential is realized. We also like Comstock Resources (CRK) which we think will ultimately be acquired, although its daily volatility is multiples of the broader equity market so it’s not for the faint of heart.

Back in April some were forecasting that natural gas prices might go negative, such was the excess supply and shortage of available storage. That was around the time prices hit their low.

The Bond Market Rejects Coeur d'Alene

Last week Coeur d’Alene (CDE) announced plans to issue debt, even though they have no obvious need of any extra cash. It looked very much as if the company was planning to make an acquisition rather than focus on returning value to shareholders, and we commented as such on this blog. It seems the bond market reached a similar conclusion since today CDE announced that unfavorable market conditions had prompted them to withdraw the bond offering.

Of course it’s not hard for any creditworthy borrower to raise funds at today’s rock-bottom interest rates, but evidently the long history of value destruction by prior management combined

with CEO Mitch Krebs' very small personal investment in CDE equity persuaded bond buyers that CDE debt was not an investment the market needed. The irony is that pulling the issue has boosted their stock price by 5% today. What a pity CEO Krebs doesn't believe more fervently in his company's ability to create shareholder value, otherwise he'd have a bigger stake and would be benefitting from the bond market's rejection of their acquisition plans.

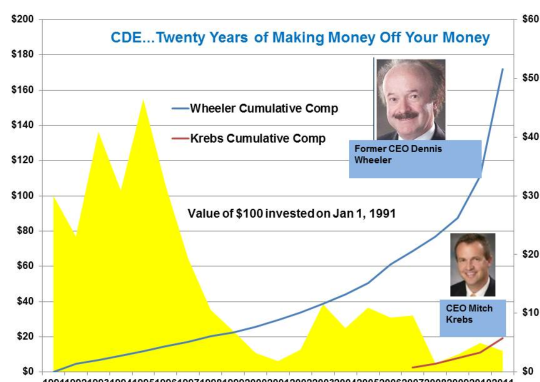
Why We're Betting on CDE Management

Yesterday we aligned our interests with the management of Coeur d'Alene. This gold and silver mining company, like much of the mining sector, trades at a steep discount to our estimated NAV of $31 (based on Proved and Probable Reserves). In addition they're generating $300-400MM of cash annually and the business looks to be going well. Until recently we believed the best way to bet with CDE was to own shares in the company; however, their debt issuance earlier this week makes it much more likely that the company will make acquisitions in the sector rather than buy back additional stock (they recently announced a $100MM buyback which was positive, but the $350MM debt issuance is cash that they really don't need for their existing business and it doesn't appear that they're going to use this additional cash to return value to shareholders).

Since CEO Mitch Krebs owns so little stock, and former CEO Wheeler owns none, management has little to gain from a higher stock price. In addition, the incentive compensation plan in place at CDE clearly favors efficient production based on per

ounce costs, a structure that firmly points management towards a bigger company with SG&A spread across larger revenues rather than increasing per share value.

Consequently, aligning with CDE management requires NOT owning stock in CDE but instead owning other mining stocks (through GDX for example) since any M&A activity in the sector is likely to be at the expense of CDE stockholders but may benefit the mining sector more broadly. We have no position in CDE but are invested in GDX. Mining companies have a well earned reputation of generating value for their executives while the owners do poorly. The chart below compares the return to investors in CDE since 1991 with the compensation earned by CEO Dennis Wheeler over that time. Clearly, providing labor to CDE was far better than providing capital.



The Principal-Agent Problem at Coeur d'Alene

Gold and silver miners have been underperforming precious metals for some time. As a result, many names in the sector are priced at substantial discounts to the net asset value (NAV) of their holdings. We have been invested in

Coeur d’Alene (CDE) on and off for the past couple of years. The company has historically been a pure silver miner, but in recent years has been producing more gold and by next year gold revenues will probably surpass those from silver.

The company’s market cap is around $1.6 billion and it has debt of $122MM (although they just announced a note issuance – more on that later). They are operating quite well apart from a recent setback at their Kensington mine in Alaska where production was halted while they improved their infrastructure. But the company generated $1Bn in revenues last year for the first time, and looks capable of generating $350-450MM in free cashflow all while reducing their G&A and keeping capex at around $100-120MM.

Based on their proved and probable reserves, we calculate that the company could be worth almost $3BN, or $31 per share. Well-run mining companies provide positive optionality, in that if gold/silver prices rise the operating leverage inherent in their business model will cause their earnings to rise faster. Earlier this month we were happy to see that the company announced a share buyback of up to $100MM, about 6% of the outstandings. Although they don’t pay a dividend they’re returning some of their cashflow to shareholders.

Yesterday CDE announced an issuance of $350MM in senior notes. They have very little debt so the company’s balance sheet can certainly handle modestly more leverage. However, they don’t obviously need the money since their operations are generating plenty of cash. So now we’re going to see whether the principal-agent problem so prevalent in mining companies exists at CDE.

The most obvious use for the cash raised from the debt issuance is to buy back their underpriced stock. This would be an intelligent way to take advantage of interest rates maintained at extraordinary low levels and the cheap price of the company. Their SEC filing said, “The Company intends to

use the net proceeds from the notes offering to fund internal and external growth initiatives and for general corporate purposes." This could mean they want to buy back additional shares, but the "…external growth initiatives…" also sounds suspiciously like an acquisition.

It's hard to believe there could be anything better for CDE's spare cash than to buy back their shares. The biggest impediment we can see to this is that senior management holds so little stock that they might be thinking more like agents than principals. CEO Mitch Krebs owns 74,812 shares according to their recent proxy statement, less than 0.1% of the company and currently worth just over $1MM. His total compensation for 2011 was $2.4MM. Mr. Krebs' incentive compensation is generally tied to production-related metrics, so given his modest ownership of stock his incentives appear to be more closely aligned with a bigger operating company rather than a higher share price.

What CDE does with the proceeds of their debt issuance will provide some insight as to whether it's better to provide labor to CDE (like Mr. Krebs) or capital (like his investors, including us). His financial incentives clearly direct him towards acquisitions. Perhaps some of the other large shareholders such as Vanguard and Dimensional Fund Advisors will make their views known. Or perhaps CDE will simply begin scooping up some of its cheap stock and return some value to its owners.

We are long CDE.

The Fed's Evolving Yield Curve

On Wednesday the Federal Reserve released their third set of detailed interest rate forecasts this year. Following Ben Bernanke's philosophy of open communication, the FOMC publishes forecasts for short term rates from each voting member. While they don't link a name with each number, you can see what members expect short term rates will be at the end of this year, 2013, 2014 and over the long run (whose start is not defined).

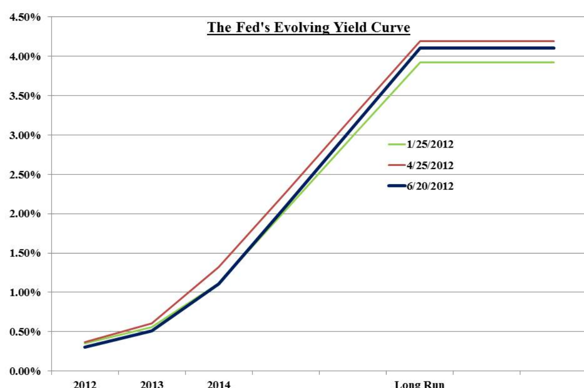
In effect you can construct a crude yield curve incorporating their collective outlook. Comparing their yield curve with the market is fascinating, although market yields and implied rate forecasts have been steadily diverging from those issued by the Fed. In fact, the Fed's own forecast has been remarkably stable even while ten year treasury yields have traversed a 1% range reaching 2.5% before falling recently to 1.5%. The chart below is derived from the average of all FOMC member's rate forecasts at year-end. So there's a clear discrepancy between the Fed's statement that short term rates will remain low through the end of 2014 and the six FOMC members who expect rates to be higher (three of whom target hikes as soon as next year). At the same time that the Fed extended Operation Twist to the end of this year, they reaffirmed that the long run equilibrium short term rate is around 4%. Long term bonds continue to trade at yields that defy that forecast. The Long Run is still some ways off, but today's bond buyers are fairly warned.

There is growing evidence that the "Fiscal Cliff", looming in January 2013, will take a toll on the economy before its arrival. Although reports suggest that both parties are discussing a resolution to the sudden tax hikes and spending cuts that will take place under current law on January 1st

next year, there’s little tangible evidence of such. There is growing evidence that companies are managing their businesses by incorporating this uncertainty into today’s spending decisions. It occurs to me that, while most economic forecasts project a substantial (3%+) GDP hit in 1Q13 IF no action is taken, few have considered that waiting until December’s lame-duck session of Congress to do the inevitable is quite likely to depress growth in the meantime. The non-partisan view surely blames both sides for placing the purity of their own political beliefs ahead of the pragmatism of removing at least one element of uncertainty.

The comments from many Congressmen that the planned tax hikes and spending cuts will assuredly be rolled back would be more credible if they didn’t insist on waiting until the last possible moment do do so.

For our part, we remain generally fully invested across our strategies. Owning steady, dividend paying stocks combined with a beta neutral hedge provides an uncorrelated source of return while markets are being buffeted around. Our most recent decisions have been to exit the last remaining shares of Family Dollar (FDO) which no longer provides compelling value given its recent increase in price. We have added modestly to Coeur d’Alene (CDE) which recently announced a share buyback given the large discount of its stock price to the estimated net asset value of its gold and silver reserves.



We have largely exited the short Euro position which has been held in our Fixed Income strategy as useful protection for the holdings of bank debt (given their equity sensitivity). It worked well for quite a while, but a few weeks ago I heard a reporter from the New York Times confidently announce on a radio interview that the Euro was going down and Greece would soon exit. Short Euro is probably too widely held, and isn’t that interesting any more.

Disclosure: Author is Long CDE

The Price of Fear

The Equity Risk Premium has once again drifted up to all-time high levels in recent weeks. The S&P500 has an earnings yield of around 7.9% (assuming S&P earnings of $105 versus current price of 1,330). Ten year treasuries are 1.6%, so the resulting 6.3% spread is back at levels not seen since the early 70s. Yields remain excessively low; JPMorgan pointed out this weekend in their Global Data Watch publication that the yield curve implies negative real rates on government debt going out for ten years, an outcome outside even the experience of Japan. Whatever you think of stocks, bonds have to be a worse bet.

The Math is as follows: a 1.9% dividend yield on the S&P500 will, assuming 4% annual dividend growth (the 50 year average is 5%) deliver almost five times the return as ten year treasuries – assuming (perhaps crucially) no change in dividend yields in ten years. Or put another way, the holder of ten year treasuries could sell them, place 22% of the proceeds in stocks with the rest in riskless/returnless treasury bills and get to the same place, with 4/5ths of his capital available for other opportunities.

Once you figure in taxes (35% on treasury interest versus 15% on dividends) you only need put 17% of the proceeds from selling the treasuries into stocks. This is how distorted bond yields are – and they're likely to remain so. Recent weakness in economic data, most notably the June payroll data, may result in further Fed buying of long term bonds. They wouldn't recommend you do this yourself, as I wrote some weeks ago. The Fed is relentlessly driving the return out of bonds.

Investors have good reason to be cautious. This weekend's Spanish bank bailout seemed inevitable and also inconclusive at the same time. Few believe the Euro's fundamental problems have been solved. At the same time, in the U.S. current law requires a series of tax increases and spending cuts starting on January 1. The so-called "fiscal cliff" is estimated to be as much as a 3% hit to GDP and an instant recession. Few believe this will actually happen, reasoning that Congress will roll everything back another year and rely on the 2012 election results to settle the fiscal policy argument once and for all. However, while it seems sensible to assume Congress will act in this fashion, there seems little urgency to do so until the lame-duck session following the November elections. Meanwhile, hiring and capital expenditure decision that rely on some reasonable assumptions about positive GDP growth next year are increasingly at risk. One thing on which supporters of both parties can surely agree is that leaving resolution of near term fiscal policy to so

late in the year is irresponsible. The Price of Fear is set in part by our elected representatives in Washington, DC.

Our most recent investment has been to increase our position in Coeur d'Alene. Based on our analysis we think it's valued at around a 30% discount to the net asset value of its reserves, in common with most miners. Having some exposure to gold and silver at a discount is one way to protect against higher inflation, since that will increasingly appear an attractive solution for most people's problems (there are more debtors than creditors in the world). In addition, CDE recently announced a stock buyback of $100M< around 6% of their equity market capitalization.

Natural Gas Steadily Supplants Coal

The New York Times has an interesting article today highlighting the dilemma for Louisa, KY, in the heart of coal country. American Electric Power (AEP), which operates the local coal-burning power plant, wants to switch to burning cleaner, cheaper natural gas. As might be expected this has caused an uproar, but there are few easy choices. Following the local outcry about lost jobs through lower coal consumption by one of the country's largest coal consumers, AEP offered to spend $1BN to fit scrubbers on the Big Sandy power plant so that it could continue burning coal while complying with tighter emission standards. The problem is, they need to increase the average residential utility bill by $472 annually to pay for it and have applied to their regulator for permission.

AEP's long run strategy is to burn less coal. Their consumption of coal and lignite fell 17% from 2009-2011 according to SEC filings by the company, and natural gas almost doubled its contribution as a source of fuel (from 6-11%) over the same period. This reflects a nationwide trend, and one of the unexpected but positive outcomes of the shale gas revolution which has made this possible is that the U.S. may achieve a cut in greenhouse gases by 2020 equivalent to that included in a 2009 climate bill that never became law. The Sierra Club is helping the process along by highlighting how many "dirty coal-burning plants" they have helped retire, and how many are left.

In these efforts they have Chesapeake's CEO, Aubrey McLendon as an ally. He has apparently contributed $26 million to their cause. Coal is steadily becoming an export, and helping lead to cleaner U.S. air.

Unlocking Value in Prisons Through a REIT

We've been invested in Corrections Corp (CXW), the largest private operator of prisons, since 2010. Sometimes we've had a large position and at other times not; we think the current opportunity is compelling. We've written about it before here.Around 9% of the U.S. prisoner population is housed in privately run prisons. CXW is the largest publicly traded operator – Geo Group (GEO) is the other. Private operators are, as you might expect, far more efficient than the public sector – not least because their workforce is not unionized. This is most dramatically revealed in the case of California, where the state spends around $140 per prisoner per day

compared with CXW’s per diem rate of $67. Chronic overcrowding in California and other states as well as this cost advantage mean that the long run outlook is for increasing numbers of prisoners to be run in privately operated facilities.

The embrace of private solutions isn’t seamless; prison guard unions are clearly opposed, and California itself represents 13% of CXW’s revenues. Politics can sometimes intervene, but the trend towards increasing market share is robust. It’s a business with limited economic sensitivity, reasonable barriers to entry and good growth prospects.

CXW was once structured as a REIT with the managed business as a tenant. They basically own and manage real estate. The REIT was overleveraged, was building prisons aggressively and had falling occupancy. This combined with the requirement common to REITS that they distribute at least 90% of their pre-tax income to their investors made it hard to fund their capex program, and they raised equity and restructured as a corporation. While this gave them more flexibility around managing cashflow, it also burdened them with a 38% tax rate once they returned to profitability.

We’ve long been intrigued at the possibility of the company returning to the REIT structure. As well as reducing their tax liability, splitting into a management company that operates prisons and a REIT which owns them would attract a REIT-type valuation on pre-tax income on the latter and lead to a re-pricing. It’s not a bad investment as a corporation, but as a REIT we think it’s mis-priced.

Eighteen months ago the company had told us they would never consider restructuring as a REIT. But in their 1Q12 earnings call they disclosed that such analysis had begun in the Fall.

CXW manages some prisons, and own/manages others. They break out the segment operating margins for both (13% and 36% respectively). Based on this and other information in their

10K, it's possible to construct an income statement for a new management company (we'll call it ManCo) and a REIT entity owning prison properties (call it NewREIT).

Assuming the 13% margins they earn managing prisons applies to those they own as well, it's possible to calculate pro-forma operating earnings for ManCo and net operating income for NewREIT.

CXW's market cap is $2.8BN. Their 13% operating margin on managing prisons applied to their total revenues of $1.7BN generates $228MM of operating income, $141MM after tax. A market multiple of 14X would value this at $1.7BN or 60% of their market capitalization.

We calculate NewREIT would generate $313MM of net rental income based on the 23% difference between their operating margins for each segment above, on the $1.36BN of revenues that come from prisons they own and manage. REIT cap rates vary from 8% for industrial properties to 6% for high quality offices and in some cases even lower. Their business is economically insensitive, clients are good credit, maintenance costs are minimal, and they have half the share of the U.S private prison market, so a 6% cap rate doesn't seem unreasonable (by comparison, Simon Properties Group, SPG, trades at a cap rate of around 5% of Adjusted Funds From Operations or AFFO).

Applying a 6% cap rate to this rental income values it at $5.2BN. We still have to deduct the market value of so far unallocated expenses such as G&A ($91MM) and maintenance cap ex (we estimate at 15% of net rental income or 3.5% of rent, $48MM). Applying a 14X multiple to these pre-tax figures and adjusting for their 38% tax rate deducts $1.2BN in value. The company has another $1.2BN in debt.

CXW Valued as ManCo and NewREIT

Category	Value ($MMs)	Explanation
Managed only Business (ManCo)	$1,698	13% operating margin as disclosed in 10K on managed business applied to entire revenue stream of $1,729MM and valued at 14X
Owned prisons housed within NewREIT	$5,223	23% margin on $1,357MM revenue derived from owned/operated prisons, valued with REIT cap rate of 6%
Other Expense	($1,208)	G&A of $91MM, estimated maintenance capex of $48MM (3% of rent) is $139MM pre-tax, $86MM after-tax and valued at 14X
Debt	(1,189)	
Equity Value	$4,524	
Implied Share Price	$45	Current price $28

Source: CXW SEC filings, SL Advisors

The valuation is of course sensitive to the cap rate. An 8% cap rate reduces the value to $32 per share. And they may not convert to a REIT, although the company has hired JPMorgan and E&Y to do the analysis and has asked the IRS for a private

letter ruling related to the conversion. We think their analysis is sufficiently far along that the company believes it's likely they will convert.

CXW is a holding in our Deep Value Equity Strategy

Natural Gas Update

Today I was invited back on Business News Network, Canada's answer to CNBC. The presenters are charming and somehow always like to get me on when natural gas prices are plummeting – as if we haven't noticed! But it did give me the opportunity to talk about Range Resources (RRC), one of our larger holdings in the sector. Last week RRC held an investor dinner to which I was invited. It was great to discuss their business in an informal setting, and while naturally nothing of a non-public nature was disclosed, it did reinforce my feeling that CEO Jeff Ventura leads a capable management team that's hard-working and straight. Whether or not RRC really will ultimately access 60 Trillion Cubic Feet of natural gas, I assess that Jeff Ventura sincerely believes they have that much. It's the upside case to be sure, but at $9BN in market cap with a solid, simple balance sheet they represent an attractive investment in the developing natural gas story. We are long RRC.