Why Comstock Resources Has Fallen Too Far

In sorting through the wreckage of the past quarter's bear market, I've spent some time reviewing Comstock Resources (CRK). We own CRK – we liked it at $30 a share truth be told, although we did have the good sense to lighten up the position at those heady levels. CRK is a natural gas E&P name drilling for shale gas mainly in East and South Texas and North Louisiana. We've long liked natural gas as a replacement for coal in fuelling America's power plans. It is cheap, abundant, clean(er) and here, in the U.S. But the very abundance of natural gas has depressed its price for some years now and forced the E&P companies exploiting it to operate at successively lower costs. CRK qualifies, in that it has estimated extraction costs of around $1.26 per MCF (thousand cubic feet) although that continues to fall. It also has manageable debt. They operate in a similar area to Petrohawk, which was acquired earlier this year by BHP Billiton. We think CRK may ultimately be acquired, although today's market environment offers much less immediate prospect of that given the difficulty of financing acquisitions.

Meanwhile, CRK's stock price recently sank as low as $14 (and even now has only rebounded to just over $16). At current prices you can buy the entire company for less than $800 million. Assuming they can realize $1.25 per MCF on the proved reserves of 1.05 TCFE (trillion cubic feet equivalent), and after adjusting for debt net of cash the company is trading for approximately the value of its proved reserves alone. This doesn't account for their reserve potential which could be 3-5 times as much again. CRK's problem is that the market always worried they won't have enough cashflow to fund their drilling program and as a result will need to come to the market for additional equity , and this along with the disappearance of any imminent takeover explain the precipitous drop in the stock. The company believes they will fund all their capex needs from internally generated cashflow, and they expect to spend $610 million on capex (i.e. drilling new wells) in 2011 for which they don't expect to tap the equity market. In addition they have $400 MM in unused credit through their bank revolver.

I've met Roland Burns and chatted with him several times over the past year. We think this stock offers an attractive risk/return at current prices, and will be looking for opportunities to add to our position.

Disclosure: Author is Long CRK