

The Year in Review - 2014

*Let's talk turkey; while OPEC was talking Volume.
The near-term world economy got a boost on Thursday when the
Saudi's refused Russia's request to cut production.*

Distressed Investing 2014 Conf. – *Steve Gidumal, Virtus Capital, LP*

December 1, 2014



Noteworthy Events of the Past Year:

Events in the Middle East & Ukraine slow growth, but will resulting drop in oil prices bode well for Investors?

- With the chaos in the Middle East and in Ukraine throughout the year, one would have expected oil prices to have risen in '14. Instead in August, oil prices cracked.
- Predictably, the market reacted to the collapse of oil prices from \$100 on 7/30 to \$66 on 11/28 by impacting other industries. Airlines, retailers, transportation companies are up double-digits (AAL +25%, WMT +19%, CSX +23%) since 7/31. The S&P 500 Index rose **7.4%** from 7/31 to 11/28; representing 60% of its gain for the year in 4 months. Offshore drillers (DO **-35%**), coal companies (BTU **-33%**) and solar companies (FSLR **-23%**) have all declined. Markets are efficient.
- So is there more at work here; are Saudi Arabia, the UAE and Kuwait pumping oil to apply pressure to Russia and Iran?
- What a whacky year for our Federal Gov't. Who saw these terms coming last year: “**JV Team; ISIS, Crimea, Ebola**, VA scandal, Bowe Bergdahl, ‘**Grubered**’, Maryland/ Massachusetts/ Illinois **Republican Governor**, Unaccompanied children at the border, **IRS found the tapes?**”



Noteworthy Events of the Past Year:

Will the Slowdown start slowing down?

- On Sept. 30, the Court ruled on Fannie Mae lawsuit brought by shareholders and sided with the Government. Why was anyone surprised by this? Stock (\$2.45) has recovered from it's lows of \$1.50, but off its March high of \$5.82.
- In August/September 3 large Atlantic City casinos (Showboat, Revel, Trump Plaza) shut down, casualties to unrelenting regional competition from other State governments.
- There is a steady market in corporations looking for companies with large NOLs to merge into. Signature Holding is one of several companies to pursue this strategy.
- The 10-year bond rate moves down from 3.03% to 2.25%, a very significant move. However, there is chaos at PIMCO, the world's largest bond fund, as it's lead portfolio manager and founder leaves.



Comparison of Returns (YTD thru 11/28/14)

• Dow Jones Index (ex dividends)	+ 7.5 %	
• S&P 500 Index (ex dividends)	+ 12.1 %	
• Nasdaq Comp.	+ 14.6 %	
• 10 year Treasuries	+ 10.8 %	(3.03% to 2.25%)
• HY Index (Merrill Lynch)	+ 4.4%	
• Distressed Funds (Barclays Index)	+ 2.7%	
• Gold	- 1.4 %	(\$1,205 to \$1,188)
• Oil	- 28.6 %	(\$98 to \$70)

Sources: Bloomberg, WSJ, ML HY 100, Barclays Hedge Fund Index.



A Booming M&A Market

With high stock prices & low interest rates
Merger activity was insatiable in 2014

Total M&A Deal \$ Aggregates (\$ billions)

	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>
Deal \$ Amounts	\$1,930	\$2,550	\$2,700	\$2,460	\$2,650	\$3,920
Year-to-Year % Change		+ 32.1%	+ 5.9%	- 8.9%	+ 7.7%	+ 47.9%
% Change from 2009						+103.0%

Source: Bloomberg.



The Macro Environment 2014

*World Economies: Growth is Slowing; hence decline in oil prices
(Economists are watching the 2nd Derivative – rate of change)*

	<u>GDP % Q3</u>	<u>GDP % Q2</u>	<u>Δ Q3/Q2</u>
China	7.3 %	7.5 %	- 2.7 %
India	5.3 %	5.7 %	- 7.0 %
U.K.	5.1 %	5.4 %	- 5.5 %
U.S.	2.4 %	2.6 %	- 7.7 %
Canada	2.3 %	2.2 %	+ 4.5 %
Mexico	2.2 %	1.6 %	+ 37.5 %
Germany	1.2 %	1.4 %	- 14.3 %
Japan	0.8 %	1.9 %	- 57.9 %
Russia	0.7 %	0.8 %	- 12.5 %

Source: Bloomberg. GDP growth Year-over-Year by Quarter.



The Macro Environment 2014

The PIGS: Showing Real Signs of Growth

(Lower oil prices should help the PIGS)

	<u>GDP % Q3</u>	<u>GDP % Q2</u>	<u>Δ Q3/Q2</u>
Portugal	+ 0.3 %	+ 0.3 %	+ 0.0 %
Italy	- 0.1 %	- 0.2 %	+ 50.0 %
Ireland	+ 3.3 %	+ 1.9 %	+ 76.5 %
Greece	+ 0.7 %	+ 0.4 %	+ 75.0 %
Spain	+ 1.6 %	+ 1.3 %	+ 23.1 %

Source: Bloomberg. GDP growth Year-over-Year by Quarter



Cracks in the Cartel

OPEC Refuses to Cut Production.

- On Thursday, Russia Oil Minister asked Saudi Arabia for cuts in SA's production, and the Saudi's refused.
- OPEC announced that it's policy has changed from "defending prices, to defending volumes."
- If lower oil prices are here for 6 to 12 months in 2015 that will help the US economy. Already gasoline prices are approaching \$2.90 / gal.
- Lower oil prices hurts the stretched economies of Russia, Iran, Venezuela the most. Perhaps the Saudis are taking a stand against those countries supporting chaos in Iraq.
- Winners will be: Retailers, Airlines, Refiners, Auto companies, China, Shippers, US consumers...
- Losers will be: Oil drillers, Natural Gas companies, Coal companies, wind farms, solar panel suppliers, Ukraine...



Lower Oil Prices, to Pressure Whom?

OPEC 2013 Production data (Source: OPEC) (1,000 bbls)

Country	2013 Daily Bbls	Cumul Prod. ^{1 2}	Oil Reserves ²
Saudi Arabia	9,637	132,877	265,789
Iran	3,575	69,131	157,800
Iraq	2,980	37,730	144,211
Kuwait	2,925	43,675	101,500
UAE	2,800	31,193	97,800
Venezuela	2,790	65,460	298,350
Nigeria	1,755	30,274	37,070
Angola	1,700	10,653	9,011
Algeria	1,200	17,380	12,200
Libya	995	28,666	48,363
Qatar / Ecuador	<u>1,250</u>	<u>14,625</u>	<u>34,075</u>
Total OPEC	31,600	481,670	1,206,170
USA	7,441	n/a	33,000
Russia	<u>10,147</u>	n/a	<u>80,000</u>
Total World	72,842		1,489,365 ²

¹ - 1960 thru 2013

² - In Millions bbls.



Natural Gas, the Players are Different

The US is # 1 Producer, Russia # 2

Country	2013 Production	% 2013 Total
USA	689,125	19.8 %
Russia	627,100	18.0 %
Iran	199,293	5.7 %
Qatar	177,602	5.1 %
Canada	155,601	4.5 %
China	111,640	3.2 %
Norway	109,040	3.1 %
Saudi Arabia	<u>100,030</u>	<u>2.9%</u>
Total World	3,480,570	

World Landed LNG (Nat. Gas) Prices October 2014

US is the price leader in the cleanest fuel source, but we don't Export



Source: Federal Energy Regulatory Commission



A Solution for Growth, if we will Frack it

LNGs are the Cleanest Hydrocarbon & 1/3 Price of Oil

Winners / Losers of Exporting LNGs

- 1 barrel oil has same energy content of 5.8 mcf of nat. gas.
- So Nat Gas selling at \$14.10/mcf = \$81.78/bbl of oil. The current world price of oil is around \$70.
- But if Nat Gas selling at \$4.55/mcf were exported as LNGs, Countries would be purchasing the same BTU content at \$26.40/bbl equivalent.
- In reality, LNGs would push Nat Gas price to about \$8.00/mcf, but would bring out more supply, and would push oil price to \$55 to \$60/bbl.
- The Japanese Govt. has had 2 requests shot down to permit an LNG facility along Gulf Coast; over 10 LNG export facilities could exist now.
- Lower oil prices help US consumers, less wealthy, China, US manufacturers.
- Lower oil prices would hurt Russia, Venezuela, Iran and the Green lobby.





Current Areas of Environmental Concern

Green Energy is not Costless

Winners / Losers of Current Green Policies

- The BP Wind Energy facilities in the Mohave Desert will use 47,000 acres to generate 425 MW of electricity.
- The USA uses 4,095,000,000 MW of electricity per year.
- The USA land mass consists of 2,380,000,000 acres.
- So if **every acre** in the USA was used to generate wind power, it could generate only 21,500,000 MW of electricity or about 1% of total USA needs.
- Currently, about **1,400,000 birds are killed** by wind turbines per year; over 100 of these killed birds are endangered eagles, including bald eagles.
- Since 2008, according to OPEC, Iraq has doubled the amount of gas it flares into the atmosphere (6,005 to 12,432 Mmcf) each day, while Venezuela has increased its flared emissions by +50% (9,173 to 13,725 Mmcf).
- Can one be pro LNGs and pro Environment? Seems so.



World Cost of Labor (Mfg. Wage/Hr.)

Can lower Energy costs but rising US wages compete w Asian Wages?



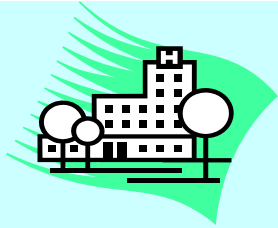
Source: Barron's & Government statistics.

Industry Bell Weathers of 2014

A Transition Year to see if Energy Price declines Stick

<u>Industry Sample</u>	<u>12/31/13</u>	<u>11/26/14</u>	% IRR
Oil: XOM (Exxon-Mobil)	\$101.20	\$ 94.48	- 6.6 %
Nat Gas: DVN (Devon)	\$ 61.87	\$ 64.02	+ 3.5 %
Fertilizer: MOS (Mosaic)	\$ 47.27	\$ 45.60	- 3.5 %
Radio Broadcast: ETM	\$ 10.51	\$ 10.68	+ 1.6 %
Lumber: IP	\$ 48.33	\$ 53.37	+ 10.4 %
Homebuilder: TOL	\$ 37.00	\$ 34.60	- 6.5 %
Steel: X	\$ 29.50	\$ 35.34	+ 19.8 %
Retail: WMT	\$ 78.69	\$ 84.98	+ 8.0 %
Hospitals: CYH (Com Health)	\$ 39.27	\$ 47.27	+ 20.4 %
Insurance: ALL	\$ 54.54	\$ 67.52	+ 23.8 %





Hospital Stocks

Repeal ObamaCare? Four More Years!!

	<u>11/27/13</u>	<u>11/26/14</u>	<u>% IRR</u>
HCA	\$ 46.52	\$ 69.48	+ 49.4%
HMA <small>acquired by</small> CYH	\$ 13.10	Acquired	+ 15.3%
LifePoint (LPNT)	\$ 51.21	\$ 68.59	+ 33.9%
Tenet Healthcare (THC)	\$ 42.82	\$ 48.23	+ 12.6%
Universal Health (UHS)	\$82.21	\$104.00	+ 26.5%

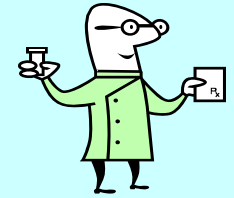




Health Insurance Stocks

No “Stupidity of American” Shareholders here!

	<u>11/25/13</u>	<u>11/26/14</u>	<u>% IRR</u>
Aetna (AET)	\$ 68.80	\$ 86.91	+ 26.3%
United Healthcare	\$ 74.07	\$ 98.11	+ 32.5%
Cigna	\$ 88.18	\$102.00	+ 15.7%
WellPoint	\$ 93.61	\$126.90	+ 35.6%
Humana	\$103.48	\$137.50	+ 32.9%



Drug Co. Stocks

The First Signs of a Return to Earth for the Sector

	<u>11/27/13</u>	<u>11/26/14</u>	<u>% IRR</u>
Bristol Meyers	\$ 53.41	\$ 58.86	+ 10.2%
Eli Lilly	\$ 50.36	\$ 67.32	+ 33.7%
Johnson & Johnson	\$ 95.63	\$107.21	+ 12.1%
Merck	\$ 49.83	\$ 59.75	+ 19.9%
Pfizer	\$ 31.88	\$ 31.10	- 2.4%

Winners 2014

Declining Energy Costs were a Major Determinant of Success

	<u>12/31/13</u>	<u>11/28/14</u>	<u>% IRR</u>
American Airlines (AAL)	\$ 25.25	\$ 48.53	+ 92 %
HCA (Hospital Corp Amer.)	\$ 46.52	\$ 69.48	+ 49 %
Emerge Energy Svcs. (EMES)	\$ 44.33	\$ 64.15*	+ 45 %
Union Pacific (UNP)	\$ 84.00	\$116.77	+ 39 %
CSX (Railroad) (CSX)	\$ 28.77	\$ 36.49	+ 27 %

* - Stock hit a high of \$144 on 8/29 before oil sell-off





Coal Rush



Slowing Growth in China & US Gov't Regulation
Hurting Coal & Mining Co's

	<u>12/31/13</u>	<u>11/26/14</u>	% IRR
Alpha Natural Res. (ANR)	7.14	\$ 2.26	- 68 %
Cliffs Natural Res. (CLF)	26.20	9.15	- 65 %
Peabody Energy (BTU)	\$ 19.53	\$ 10.83	- 45 %
Arch Coal (ACI)	4.45	\$ 2.41	- 45 %
Cloud Peak Energy (CLD)	18.00	12.25	- 32 %

A Casino Monopoly, if you can Keep It

States discover the effects of Open Competition
Regional oligopolies in Gaming are crumbling

State	#	Next 8	#	Next 8	#
Nevada	220	Michigan	26	Missouri	14
California	149	Arizona	22	Indiana	13
Oklahoma	55	Iowa	22	Pennsylvania	12
Washington	49	Louisiana	22	Ohio	11
Colorado	43	Wisconsin	22	Illinois	10
Mississippi	37	Minnesota	20	Oregon	10
Florida	35	New York	19	NJ (was 11)	8
New Mexico	<u>28</u>	So. Dakota	<u>19</u>	Kansas	<u>8</u>
Top 8	616	Next 8	172	Next 8	86

15 of the 50 States do not have casinos:

- NH, VE, RI, MA
- GA, SC, VA, TN & Kentucky
- Nebraska
- MO, UT, ND
- AK, HA

Remaining casino states are: MD (6), ID (5), WV (5), AL (3), CT (3), WY (3), ARK (2), DE (2), ME (2), NC (2), and TX (1). Total of 908 casinos

Source: Wikipedia.



Losers of 2014

As oil prices softened in Q3, Offshore Drillers & Coal companies got hit

	<u>12/31/13</u>	<u>11/28/14</u>	% IRR
Mississippi Phosphate	\$ 0.65	\$ 0.15	- 77 %
Transocean (RIG)	49.42	21.00	- 57 %
Diamond Offshore Drilling	53.27	29.37	- 45 %
Arch Coal (ACI)	4.45	2.41	- 45 %
NIHD 10% Sr. Unsec.	54.35	37.00	- 32 %
^{8/16} Fannie Mae (FNMA)	3.00*	2.45*	- 18 %
JC Penney stock	9.15	7.75	- 15 %

* - High of \$5.82 (March), low of \$1.50 (Oct.).



What to Watch For in 2015:

- A new Republican majority in the Senate and House, and an immediate amnesty constitutional crisis. But we expect the Keystone pipeline to be approved. But what new surprises will hit the USA next year?
- ObamaCare gets to its next level of implementation, this time with businesses. How will the nation react? How will this redistribution program affect growth? Will the Supreme Court over-rule the mandate?
- The Fed should use the easing on the economy stemming from lower oil and gas prices to unravel some of the inflationary damage to come from the inevitable end of QE III. Expect talk of this, if lower oil prices stick.
- China has been quietly having a hard time of things. Lower energy prices will certainly help their economy. A productive China is good for US consumers. *(Next year we can discuss how China worker wages subsidize US consumers).*
- We have not had a real “merger boom” in at least a decade, and we seem to be heading that way now. Finally, after 2 decades, M&A bankers may be all the rage again.



In Conclusion:

Stock prices are at historic highs and it seems the Fed will delay solving QE III until the next President (why?), but energy costs could be a real driver of Growth in 2015.

We expect 2015 to be a year where lower energy costs create a new set of winners and losers in the market. Overall, it should be a Good Year.

Best wishes for Good Investing, Steve Gidumal

