HARGREAVEHALE

INVESTMENT BULLETIN

Madame “Nein”, and Auf wiedersehen “green” energy.

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A neat way of defusing the financial crisis would be to address its cause, which boils down to the hugely disproportionate speculative capital still at the disposal of the “casino" investment banks, and their cohorts the hedge funds. Neuter these banks and hedge funds by legislation, taxation, and regulation and you take away their power to destruct economies. In the words of John Maynard Keynes, when he published in 1936 his critique of stock market behaviour, The General Theory of Employment, Interest and Money: "When the capital development of a country becomes a buy-product of the activities of a casino, the job is likely to be ill done".

Robert Jenkins, named in July as one of eleven members of the Financial Policy Committee, recently established by the Government and Bank of England to oversee banking activities in the UK, has broken ranks and accused the lobbying operations of the investment banks as being intellectually dishonest. He said: "The latest lobby tactic is to convince pundits, public and politicians that encouraging prudence too soon will hit the economy too hard. This is no longer amusing .This strategy is intellectually dishonest ....It is dishonest because it is untrue." Mr Jenkins characterized the banks as attempting to hold regulators hostage by claiming that only by starving the economy of credit can they be made safer. Getting into his stride, Mr Jenkins said; “The truth is that banks can strengthen their balance sheets by cutting bonuses, curtailing intra financial risk taking ...Thus a profession which should stand for integrity and prudence now supports a lobbying strategy that exploits misunderstanding and fear."

Sadly, the Lobbyists of the integrated banks have successfully fought off proposals to re-enact in the UK the equivalent of the US Glass Steigal Act, which enforced total separation between commercial banking activities and investment banking activities in the US. Glass Steigal was enacted after the 1929 US stock market crash and served the US Banking system well until its unfortunate repeal by the Clinton administration following a combination of political campaign, cash donations and lobbying by the banks.

The UK authorities seem content with the halfway house compromise of "ring fencing" the two activities. The trouble with ring fencing is that it actually makes matters worse. This is simply because you end up with a requirement for additional capital buffers in an attempt to protect the retail banking business from the much larger investment banking business. And of course the two are still conjoined so in the ultimate analysis, the "too big to fail" argument remains. Far more sensible would be total separation, not just because it de-risks commercial banking and deposit taking but also the requirement for excess capital is eliminated. It is not as if the UK Banks are undercapitalised.

The recently released Independent Report on Banking would have had John Maynard Keynes gasping for breath. It revealed that the aggregate balance sheets of the UK Banks exceeded £6 trillion, more than four times annual UK output. The extraordinary problem is that £4.5 trillion of this capital is tied up in market speculation where the bonuses are generated and a mere £1.5 trillion is used for legitimate banking activities. The sheer size of capital earmarked for speculation, particularly when geared up via financial instruments, enables the investment banks to take on governments, destabilize sovereign debt, and create unnecessary volatility in stock markets in their untiring search for quick bucks.

Because the lobbyists have won the argument on ring-fencing rather than complete separation of activities, the investment banks, instead of shrinking their "casino" capital, where the bonuses lie, stand accused of shrinking their smaller commercial loan books, in anticipation of the additional buffer capital involved in protecting depositors. If true, they should be encouraged to do the reverse. In simple terms "casino" banking needs to be made uneconomic. The Germans have proposed a tax on financial transactions which could raise over £50 billion a year. Unfortunately here again, the bank's lobbyists have been very successful. They have claimed that a "Tobin tax" on financial transactions would just be passed on to members of the public. They omitted to say that this could not happen if the two businesses were separated. In addition, a simple legal solution would be to restore the concept of Directors personal liability. That could be very effective, very quickly.

However, left to their own devices, the banks have initiated a largely successful demolition job on sovereign debt in Europe and destabilized markets accordingly. To some extent they deserve their profits because they have identified the obvious folly at the heart of the Euro experiment, simply that a common currency requires a common fiscal policy.

But, unfortunately, the resulting increase in sovereign debt yields is starting to erode the balance sheets of banks and insurance companies. At the same time, the need for additional capital to finance ring fencing exaggerates the search for liquidity, particularly in the light of additional “stress” tests now being imposed on US banks. This is taking wholesale money out of the system and the European interbank market is looking increasingly stressed, as banks refuse to lend to each other. All this is forcing banks to sell off assets at distressed prices and squeeze lending. As a result, funding costs for European and UK banks are now rising, which will eventually feed through to higher interest rates for loans to consumers and businesses. This is somewhat odd given the recessionary background, but if real interest rates actually start rising then it could tip the balance towards deflation.

Draining liquidity out of emerging markets as US centric money goes home, increasing the cost of trade finance rendering exporting more expensive, the rising cost of borrowing money, the sharp rise in the price of credit default swaps - all this is leading to a loss of confidence in money markets. Cross border financing seems set to fall by over twenty per cent in the next year according to financial analysts at RBC. Just this week, for example, the Austrian Central Bank has instructed three banks to raise capital reserves and limit cross border loans going forward. These uncertainties were reflected in a surprise failure in the midweek German Bond Auction. The German Government was unable to sell about 30% of its 6 billion euro bond auction. These were ten year Government bonds offered at a yield of just 1.8%. Thinking about it, 1.8% is not that attractive adjusted for inflation and in view of the potential contamination to German Government bonds as a result of the commitment to the Euro. The 1.9% available on US Treasuries looks somewhat more interesting for fun money (unless the American Civil war is about to repeat itself).

The idea that ten year German Bonds could be contaminated by underwriting weaker sovereigns in Europe must be exercising Mrs Merkel. Her thinking seems to be that only fear of imminent ejection from the Euro will keep Spain, Greece, and Italy on the path of fiscal rectitude. As a result, many proposals for saving the Euro, gearing up the European Stability Fund, issuing Eurobonds, ECB guarantees both for banks and sovereign debt, IMF special drawing rights, all have been rejected by the Germans. It is a rather large game of poker played by seventeen sovereign states operating with one currency and seventeen different fiscal policies and the problem is that the creation of a common fiscal policy will take a very long time.

Stock markets are growing impatient. They are getting fed up. They know that at the end of January, Italy must refinance 30 billion euros of debt and they are starting to wonder if this can be done. Hence the failed German Government bond auction. The market is betting that the pressure on Mrs Merkel to produce a bazooka of financial instruments to underwrite the Euro will be too powerful for her to withstand. The market simply cannot believe that the Germans would be prepared to accept the consequences of a Euro breakup, in particular the impact on the banks. By way of example, British banks have loans outstanding to Ireland, Spain, Italy, Portugal and Greece amounting to £220 billion and exposure to French and German banks of £130 billion. Surely, investors are thinking to themselves, Mrs Merkel will blink at some point.

However, according to her biographer, Mrs Merkel is a very cautious human being. At school she was always the last in the swimming pool awaiting her turn to get in after the water temperature had been comprehensively tested by all of her pals. So it could be a long wait. However, each day brings news of a possible fresh compromise. The most recent proposal is for a fiscal pact amongst the seventeen member states or failing that amongst the core members which would dictate terms for future bailouts. This would be accompanied by massive intervention in bond markets by the ECB. Monetizing debt is said to be acceptable if there are associated fiscal limits, defined via legislation. This latest proposal might well work. It would be excellent news for markets, particularly financials.

But until a compromise is brokered, market confidence will wither and impact adversely on sentiment amongst consumers and businesses alike. These uncertainties could start being reflected in order books in the New Year. Of course this is how deflation emerges under the radar. At a recent speech given to the Council of Mortgage Lenders, Charlie Bean, a senior director of the Bank of England included a chart which showed the Bank's calculations of the contribution to the CPI inflation index made by VAT, energy and import prices over the past two years. The result was that excluding these items there was no inflation. With the Bank additionally estimating that its quantitative easing measures increased CPI by upwards of 2.5% and you can see that we would have been suffering a deflationary environment even before the current downturn. This means that the forecast by the Bank of England of 2% inflation a year out could well be accurate or even conservative. Imagine what might happen if you are a consumer on the periphery of Europe without the ability to depreciate your own currency, beaten down by deflationary fiscal disciplines imposed by Germany. Despite therefore the derisory nominal yields currently obtainable on European, UK and US Treasuries, there remains an investment case for staying put in bonds.

As an alternative to sovereign debt of course there are both corporate bonds and equities. Equities should respond well to a signal that Merkel and the ECB were softening their stance, bearing in mind that the FTSE 100 trades on forward earnings multiple of 9.2 and the S&P 500 trades on an estimated 11.6 times. Their respective valuations two years ago were 13.2 and 14.7. Not only can you often obtain higher yields, but in the case of equity you have the opportunity to lock into compounding growth in dividends and earnings in the event your selection is correct. Clearly a deflationary environment is not ideal for equities in terms of pricing power, but nevertheless there is plenty of growth in emerging economies and if your selected equity is addressing a global market and is big enough to obtain bank or equity finance from banks / financial institutions worldwide rather than be mainly dependent on Western banks then all the better. The absolute ideal is that your chosen equity does have pricing power whatever the financial background .Probably this means operating in a niche market where it has dominant pricing power and where demand is ballooning as a result of new technology, ideally patent protected. It is probably too much to hope for a meaningful dividend but the selected equity should have a strong balance sheet with adequate working capital and cash generation to finance its growth. None of this, of course, guarantees anything, but it does give you a better chance if your initial timing is wrong, particularly if you are content to characterise yourself as a long term investor.

The fracking industry still has a lot of detractors, in particular lobbyists representing the "green industry" protecting its taxpayer subsidized clients from an industry which has the potential not only to lower electricity and transport costs in a dramatic manner but also to end the West's dependence on the princes of Saudi Arabia. The process of fracking involves injecting at high pressure, water, sand and chemicals at the huge beds of shale rock in which bubbles of natural gas are trapped. This is a process known as hydraulic fracturing. This process has been around since the second world war, but only recently has technology been available to make it economic on a large scale, with the possibility of replacing wind turbines, solar panels and coal fired powered coal stations. The creation of low cost gas on a wide scale would revolutionize the energy industry and is now being taken as a serious threat by the "green" energy industry. The Washington lobbyists are furious. They have tried to force feed renewable energy with tens of billions in taxpayer subsidies, but whilst renewable energy breakthroughs have been slow to arrive, horizontal drilling and hydraulic fracturing have revolutionized oil and gas extraction. This has resulted in a jobs bonanza. North Dakota which has tripled oil and gas production in four years has, at 3.5%, the lowest jobless rate in the US. The Marcellus shale formation in Pennsylvania has created 18,000 new jobs just in the first half of 2011.

Gas is a clean fuel releasing 50% less carbon dioxide into the atmosphere than burning coal and it is much cheaper to access than nuclear and other "green" energy sources. There are accusations that fracking can cause minor earthquakes and interference with water tables but so can any process when fluids are injected into deep wells - and this includes geothermal energy production and other parts of the oil and gas production process. In any event the fracking process is growing rapidly and shale beds now provide over a quarter of the US's natural gas supply from a standing start ten years ago. As a result of this abundance there is an extraordinary difference between the price of natural gas in the US, around $3 per tcf in Europe and Asia where the prices are $5 and $9 respectively.

This clearly represents an interesting arbitrage opportunity which is perhaps why in the middle of all this stock market gloom and doom, UK engineer Hamworthy was in receipt of what looks on the face of it a very generous bid from Finnish rival Wartsila. Hamworthy has a strong market share in the niche business of providing high technology equipment which enables liquid natural gas to be frozen and stored for transport on a tanker and unfrozen at destination. Quite clearly the global pricing opportunity thrown up by the differential in US, European and Far East has attracted a bid. On the same day, Weir Group, the FTSE 100 supplier of pumps and drilling equipment announced the £430m purchase of Texas based well head specialist Seaboard Holdings. The deal is aimed at complimenting Weir's existing business in the US and Canada, which is struggling to keep up with demand for its pumps and drills used by energy companies in the development of "unconventional shale gas". Keith Cochrane, the CEO, has admitted that customers currently face waiting several months for delivery of new kit needed to drill and operate fracking wells. Seaboard generated sales of $163 million last year and generated earnings of $34m. This year, sales are expected to exceed $200m and therefore the price paid of $675m represented 3.4 times estimated sales for the current financial year and 11.6 times EV/EBITDA.

Such valuations make other quoted shale specialists look quite interesting. These include water and waste water companies treating recovered fracking fluid, "greener" fracking chemicals providers to reduce water related risks and companies providing waterless fracking via gel products to reduce many of the environmental issues associated with hydraulic fracking. But the prime interest for investors lies in those companies providing both the materials and the finished products, in particular high precision drilling equipment for initially drilling vertically to reach target depth and then drilling horizontally into the shale, initiate the fracking process and then release the trapped gas to surface. A much more complicated and expensive process than old style vertical drilling involving drill bits used to break up the rock formations, drill "collars" which are heavy thick walled tubes used to apply weight to the drill bit and drill stabilizers which keeps the drilling centered. Other tools include rotary steering systems, and logging and measurement systems using proprietary software.

The market leader in the supply of fracking products is Schoeller-Bleckmann Oilfield Equipment, with an 800 million Euro market capitalization, quoted on the Frankfurt Borse. It controls more than 50% of the global market for tools that enable horizontal and directional drilling and an estimated 60% of the global market for drilling motors and circulation tools and is a prime beneficiary of the strong conversion trend in the US from vertical to horizontal and directional drilling for onshore rigs. In all of its existing products, the company is up to three times larger than its nearest competitor. And this market looks like expanding rapidly as the search for politically uncontentious energy, made available largely through Schoeller's technology, continues.

Oil equipment capex is forecast to double between now and 2015, and given the turmoil in the Middle East and the continued growth of BRIC it is difficult to see why it should slow in the immediate future. Schoeller has just reported a strong set of Q3 results, with incoming orders well ahead of markets estimates. Following an all time high order intake in Q2, of Euros 113m, the Group reported a 30% increase in orders for Q3 to Euros 131m. As a result, the order backlog now amounts to Euro 160m, providing good earnings visibility until the autumn of next year.

Given the discrepancy between US gas prices and world gas prices as a result of the shale gas revolution it is difficult to see demand for shale production technology slowing. The US was perceived to be a net importer of natural gas until recently, but easily available cheap energy from low population areas in the US has fundamentally altered this preconception. Moves are now being considered to alter the construction of LNG terminals for export, to encourage gas fired rather than coal fired electricity stations, and to utilize gas for public transport and fleet transport where there is easy access to depots.

Clearly, there are likely to be periods of overcapacity in oil markets and book to bill ratios will decline as a result. However, the depletion rate of existing oilfields is expected to increase significantly in the next decade and at the same time OPEC's spare capacity utilization rates are falling globally, the old vertical drilling methods accounts for around 55% of activity, whilst horizontal and directional drilling at present accounts for the balance of 45%. Estimates suggest that the latter activity could account for 70% within the foreseeable future.

Schoeller's cash flow looks healthy going forward, despite continued maintenance and capex spend. Cash generation should raise 80m euros in 2010, to 116m euros this year, with 133m euros estimated for 2012. Dividend payments are low but are estimated to double in the current year, providing a yield of 2.4%.

Obviously, with sentiment in the equity market well below par, equities such as Schoeller are likely to have periods of weakness. But on a longer term view, the product mix and the global nature of the business, looks like being able to deliver for shareholders. A smaller version of Weir, more concentrated in terms of specialist product profile, they are trading on 1.9 times EV/sales and 8.5 times EV/EBIT. The PER is 14/15. Net profit progression 2010 to 2012 is estimated at Euros 27m (reported) in 2010 to Euros 52 estimated in 2011 and with Euros 65 conservatively pencilled in for next year. But more to the point, what would somebody like Weir pay for such a company if the opportunity presented itself? It would likely at least match what it has just paid out for Seaboard, being 3.4 times sales. That would deliver Euros 1.5 billion of value compared with the current market cap of Euros 790m. The lesson of Hamworthy must surely be that the right product will likely deliver you a good profit in the end. Horizontal drilling could make you vertical profits.

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