Why We’re Long BP

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June 11, 2010

We recently established (and disclosed publicly on CBNC; see here and here) a modest (4-5% of our funds) position in BP, and the blowback has been unlike anything we’ve encountered in our careers – and being value investors, we’ve owned a lot of unpopular stocks over the years! This blowback, combined with hysterical headlines, rumors and speculation, have not shaken our confidence, but rather reinforced it, as we love buying when other investors are panicking.

And panic there is: even with the rebound of the past two days, the stock is down 44% since the Deepwater Horizon accident, the credit-default swap spreads have widened to all-time highs, seven analysts have cut their rating this week alone, and well-known energy investment banker Matt Simmons said on Wednesday that “I don't think BP is going to last as a company for more than a matter of months.”

Politicians at all levels are engaged in ever-more-heated tough-sounding rhetoric, including President Obama saying that he would fire BP’s CEO, Tony Hayward, if Hayward was his employee. Finally, while BP has said it will pay for the clean-up and direct damages to those affected by the spill, the Obama Administration is going a step further and threatening to force BP to cut its dividend and “repay the salaries of any workers laid off because of the six-month moratorium on deepwater exploratory drilling imposed by the U.S. government after the spill.”

So why on earth would we own the stock of this pariah company? And if we think it’s cheap, why don’t we wait for the dust to settle, the panic selling to stop, and for the outlook to become more clear, and then buy it when it’s safer to do so? The second question is easy: because by the time the outlook is clear, the stock will be at least 50% higher. The former is a tougher question, which we discuss at length below, but in short we own the stock for two simple reasons: 1) BP is not going bankrupt. It is the 4th most profitable company in the world, which means it’s highly likely that it will be able to cover the clean-up costs plus all damages/fines/lawsuits, especially since these costs will be spread out over many years; and 2) the stock is extraordinarily cheap, currently trading 5.4x this year’s estimated earnings (it’s also yielding 9.9% at today’s closing price of $33.97, but the dividend may be suspended temporarily, as discussed below).

Note that in owning the stock, we are not defending the company or its CEO. BP appears to have an atrocious safety record, and it wouldn’t surprise us if regulators
and the legal system determine that it cut corners on the Deepwater Horizon rig, leading to the tragedy. Compounding this, BP so far has botched both the clean-up and the public relations. We think the company should have to pay for all of the damages it has caused, plus a huge fine. Thank goodness BP is so profitable that it should be able to pay for all of this.

Here are the key questions about which we’re thinking:

1) How big is the spill today and how bad could it get? How much could the clean-up cost, and what might legal liabilities be – and, critically, over what time period might BP have to pay? Are there any relevant precedents?

2) How profitable is BP? What do its balance sheet and free cash flows look like? Does BP have the liquidity to handle this crisis?

3) How much might future profits be impacted? What would be the impact of a permanent ban on offshore drilling in the Gulf of Mexico? How tarnished are BP’s brand and reputation, and what might be the impact of this?

4) What if BP cuts its dividend? If need be, could it raise cash in other ways?

5) Regardless of how cheap BP’s stock is, is it immoral to try to profit from owning it, in light of the company’s bad behavior?

We address all of these questions in Appendix A (below), but in summary, we think what’s happening to BP right now is similar to the overall market in March 2009: the near-term fundamentals are terrible, nobody knows when they will improve, and fear-mongers dominate the headlines. But for investors with courage, conviction, and an outlook longer than a few months, we think this market overreaction is a wonderful buying opportunity.
Appendix A

Question 1: How big is the spill today and how bad could it get? How much could the clean-up cost, and what might legal liabilities be – and, critically, over what time period might BP have to pay? Are there any relevant precedents?

These are the most important questions, and the lack of clear answers has caused investors to sell first and wait for answers later. The fear is that, regardless of BP’s profitability, the company will be swamped by astronomical liabilities associated with untold environmental damage.

Given that these liabilities can’t be known with any degree of certainty, how can we get comfortable owning the stock? The answer is that we think we can make some reasonable guesses, based on numerous precedents, and while we can’t rule out a disaster scenario entirely, we think that the expected value among many different possible outcomes makes this an attractive risk-reward situation.

Wall Street analysts are scrambling to come up with loss scenarios – for example, here’s what J.P. Morgan Cazenove analysts write: “BP’s loss of relative value has overshot a worst case. The sum of clean up costs ($5bn), a fine under the Clean Water Act ($8.1bn) and litigation ($16bn) is around $29bn.” Other analysts are in the $30 billion range as well. (Note that BP has paid roughly $1.4 billion to date.)

$30 billion is less than one year of operating income for BP. Even if the total amount is double or triple this, keep in mind that the payout on these liabilities will be over many, many years, allowing BP to earn its way out of trouble (similar to what the nation’s big banks are doing right now). This is a critical point that isn’t being discussed: everyone is focused on what the total costs to BP might be, without asking the equally important question of when BP might have to make these payments. The clean-up costs will be spread out over the next few years, and the legal liabilities and fines over a much longer period. In the case of the Exxon Valdez oil spill, for example, the Supreme Court didn’t make a final ruling until 2008, 19 years after the spill.

But what if the liabilities are much larger? What if the spill permanently destroys the ecosystem and tourist industry in the Gulf of Mexico? In this case, BP’s shareholders will likely get wiped out. But is it likely? We think not.
Pretty much the only good news about this spill is that the Gulf of Mexico is huge, covering 615,000 square miles of surface area and containing 660 quadrillion gallons of water. Let’s compare this to the amount of oil spilled, where one team of scientists just estimated that “the Deepwater Horizon well is most likely spewing at least 25,000 barrels of oil a day, and may be producing 40,000 or even 50,000 barrels a day” – more than double the high end of current estimates.

Let’s take the high end of 50,000 barrels per day and also assume that the well isn’t capped until mid-August, four months after the accident. Let’s also assume that the cap captures no oil (the latest reports are that it may be capturing most of the oil, but let’s be conservative). 50,000 barrels/day x 120 days x 42 gallons/barrel = 252 million gallons of oil released.

252 million divided by 660 quadrillion is one gallon of oil for every 2.6 billion gallons of water in the Gulf of Mexico. That’s equal to roughly one ounce of oil spread over 300,000 bathtubs full of water.

Of course the oil from the Deepwater Horizon spill isn’t spread out evenly throughout the Gulf of Mexico, and we’re certainly not minimizing the severe environmental damage. We’re simply pointing out that – while it may not be politically correct to do so in this emotionally charged environment, with scenes of dead oil-covered birds – the Gulf of Mexico (and the beaches, tourist and seafood industries, etc.) will likely recover from this spill.

Our belief that, eventually, this too shall pass is rooted in five precedents, all of which bode well for the Gulf of Mexico (and BP).

1) Though almost nobody has heard of it, the second largest oil spill ever was in the Gulf of Mexico in 1979. Ixtoc I, an oil well owned by Pemex, Mexico’s state-owned oil company, suffered a blowout and spewed an estimated 30,000 barrels of oil per day into the Gulf for nearly 10 months. An oil slick covered about half of Texas’s 370-mile gulf shoreline, devastating tourism. Did this bankrupt Pemex? Hardly. It spent $100 million to clean up the spill, avoided paying compensation by asserting sovereign immunity, and Texas beaches recovered quickly.

Here’s an excerpt on it from a recent Newsweek article, Four Environmental Disasters Worse Than the Deepwater Horizon Spill:

Ixtoc Blowout, 1979
News reports on the 1979 blowout of an undersea oil well off the Gulf of Mexico seem
all too familiar today. There was a failure of the “blowout preventer,” an undersea fail-safe device that is supposed to close off a gushing pipe. There were frustrated reports about the Mexican government vastly underestimating the volume of oil gushing from the seabed, much like the lowball guesses from BP in April.

Day after day for a span of 10 months, a torrent of oil rushed into the Gulf of Mexico after the initial explosion near the Yucatan Peninsula. The spill was checked only in part by a cap that was lowered over the leak to siphon off a portion of the flow. After four months an oil slick had covered about half of Texas’s 370-mile gulf shoreline, devastating tourism. Only by drilling two relief wells to connect to the initial hole, then pumping mud and concrete into the gushing pipe could Petroleos Mexicanos, or PeMex, Mexico’s national oil company, stop the leak.

“The accident does suggest that blowout prevention equipment is not designed to handle the worst emergencies,” The New York Times wrote in an April 1980 editorial after the leak was finally capped. “Could a blowout in American waters be quickly capped and cleaned up?”

By the easiest measure—volume of oil spilled—PeMex’s Ixtoc I oil well was far worse than the Deepwater Horizon well: 140 million gallons of oil poured out of the Mexican well, compared to the estimated 94.2 million gallons that could escape from the well near Louisiana by mid-August, when a relief well is expected to be complete. (The worst oil spill in history occurred in 1991, when the Iraqi army ripped apart Kuwait’s oil infrastructure and released more than 252 million gallons during the Persian Gulf War. The Exxon Valdez crash in 1989 released 10.9 million gallons.)

2) Consider the Gulf War oil spill in 1991, the largest ever, when Iraqi forces, to foil a potential landing by U.S. Marines, deliberately released an estimated 11 million barrels of oil into the Persian Gulf, creating a slick that reached a maximum size of 101 by 42 miles and was 5 inches thick in some areas. Roughly 10 times the amount of oil than has been spilled in the Gulf of Mexico so far was released into a much smaller body of water (the Persian Gulf is less than 1/6th the size of the Gulf of Mexico by surface area and has an average depth of only 160 feet and a maximum depth of a mere 300 feet vs. a maximum depth in the Gulf of Mexico of 14,383 feet).

There is some dispute about the long-term environmental damage, but according to an article in the NY Times, “a 1993 study sponsored by UNESCO, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates and the United States found the spill did ‘little long-term damage’…About half the oil evaporated, a million barrels were recovered and 2 million to 3 million barrels washed ashore, mainly in Saudi Arabia.”
3) In 1989 the Exxon Valdez tanker hit a reef and dumped 250,000 barrels of oil into Alaska’s pristine Prince William Sound. The spill covered 1,300 miles of coastline, 11,000 square miles of ocean, and killed thousands of animals. BP’s spill is much larger and is in a more populated, economically sensitive area, but it’s worth noting that the total cost to Exxon was only $3.5 billion (after multiple appeals courts and finally the Supreme Court knocked a $5+ billion judgment down to $507.5 million).

4) A recent New York Times article speculating on a BP bankruptcy filing mentioned Texaco’s 1987 bankruptcy filing, but failed to include a critical piece of information: that Texaco’s shareholders, far from being wiped out, in fact weren’t harmed at all. Here’s an excerpt from the NY Times article:

   "This outcome might seem far-fetched right now. But on Wall Street bankers have already coined a term for it: “the Texaco scenario.”"

   In 1987, Texaco was forced to file for Chapter 11 because it could not afford to pay a jury award worth $1 billion to Pennzoil. That award had been knocked down by a judge from a whopping $10.53 billion. (Pennzoil successfully sued Texaco for “jumping” its planned merger with Getty Oil, in part, by moving the case to local court near its headquarters. The jury awarded triple damages.)

   And here’s an excerpt from a 1987 Time Magazine article, explaining what really happened:

   The $10 billion legal battle royal between Texaco and Pennzoil clearly entered a new and murky phase after the country’s third-ranking oil company (1986 sales: $32.6 billion) made its bombshell decision on Sunday, April 12, to file for Chapter 11 protection. Whichever side was right in the dispute, the horrendous legal tangle surrounding the two firms vastly increased -- along with the business uncertainty.

   Nonetheless, as New York Bankruptcy Judge Howard Schwartzberg assumed his overseeing duties with Texaco, it seemed to many analysts that the company had suddenly gained the upper hand in the high-stakes brawl it had appeared to be losing. Said Sanford Margoshes, an oil analyst at the Shearson Lehman Bros. investment firm: "Texaco has bought time. Its prospects are not as bleak." Wall Street seemed to agree. When the New York Stock Exchange opened trading after Texaco's bankruptcy filing, the company's stock dropped from 31 7/8 to 28 1/2 a share. Then the holdings rebounded, closing last week at 31 1/4. Pennzoil shares, which had surged from 79 3/4 to 92 1/4 during the previous week, plunged by more than 15 points the day after the Chapter 11 action and closed the week at 78.

   The Big Board seemed to judge that Pennzoil's combative chairman, J. Hugh Liedtke, 65, had overreached himself in the dispute.
5) But what about the precedents for tobacco, asbestos or breast implants? The latter two bankrupted numerous companies, so why won’t this happen to BP? In large part because the legal environment has changed: it’s much more hostile to mass tort actions, thanks in large part to a conservative majority on the Supreme Court. If the asbestos or breast implant class action cases occurred today, the outcomes would likely be very different – witness, for example, the outcomes of the lead paint cases against Mattel and paint manufacturers.

The closest analogy to today’s situation with BP is, we believe, the Vioxx crisis in late 2004 when Merck withdrew one of the most prescribed drugs in history from the market due to an increased risk of heart attacks – a risk Merck had known about years earlier, but had not disclosed. Based on speculation that Merck’s liability could be as high as $50 billion, the stock tanked from $45 to $26 in less than two months in late 2004. Here’s what Jim Cramer wrote at the time:

Please don’t read the articles that tell you that Merck will come through this whole because, after all, it’s a great American company, and great American companies always come back if you just buy and hold ’em.

Close your eyes and ears to the Merck sirens, because they don’t know what they are talking about. They are naïve. All of them. Because they don’t recognize that with the Vioxx debacle, Merck, overnight, has become the trial lawyers’ next big score, the next big bankruptable company out there. The Merck lovers don’t understand the vast powers of the mass-tort bar. They underestimate the power of the American judicial system to wipe out companies, innocent or guilty, for fatal mistakes. They don’t get that the plaintiffs have all the cards in these lawsuits and management has none. In fact, if I were the New York Stock Exchange, I would put a big skull-and-bones warning label on Merck’s stock that would say: “Warning—the security you are purchasing may end up worthless to you. All Merck stock bought after the recall of Vioxx might soon belong to those class-action plaintiffs who used Vioxx after the time when Merck knew that Vioxx may be lethal.”

So what happened to Merck? It has settled nearly all of the claims for around $5 billion, has won nearly all of the cases that reached juries (with relatively small awards in the losses), and the stock rallied to over $60 in the subsequent three years.

**Question 2:** How profitable is BP? What do its balance sheet and free cash flows look like? Does BP have the liquidity to handle this crisis?
According to the Fortune 500, BP has the 4th highest revenues of any company in the world, and also earns the 4th highest profits, trailing only Gazprom, Exxon Mobil and Royal Dutch Shell. Profits were depressed in 2009 due to the global economic crisis, but analysts are projecting (and robust Q1 results affirm) operating profits of around $34 billion ($93 million per day) in 2010 and net income of around $22 billion, consistent with the 2005-2008 average. (These estimates are before Deepwater Horizon costs are factored in.)

BP has an exceptionally strong balance sheet, that has been getting stronger over the past few years, as this table shows:

<table>
<thead>
<tr>
<th></th>
<th>Q4 2006</th>
<th>Q4 2007</th>
<th>Q4 2008</th>
<th>Q4 2009</th>
<th>Q1 2010</th>
</tr>
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<tbody>
<tr>
<td>Cash</td>
<td>$2,590</td>
<td>$3,562</td>
<td>$8,197</td>
<td>$8,339</td>
<td>$6,841</td>
</tr>
<tr>
<td>Debt*</td>
<td>$24,010</td>
<td>$31,045</td>
<td>$33,204</td>
<td>$34,627</td>
<td>$32,153</td>
</tr>
<tr>
<td>Net Debt</td>
<td>$21,420</td>
<td>$27,483</td>
<td>$25,007</td>
<td>$26,288</td>
<td>$25,312</td>
</tr>
<tr>
<td>Equity</td>
<td>$85,465</td>
<td>$94,652</td>
<td>$92,109</td>
<td>$102,113</td>
<td>$104,978</td>
</tr>
<tr>
<td>Debt/Debt+Equity</td>
<td>.20</td>
<td>.23</td>
<td>.21</td>
<td>.20</td>
<td>.19</td>
</tr>
</tbody>
</table>

* Excludes minor adjustments for “fair value asset (liability) of hedges related to finance debt”

According to CA Cheuvreux, “BP has over $5 billion of accessible cash on its balance sheet, $5 billion in banking facilities, and $5 billion on standby alliance. BP has thus got considerable fire power to deal with the costs as they accrue.”

BP’s cash flow statement is also healthy, as this table shows:

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>Q1 2009</th>
<th>Q1 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Cash Flow</td>
<td>$28,172</td>
<td>$24,709</td>
<td>$38,095</td>
<td>$27,716</td>
<td>$5,572</td>
<td>$7,693</td>
</tr>
<tr>
<td>Cap Ex</td>
<td>$15,125</td>
<td>$17,830</td>
<td>$22,658</td>
<td>$20,650</td>
<td>$4,817</td>
<td>$4,289</td>
</tr>
<tr>
<td>Dividends</td>
<td>$7,969</td>
<td>$8,333</td>
<td>$10,767</td>
<td>$10,899</td>
<td>$2,730</td>
<td>$2,629</td>
</tr>
</tbody>
</table>

Very simply, BP takes its $30 billion of operating cash flow (it’s averaged $29.7 billion over the past four full years) and reinvests two-thirds of it into the business and pays the rest out as a dividend to shareholders.

In summary, by any measure BP has extraordinary financial strength.

**Question 3: How much might future profits be impacted? What would be the impact of a permanent ban on offshore drilling in the Gulf of Mexico?** How
tarnished are BP’s brand and reputation, and what might be the impact of this?

A key pillar of our investment thesis on BP is that the earnings power of the business remains intact. We’ve heard two contrary arguments: the first is that BP’s entire offshore Gulf of Mexico operation, the largest of any company in the region, could be shut down permanently. While we think this is unlikely, BP could weather this hit as it accounted for only 15.3% of BP total oil production and 3.6% of natural gas production in 2009.

To consider an even more extreme scenario, what if BP stopped (or was forced to stop) doing business in the U.S.? Even then, BP would survive: in total, the US accounted for 33.3% of BP’s exploration and production profits in Q1 2010 (E&P was 93.2% of BP’s total operating profit).

The second argument is that BP’s brand and reputation have been so tarnished, or the rumors about BP filing for bankruptcy have so spooked folks, that drivers will shun BP’s gas stations and BP’s counterparties won’t do business with BP or demand onerous terms like cash prepayment. It’s an interesting theory, but we can find no evidence for it – and we’ve looked.

Our best guess is that when all is said and done, BP’s normalized profits might be a few percent lower due to this crisis. There will surely be expensive new safety regulations (which will apply to all offshore drillers) and BP may lose some business with the U.S. government (it’s currently the “top supplier of refined fuel, including jet fuel, to the Department of Defense last year. It was also one of the top suppliers of gasoline, diesel and other fuels to the federal government.”).

**Question 4: What if BP cuts its dividend? If need be, could it raise cash in other ways?**

There’s a great deal of speculation that BP might be forced to cut or even suspend its dividend (currently 9.9%) due to the costs of the cleanup and/or political pressure (the Obama administration is pressuring BP on this front and recent reports are that the company will indeed do so).

From an investment perspective, we don’t really care, as we don’t own the stock for the dividend. In the short term, a dividend cut would likely lead to a drop in the share price, but it might be wise for the company to retain its earnings and strengthen its balance sheet.
From a financial perspective, it doesn’t appear that BP will be forced to cut its dividend unless clean-up costs rise dramatically (the vast majority of the legal liabilities, which will likely exceed clean-up costs, won’t be paid for many years). Costs to date have been $1.4 billion, BP has plenty of cash and liquidity, and in the seven weeks since the accident, it has earned nearly $5 billion in operating profits.

The political question is trickier. It’s not clear cut that the U.S. can (or should) force BP to cut or suspend its dividend, and this could become a testy issue between the U.S. and one of its closest allies, as this article notes:

Almost every pension fund in the U.K. owns shares in the energy giant, raising serious questions about the impact the firm's plummeting value will have on the retirement plans for millions of Britons. President Barack Obama's threat to block a BP dividend payment in order to ensure victims of the spill get compensation has also sparked widespread alarm.

“Obama’s boot on the throat of British pensioners” read the front-page headline in Thursday's Daily Telegraph, which added that the president's "attacks on BP were blamed for wiping billions off the company’s value."

“U.K. alarm over attack on BP” was the Financial Times' take on the crisis, which it suggested could damage transatlantic relations. The newspaper accused President Barack Obama of employing "increasingly aggressive rhetoric" against BP.

And this Financial Times article notes that BP pays 12% of the total dividend income of the UK market. Finally, according to BP’s web site, U.S. investors own 39% of BP’s stock (almost as much at the 40% by UK shareholders), and the company has over 430,000 small shareholders (less than 10,000 shares).

In a worst-case scenario, BP could of course suspend the dividend, but what if it needed more cash? The obvious next step would be to cut cap ex, a far bigger expense than the dividend (the dividend is currently a bit under $11 billion annually vs. an average of $21.7 billion in cap ex annually over the last two years). In its Q1 2010 earnings release, BP gave the following guidance for cap ex: “For 2010 as a whole, we continue to expect organic capital expenditure of around $20 billion and disposal proceeds of $2-3 billion.”

It’s hard to know how quickly and by how much BP could cut cap ex, but one clue is that “Depreciation, depletion and amortization and exploration expenditure written off” – often a reasonably proxy for maintenance cap ex – was $12.7 billion last year.
Finally, BP has valuable assets all over the world – property, plant and equipment on the balance sheet is worth $108 billion – but of course it would take time to sell.

**Question 5: Regardless of how cheap BP’s stock is, is it immoral to try to profit from owning it, in light of the company’s bad behavior?**

As noted earlier, BP appears to have an atrocious safety record. In owning the stock, we are not endorsing its behavior, either before or after the Deepwater Horizon accident. But as value investors, we sometimes have to hold our noses when we invest because the cheapest stocks are often the ones of companies that have behaved badly or are otherwise tainted. Example include McDonald’s, which many believe bears responsibility for the obesity epidemic in this country (see *Fast Food Nation* and *Super Size Me*), and Goldman Sachs, which many blame for the global financial crisis (see *The Great American Bubble Machine*).

That said, we would have a problem owning stock in a company if we believed that’s its core business harmed people – most subprime lenders at the peak of the housing bubble, certain multi-level marketing firms and tobacco companies come to mind. BP certainly doesn’t fall into this category.

As for BP’s safety record, we don’t defend it, but we don’t think BP is deliberately blowing up its own rigs and refineries and killing its employees. If an email emerged that the CEO or board of BP were warned that the Deepwater Horizon rig was likely to explode and failed to act, we would certainly rethink the morality of holding the stock.