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New Recommendation: NEUTRAL Apache Corporation (APA) Dec 13, 2012

Recent P/E: 7.83 (ftm consensus)

Recent Price: \$77.25

Target: N/A

Summary:

Apache Corporation explores and produces oil, natural gas and natural gas liquids. They have a balanced portfolio of oil and gas assets in the US, Canada, Australia, Argentina, Egypt and in the North Sea. The stock of Apache has declined from a high of \$145 in April 2008 and \$112 in February of 2012 to a present price of \$77.

Apache has shown that it can find petroleum energy resources, but it has no track record of being able to provide necessary infrastructure to bring those petroleum energy resources to market nor does Apache have a track record of adding other value that would allow it to garner anything but the market price for the various hydrocarbon commodity products that it produces. In times past, the market price of oil, natural gas and natural gas liquids has been sufficiently high that Apache's strategy focused on hydrocarbon production has been effective. (In the oil patch, the term "production" is the term used to mean all the various tasks, such as exploring and drilling, that are required to get the oil or gas hydrocarbons out of the ground and to the earth surface. The subsequent actions required to get the useful hydrocarbon products to the plethora of customers are known as "distribution", "refining", "marketing", "downstream", etc.)

While the focus on hydrocarbon production has worked well for Apache in the past, going forward, the vision for Apache is much cloudier. Couple uncertain commodity pricing with the need to develop oil and gas infrastructure and add a healthy portion of political instability in Argentina and Egypt, and you wind up with an equity that has a highly uncertain future.

Background

Tallied by revenue \$, Apache's sales are 66% oil, 32% natural gas and 2% liquid by-products of natural gas, known as "natural gas liquids". Augmenting its natural gas reserves, Apache recently announced discovery of an enormous reserve of natural gas in the remote area of north

east British Columbia, Canada. Unfortunately, the capital and political cost of bringing the gas from that remote location to market is enormous. At the present time and at the present price of natural gas in North America, the value of Apache's natural gas find at the wellhead in British Columbia is not economical to produce.

Apache also has a substantial hydrocarbon reserve in Australia that is consuming a substantial portion of Apache's capital spending budget, with disappointing results.

Apache produces about 20% of its natural gas in Egypt. Egypt is presently undergoing a substantial political upheaval. As is always the case in countries undergoing political redistributions, all the various political interests have very different views on the "ownership" rights to the local oil and gas resources. In addition to the "ownership" issues, political upheaval almost always results in an inability of the infrastructure to support anything near peak output from the natural resources of the country.

Argentina has been a political tinderbox for decades. At the moment, Apache holds a favorable position with the ruling party, but going forward, there are minimal guarantees.

Discounted Earnings Estimates Going Forward

A large number of the Apache income streams going forward are subject to present value discounts. No one knows what the resolution of the political scene is going to be in Egypt. What might happen in Argentina is unclear. The disappointment in capital investment returns in Australia could be quantified with some research if the opinion on Apache hinged on the Australian returns.

Incremental earnings for Apache, however are tied, in a big way, to increased revenue from natural gas sales over and above Apache's incremental cost for that gas. Translate the previous sentence to mean that Apache needs to realize a higher price for natural gas if it is to increase its earnings in a meaningful way.

The biggest factors affecting the price Apache will realize for its natural gas production, are; first, what will be the price of natural gas in domestic markets; second, what will be the price of natural gas in the world's, seaborne markets and third, what will be Apache's ability to convert domestic natural gas to fulfill seaborne contracts.

Seaborne Natural Gas

The world markets for oil are fairly well coupled. From time to time, there are some price differences between oil of a similar grade in different parts of the world. The price spread, however, for the same grade of oil in any two markets anywhere in the world almost never exceeds 12%. In contrast to the world oil markets, the market for seaborne natural gas is completely decoupled from domestic markets. At the moment, the price premium for seaborne natural gas is about 400% higher than that for the same grade of domestic natural gas. The big difference in the oil price spread and the natural gas price spread is explained by infrastructure constraints, particularly on the limited availability of seaborne transportation for natural gas.

Compared to natural gas, crude oil or refined oil products are very easy to transport. In very simple terms to transport oil anywhere in the world, you need a big ship, a big dock and a big hose. By contrast, to ship natural gas, you first need to get rid of almost all the impurities in it, then you need to cool the natural gas to a temperature of -200°, then liquefy it to make liquid

natural gas (LNG), then keep it real cold while pumping it into an extremely complicated ship specifically designed for the single purpose of transporting LNG. Then you need to reverse the process on the other end.

In the world today, there is very little infrastructure designed to handle LNG shipments, particularly for handling LNG shipments out of North America to the seaborne markets. In the US, there are only a half dozen or so LNG terminals. Together, the handful of terminals would handle way less than 10% of the country's natural gas needs if they were all running at full capacity. All the US LNG terminals are designed and built only to handle LNG coming into the country. The domestic LNG terminals have no capability to handle LNG going out and converting the LNG terminals to handle export of LNG is an expensive, political and time consuming process. Worldwide, the number of LNG terminals is also very small compared to the total demand for natural gas. Supporting the small number of LNG terminals, the number of seaborne LNG tankers is also very small when again compared to the total demand for natural gas.

On a short term basis, the world's capacity for seaborne LNG is fixed by the availability of LNG seaborne infrastructure, and the world's seaborne LNG capacity is fixed at a very low level. Adding the various pieces of LNG infrastructure to the world's seaborne LNG supply capacity will take years to accomplish. Adding substantially to the world's seaborne LNG demand however, only took a couple of weeks following the tsunami in Japan and the virtual shutdown of their entire nuclear power industry.

No incremental supply and a big, sustained spike in world demand, of course, led to a big price increase in seaborne natural gas. Seaborne natural gas presently sells for \$13 to \$17/mmcf. Domestic natural gas sells for about \$3/mmcf. Over time, the demand and supply for seaborne natural gas will come more into balance. As seaborne natural gas supply and demand come more into balance the huge seaborne premium will shrink.

Domestic Natural Gas

In a large number of countries, natural gas deposits are being unlocked with new technology, known as horizontal drilling and fracking. In the past three years, new natural gas discoveries have been brought to market in the US in staggering numbers. (In the world's energy markets, demand historically changes by one or two percent per year, so doubling any supply stream in a year or two, will far outstrip the industry's ability to handle the incremental production). The only reaction to a new large supply increase and a very slow demand increase, is, of course, a significant drop in price, to the point that marginal wells are simply closed.

The horizontal drilling and fracking techniques applied to US deposits are being used, to some extent, in other parts of the world, but with the exception of Australia, the results are less dramatic than that achieved in the US. (It is not yet clear if further development in the rest of the world's countries will or will not yield the kind of increased supply seen here in the States. It is, however, clear that any increase in supply is not going to coincide geographically with the demand and that a big, but not yet quantified, demand will ensue for seaborne natural gas shipments.)

Assuming that some domestic natural gas is eventually converted to the seaborne trade, there is no assurance that the domestic price will rise, however. The domestic price may rise, but it is possible that new domestic supply will simply come on-stream.

Balancing the World's Supply and Demand for Natural Gas

Eventually, the world's supply and demand for natural gas should come closer into balance, but the balancing process could take several years and the process will be fraught with winners, with losers and with price volatility. For this analysis, the question is whether Apache will be one of the winners? The answer is unclear, but the probability for Apache to be a winner is not real high.

In the US, a number of export LNG plants are presently planned or are under construction. If all the presently planned projects were to come on-stream, they would export about 20% of the US domestic gas consumption. That is a pretty big number and it's not likely, therefore, that they will all get licensed as political pressure will intensify. (There is substantial opposition to building LNG terminals in the US. Domestic natural gas users, of course, want low domestic prices, which can be achieved by limiting exports. These domestic natural gas users have a substantial say in Congress. All environmental groups are against most any hydrocarbon development. Environmentalists also have strong allies in Congress. Land owners affected by LNG processing plants and natural gas pipelines constitute another potential opposition group.) Somewhere around half of the proposed US export capacity is projected to come from facilities that were designed to import LNG. Clearly, the conversion of import LNG terminals to handle LNG exports will get first approval. Apache does not have one of these, so its plans for domestic US export facilities will go into a second grouping. It is not likely that all planned projects will get permitted and there is no guarantee for Apache.

In Canada, Apache has a LNG export terminal planned, in conjunction with a pipeline across British Columbia to bring their Canadian LNG to the seaborne markets. However, Shell has a plan that is pretty much the same and Shell's terminal and associated pipelines could handle a lot of Apache's planned production. Getting the necessary terminal and the necessary pipelines permitted is a major political process. There are at least 16, but possibly as many as 170 Native American Indian tribes which lay claim to some or all of the pipeline right-of-way that Apache wants to build across British Columbia. The route would cross heavily forested and mountainous regions. Environmental opposition will be high in spite of how environmentally careful the design is. There are hundreds of private land owners along the way. Potential revenue streams are readily identified by the Canadian Provinces of British Columbia, Alberta, the Yukon and the Northwest Territories, not to mention the national government in Ottawa.

It's a huge political process. Apache's competitor, Shell, has a lot of experience with the political processes. Shell also has extensive experience with the process of handling downstream natural gas as well as extensive experience building and running pipelines. Shell also controls the small LNG import terminal at Kismet, BC that will form part of the Shell plan.

In contrast with Shell, Apache has very small experience with the pipeline political process and very little experience with downstream installations of any type. Apache's Canadian LNG and pipeline plan also includes building a new facility in Kismet, BC, a stone's throw away from the existing Shell plant. To date, Apache's efforts in the political permitting process have not been given high marks. Given the choice between Shell and Apache, I would bet on Shell getting the job done, not Apache. I would also bet that once completed, Shell will not be the least bit bashful in charging Apache the "market" rate (read "high" rate) for using the pipeline and LNG export facility.

The process of balancing the world's supply and demand by significantly increasing the seaborne LNG volume will bring a lot of competing interests to the table. Seaborne users will expect lower prices and with increased supply, they will get those lower prices. The owners of the LNG infrastructure will want a generous return on their capital. Various governmental agencies will see an easy revenue target. Local landowners will expect generous payments as well. The seaborne LNG premium will shrink and a lot of the remaining premium will be claimed along the way and not flow back to the original gas producer.

It is virtually impossible, as a result, to project that Apache will realize anything like the present seaborne LNG price for its gas reserves in Canada. It is quite possible that the price they would get isn't that much above what they would get today, which is actually lower than the cost to get the gas out of the ground.

Making an accurate projection of the world's seaborne LNG price in an equilibrium market condition would be possible, but it would be a huge undertaking requiring the identification of virtually the entire world's supply and the entire world's demand along with projecting the costs and time required to outfit the infrastructure for the world's seaborne LNG trade. Once the seaborne supply and demand balance was researched; it is extremely unlikely that the conclusion would be a big price increase that would be assigned to Apache natural gas production. Without a higher natural gas price, Apache's earnings stream is not likely to show significant growth.

Natural Gas Infrastructure Winners

It will take at least the next three years for the world natural gas markets to come into equilibrium. Over that time, the world's natural gas infrastructure will be built out. The world price of natural gas will come down with increased seaborne shipments of LNG. It is likely that the domestic price of natural gas will come up a bit. However, domestic natural gas supply is, to a large part, a byproduct of drilling for oil. Domestically, there is a tremendous increase in oil production and with natural gas as a byproduct; the incremental cost of producing domestic natural gas will continue to be low. Domestically, with a low incremental cost, the domestic price for natural gas will continue to be low.

On the international front, Qatar has enormous gas supplies and Australia does as well. There are no major pipelines required to get Qatar gas to a seaborne port and there are virtually no political obstacles or licensing difficulties in Qatar for any energy export related items. Qatar also has strong alliances with Royal Dutch Shell who has tremendous experience with hydrocarbon infrastructure development of all kinds. Shell's accumulated LNG experience along with its existing facilities in Qatar and few licensing obstacles will facilitate further, large scale LNG infrastructure development in Qatar targeted to the seaborne markets. Given Shell and Qatar's advantages, it is likely that they will beat any US company to a substantially larger share of the seaborne LNG market.

In Australia, Exxon is partnered with BHP Billiton in natural gas production. They presently have infrastructure in place to handle seaborne LNG shipments. Further, Exxon and BHP have announced a \$1 billion expansion to their gas plant in Victoria. In contrast, Apache will need to build its LNG facility from scratch. Expanding an existing petrochemical facility is always quicker than building a new facility from scratch. Like Shell in Qatar, Exxon/BHP in Australia will beat any US company to becoming a major supplier to the seaborne LNG market.

The big winners in capturing the spread between domestic natural gas pricing and the seaborne pricing will be those people with the scarce resources. The people with the scarce resources will

be those with the most experience in LNG infrastructure development and those with the fewest obstacles. Qatar, Shell, Exxon and BHP all have great experience and few obstacles. Apache is completely on the other side of the coin. Apache does not have any particular expertise or nor does it have any particularly favored position. As such, projecting that Apache will garner higher natural gas pricing in the next few years is a stretch.

Is the Stock Cheap?

Apache is selling for 7.83 times earnings and pays a 0.8% dividend. Exxon Mobil (XOM) is selling for 11.25x and pays a 2.6% dividend. Shell (RDS-A) is selling for 8.1x and pays a 5.2% dividend. Hess (HES) is selling for 8.3x and also pays a dividend of 0.8%. Exxon, Shell and Hess would all have fundamental earnings prospects that exceed that of Apache.

I believe that the world's energy markets are undergoing a fundamental change. Since 1970, energy supply has been scarce and the price of oil and gas production has been bid up. With the new horizontal drilling and fracking technologies coming on stream throughout the world, and with the world economies experiencing very little growth, it is likely for the next several years the scarce part of the energy equation will be infrastructure. In worldwide infrastructure, no one will be able to compete effectively with Shell and Exxon. While Exxon Mobil is higher priced, Shell is selling for about the same price as Apache and pays a considerably higher dividend. On the domestic side, Hess will be able to compete on infrastructure development as well as fundamental oil and natural gas production.

Conclusion

To show a substantial increase in earnings, Apache needs to see no deterioration in today's political climate in Egypt and Argentina. Further, they need no deterioration in today's oil price and they need a substantial increase in the price they realize for natural gas. Unfortunately, for Apache, now and for the next several years, the scarce item which determines the price realized for seaborne natural gas is LNG infrastructure. Apache has none, they have no expertise in building the required infrastructure and there are a number of well financed, experienced competitors that do have the expertise.

There are just too many things that would need to go just right for Apache to substantially improve its earnings and none are lined up in favor of Apache. The probability of all of them going Apache's way is extremely small. Further, there are better choices in the energy sector that would have more compelling fundamentals.