



Gulf Drilling

McMoRan Gets Busy In The Gulf With Plains, Energy XXI

Joan Lappin, Gramercy Capital Management 11.03.10, 1:13 PM ET

More than six months after BP's Macondo well blew out in late April, one can see the difference between those who were spooked by that dreadful event and Obama's drilling moratorium, and those who see the aftermath as a huge opportunity. Put Jim Flores of Plains Exploration and Production in the camp of the spooked.

After the Gulf of Mexico BP disaster with resulting loss of life and huge ecological damage, Flores decided to retreat from offshore drilling in the Gulf and head ashore with his investments. In fairness, Mr. Flores periodically alters his portfolio and he started out as a land driller, not an offshore man. They are different breeds. His style is to invest on the cheap and then harvest what he sows from time to time.

Plains announced several weeks ago that it intended to exit the Gulf of Mexico. In step one, Flores agreed to swap his interests in McMoran's shallow water ultra deep drilling program for a 51 million share interest in McMoRan Exploration (a 23% ongoing interest at present levels of shares outstanding) and \$75 million in cash. McMoRan's Jim Bob Moffett was able to increase significantly his share interests in Davy Jones, Blackbeard East and West and future wells still to be drilled as part of his shallow Gulf of Mexico ultra deep play.

Moffett's theory for years has been that below exhausted oil and gas reservoirs in shallower depths, it was likely that there were huge reservoirs further down into the earth's crust. It has taken decades for the seismic data and drilling and extraction techniques to be developed to pursue this concept. McMoRan now will own various well participations near 70% that it could neither afford nor risk owning when the ultra deep play was first emerging and still unproven. It is still very early in the game.

For Plains, this eliminates any further cash calls for continued development and any potential liability for Plains as a drilling partner if something goes wrong. It may well be the scare about the size of the BP obligations over the Macondo explosion that really spooked him. Owning a third of the obligations on a disaster of that magnitude could put many a small company out of business. Those risks will now reside with McMoRan.

In step two for Flores, his other Gulf of Mexico interests are now being evaluated by potential purchasers. Plains Exploration has stated that it expects to announce the details of the sale of those other assets this month. It's clear that everybody seems to want to complete whatever deals they are doing before calendar year end 2010 so lots of decks are being shuffled.

By agreeing to exchange 25% of the company for Plains' interests in its drilling program, McMoRan simultaneously embarked on a significant capital raise for itself of \$900 million. If Plains owned near 40% interests in the wells that hold the key to McMoran's future, then buying them back for 25% of the company is not a bad move. MMR's \$900 million refinancing included the sale of \$700 million of a perpetual preferred stock. Its sister company, copper and gold producer Freeport McMoRan, took down \$500 million of that preferred offering.

Clearly, since Moffett is chairman of both entities, he surely believes in the future success of his drilling program to be willing to double down on his ultra deep investments. He is also now in a position to resell some of that interest to a major deep pocketed oil major and still retain a very large participation for MMR as the majors now understand that the shallow water offers big potential at a fraction of the cost and difficulty of deep water drilling. In addition, McMoRan now has enough capital to fund its continued exploration of the shallow water ultra deep for the next several years. Only Moody's would decide that was reason for a credit downgrade.

Compared to Plains and McMoran, Energy XXI, is a junior partner in the ultra deep program by size of its ownership in some of fields like Davy Jones, BBE and Lafitte. Energy XXI was started just a few years ago and its modus operandi has been to borrow money and use it to make acquisitions that would generate good cash

flow and expand its balance sheet and asset base. Energy XXI has emphasized buying older oil fields in the Gulf of Mexico with declining production, then using new techniques to find and extract more from those old fields to offset reserve depletion. So far, it has been able to reverse declining reserves in the fields it has bought. It emphasizes buying oil and prides itself on the "oiliness" of its reserves, about 63%. Natural gas has suffered severe price declines in the last year or two so this oil emphasis has served the company well.

Last week, Energy XXI embarked on its own very successful overnight offering of stock and 5.75% convertible preferreds to finance yet another acquisition. Both the common and the preferred sides of EXXI's deal were oversubscribed. Therefore, EXXI was able to raise approximately \$500 million instead of the hoped for \$400 million. If both green shoes are ultimately exercised, (the pfd already has been), then the company will take in net proceeds of about \$537 million. Some has been used to pay down its line of credit to zero and other funds have been used to retire as much of its 16% pfd stocks as it can, about 25%. Energy XXI now has a substantial war chest to fund perhaps as much as a billion dollar acquisition. The company hopes to pay no more than 3 times cash flow for whatever it buys.

On its internet road show last week, EXXI included one slide showing potential sellers of the kind of assets it wants to buy: declining oil fields that have been in production for years. The list included: 2 private sellers, several private equity investors who now want out of their investments, EOG, Helix, Petsec and Exxon Mobil. Fields that are irrelevant to the cash flow of a major oil company can add very significantly to the cash flow of a growing but small EXXI.

However, no seller wants to deal with a company with an extended balance sheet. October's activities served the purpose of reducing EXXI's debt to about 25% of Enterprise Value which we calculate at just over \$2 billion. (84 million fully diluted shares x 22 = 1.848 billion + \$233 million of net debt without \$37 million more cash if the equity shoe is exercised). EXXI hopes to buy enough cash flow with whatever acquisition it makes to lift it to a new higher asset base.

EXXI has surged to prominence in 2010, up more than 90%, largely because of its association with the McMoran ultra deep drilling program in the Gulf of Mexico, not its more conservative reworking of old fields. Both stocks jumped in January aided by the successful large discovery at Davy Jones which logs indicated has 200' of net pay. DJ will not be completed and flow tested as to its full size and potential reserves until Q3 of 2011.

Both MMR and EXXI believe that they have likely discovered hydrocarbons at both Blackbeard West and Blackbeard East but nothing can be added to reserves until the wells are completed and flow tested. Oil or condensates would be great if found but are not viewed as likely despite rumors. The common wisdom is that the targeted depths near or below 30,000 feet seem to be accompanied by higher pressures and temperatures which usually "cook" the oil into gas. Macondo was drilling at less than 20,000 feet when it blew up, spewing oil for months.

Energy XXI continues to build an interesting new company. It's board of directors has repeatedly confirmed its willingness to invest up to 15% of its drilling budget into the MMR wildcat exploration program in the ultra deep with its attendant risks. As EXXI grows, it can shoulder a bigger share of that budget but it seems at present to be intending to balance the big potential for gas in the MMR drilling program with more oily assets as an offset.

If you want a pure exploration play in the Gulf of Mexico shallow water ultra deep, then MMR is the stock for you. If you want some exposure to the potential cash flow that a discovery would mean for a small emerging company then you might like the oiliness that EXXI represents in the mix. Plains is redefining itself away from the ultra deep. It, too, is undervalued in our view and should benefit from these additional sales to be announced shortly and redeployment of its cash to onshore programs.

Joan E. Lappin, CFA, is president of Gramercy Capital Management Corp. in New York, N.Y. She and her clients are long MMR, EXXI and PXP. For more insights and ideas for your own personal investment situation, visit www.JoanLappin.com.