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Cottee cold calling as gas deal falters

Macquarie Group does not often fail to get its way. But the runes of protest are pointing to the upset of the Millionaire Factory's plans to capture value from the east coast gas supply crisis by taking control of the Northern Territory junior Central Petroleum.

But, wouldn't you know it, Macquarie might well fabricate a path forward from defeat that leaves losing merely a better way of winning.

Macquarie likes lending to Central so much that it now wants to buy the business. Having extended $84 million to finance Central's acquisition of a half share in the mature, but far from exhausted, Mereenie gas project in central Australia, Macquarie has now offered the driller's shareholders $87 million and a share of future value for control of their company.

When the Macquarie Group offer of 20¢ a share finally arrived in March it appeared to most of us to be rather generous.

The price was, for example, 14 per cent higher than the price flagged when Central's financier first approached board and management with an expression of acquisitive intent. It was also 21 per cent higher than the then share price and a cool 60 per cent higher than Central shares were changing hands at back when Macquarie's interest became known last November.

Little wonder then that the March confirmation of an offer on the table arrived with the unequivocal endorsement of Central's board and management, led by Australian gas maverick Richard Cottee.

Back then the Macquarie offer looked like encirclement completed.

Having become Central's sole source of debt funding from June 2015, the famously canny investor went on to fill the interregnum between takeover approach and firm offer by becoming the joint-venture partner in the gas production that Cottee imagined would generate the cash flow necessary to transform his growth narrative into productive reality.

But there looks to have been a messy and unanticipated slip between cup and lip. Recent weeks have seen Cottee making personal entreaties for support to senior owners on his massively retail register and making cold calls to smaller owners. That is because both Macquarie and Central increasingly fear the disruptive traction that has been developed by two apparently unrelated groups of refusnik shareholders.

Central Petroleum's Richard Cottee has threatened to resign. PHOTO: KIRK GILMOUR

One group, working in the name of management past, has run an online campaign to foment a no vote while a second group, calling itself OptionCo, has gathered the 5 per cent support necessary to force Central to call an extraordinary general meeting where the board will face a spill motion.

That meeting will occur only if the Macquarie offer is rejected by owners at the scheme vote meeting called for late next week. The spokesman for the shareholders who support OptionCo is Stuart Howes. He is apparently increasing confident of victory.

"All the indications are the current proposed scheme will fail," he told me earlier this week. "And there is increasingly likelihood that shortly thereafter the present board will be removed," he said before urging us to "provide a more balance view" of the Central dilemma.

To deflect claims by OptionCo that he might be ambivalent about the risk of a board spill, Cottee has made it plain that he will retire from the fray if change is forced on the board. I am guessing though that he would not linger too much longer than failure of Macquarie's takeover. Cottee has said a forced retreat from Central will close his career in public companies.

OptionCo has previously flagged an interest in retaining Cottee, whose past success in transforming Queensland Gas from penny dreadful to $6 billion takeover target delivers him considerable currency in the exploration and production game.

Howes expresses comfort in the options ahead if Cottee fulfils his commitment to resign (and he will).

"Mr Cottee has indicated he will leave if the present board is replaced, and while we reject that Mr Cottee feels this way, [we] have plans in place to suitably accommodate the situation with our own shortlist of current internal and external candidates," he said.

"If the board is replaced this will be one of our new board's first priorities," he said before a harsh assessment of what he assesses as Cottee's missteps in dealing with Macquarie.

"The fact of the matter is that, unfortunately, Mr Cottee was outmanoeuvred by Macquarie when he went looking for finance to secure Santos' half of Mereenie," Howes assessed. "His endorsement of, and continued support for, this low takeover offer is quickly eroding the support base he enjoyed with shareholders since joining in 2012."

Howes earlier offered responses to our view that there were three possibly uncertain foundations to the argument that Macquarie should be dismissed.

For the record, to my mind, those pillars are, in order, that the rejectors are confident that Central has more gas than the certified numbers indicate; that the gas shortage is worse than anticipated and will thus result in higher prices than Central and its independent expert have flagged; and that market regulation will allow producers to recapture some of the excessive rents being charged by the pipeline operators.

Howes told me that OptionCo is working on the belief that Central's reserve will "most likely" hit the 1000PJ that Cottee himself predicted in October of 2015.

That forecast remains just that. The exploration and appraisal drilling necessary to translate informed estimate to bankable reserves just has not happened, in large part because funding was too hard to come by.

Central asserts a future world where gas prices average about $8 a gigajoule and that simply doesn't cut the mustard when you are being asked to spend more than $5.20/GJ transporting gas and you need a ex-field price of better than $4/GJ to even start generating a return.

Howes says that Macquarie itself has forecast $9/GJ and that the costing for transport has been inflated because a material volume of gas needs only to be transported to Mount Isa rather than make the expensive journey to the national gas hub of Wallumbilla. Howes also raises the potential of backhaul to return additional value to the producer. For mine, he overstates the capacity of the Mount Isa market to take his gas and thus make backhaul relevant to the volumes Central can push down the new NT gas pipeline that should enter service from 2018.

The other point to make here is that talk of a spot price is, to some degree, taking a step away from harsher realities. As the market is presently constituted, only those with pipeline access can participate in spot markets. Central does not yet own pipeline capacity.

So, whether or not Central's progress is bankable will be determined by the term pricing that is established by firm contracts rather than the shorter market dynamics reflected by the spot price. And just what that term pricing might be is going to depend a whole lot on when Central is able to get its gas to market.

The second part of my introduction raised the possibility that Macquarie might still end up a winner even should shareholders reject its offer. The thesis there is sustained by the fact Macquarie is Central's joint-venture partner in Mereenie, that from 2019 at the latest the financier owns all of the cash flows generated by any gas Central sends down the new NT pipeline, that Macquarie is owed $84 million by Central and that Central needs $42 million to develop the fields that might send gas eastwards.

Looked through this daunting prism, it seems almost a bit of a kindness that Macquarie has arrived offering Central's owners anything at all for a business whose fate, for the moment, sits already wedded to the financier's whims.

Asked about a future life living in the grip of a potentially disappointed suitor, Howes confirmed that OptionCo had not yet approached Macquarie to discuss its plans.

"We currently don't intend to directly engage with them until the scheme vote has been held," he said. "We are not naive to the challenges posed going forward, however."

That is a relief.

Philip Baker

Value traps abound even for Buffett

Warren Buffett, and all the armchair Warren Buffetts out there, you've been warned. There is so much change going on in the world that value investing, as a strategy, is on its way out.

Buying stocks with the lowest valuations is just not working.

It's a major reason why so many investors are heading to passive managers to get returns that just match the index.

Indeed, in the US there has been such a rush to this style of investing that Vanguard now has a stake worth 5 per cent or more in 468 companies in the S&P 500, according to Morningstar.

But it also talks to just how fast technology is changing the investing landscape.

"The unprecedented change we are living through means that the risks of value investing have never been higher. This is because unprecedented change means very high risk level," says Alex Pollak, who runs Loftus Peak, a global fund manager in listed disruptive businesses.

The debate about value investing – first started by Eugene Fama and Kenneth French but made famous by Buffett – was put in the spotlight again a few weeks ago when Goldman Sachs' portfolio strategy research team said it was dead. Sticking to the value method meant an all-up loss of 15 per cent since 2007, according to the broker.

That performance goes a fair way to counteract the good times from 1940 to 2007 when value-style investing recorded an annual return of 5 per cent and made it the best investment strategy of all time.

But there have also been long periods where it has struggled. In the late '90s when technology stocks were all the rage, growth managers ruled the roost until it all went pear-shaped in 2000 and the Nasdaq crashed.

In the early 2000s, the resources boom and China meant growth stocks were also popular but value stocks were not.

Record low interest rates, which helps narrow the gap between the number of high and low PE stocks, and the pace of technology means that value investing ain't what it used to be.

In addition, it's always been the case that buying stocks with a low PE means there is a risk the company is cheap for a reason and it can't be turned around. That's the value trap.

Value did try to rise from the dead during 2016 with the Russell 2000 Value index increasing by around 30 per cent, although so far this year that index is flat.

Value has died at a time when passive investing and quant strategies have been flavour of the month.

The big question now is whether or not this is the death of value once and for all or if it's just a blip in its performance?

For Pollak it's all to do with change. He said there's nothing wrong or right about value or growth investing and doesn't favour one over the other. Put simply, there is more to it than that and the whole debate is "being misunderstood" and "poorly applied".

Financial markets are being tested by new businesses such as Facebook and Google which are "pushing the boundaries" in how companies get valued.

"It's not that cash flow isn't important – it is – just as much as gearing, stock turn and interest coverage. They remain as critical as they have always been. But the mechanisms for hitting success in these milestones are changing, which in turn is expanding the criteria for what makes a company valuable," says Pollak.

The pace of change is so extreme that analysts are finding it hard to plug it all in to their traditional valuation methods. It means the boundaries of "prudent investing" are getting tested all the time and it can, at times, make the blue chip companies look like value when they are really getting severely challenged.

Pollak thinks that a fair chunk of the value plays of today are not just underloved stocks, that will eventually come good, but companies that are in long-term structural decline.

Buffett, a well known tech bear, has had a change of heart and Berkshire Hathaway is now one of the largest single shareholders in Apple with a $US20 billion stake.

"In saying that, Buffett looks to have underestimated technology companies' ability to adapt, evolve and most importantly, further innovate. It doesn't mean that Buffett has stopped valuing cashflow, or balance sheet quality or growth, just that he understands that the times demand these don't always present in the same ways as before," Pollak says.