A Search For Global Value…TRAPS!

VALUEx Vail

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James Chanos
Kynikos Associates

Value Stocks: Definitive Traits

- Predictable, consistent cash flow
- Defensive and/or defensible business
- Not dependent on superior management
- Low/reasonable valuation
- Margin of safety using many metrics
- Reliable, transparent financial statements

Value Traps: Some Common Characteristics

- Cyclical and/or overly dependent on one product
- Hindsight drives expectations
- Marquis management and/or famous investor(s)
- Appears cheap using management's metric
- Accounting issues

Current Value Traps

- U.S. Shale Explosion
- National Oil Company
- Computing Revolution
- Digital Distribution
- Troubled National Balance Sheet
- Iron Ore Rush

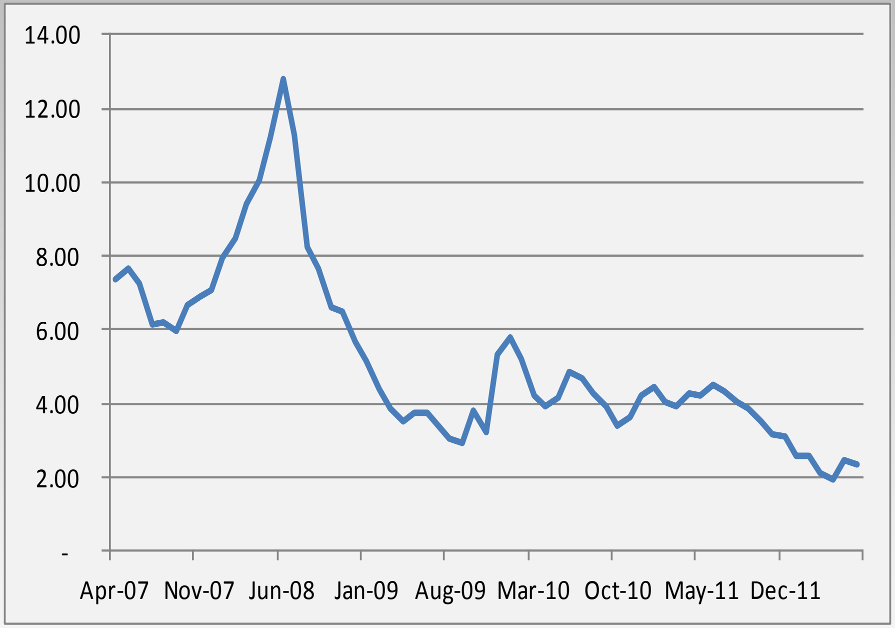
U.S. Shale Explosion: Cheap Gas at Coal's Expense

- Shale is a game-changer: U.S. is now 75% energy independent
- The rapid expansion of shale gas production capacity has led to record low prices
  - Henry Hub natural gas price around $2.60/mmBtu
    - Down 41% YoY
    - Over 75% below 2008 peak
  - Gas inventories are at record levels
- Shale production economics imply even lower natural gas prices
  - Cash operating costs of production are extremely low (less than $1.50/mmBtu in some cases)
  - At current natural gas prices, there is still little incentive to cut production
- Cheap natural gas leading to substitution from coal-fired power generation:
  - 1Q12 coal-fired electricity was down 21% YoY
  - 1Q12 gas-fired electricity was up 33% YoY
- Coal industry is feeling the heat
  - Domestic coal prices down 28-44% YoY
  - Coal train car loads down 11% YoY

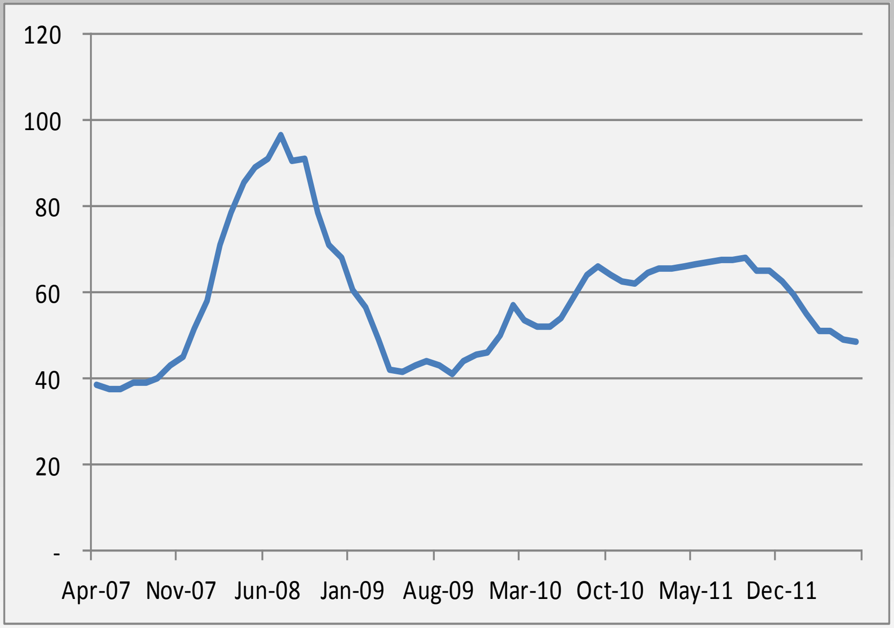
Sources: Bloomberg; EIA; AAR

US Shale Expansion: Cheap Gas at Coal's Expense

Natural Gas Price (Henry Hub $/mmBtu)

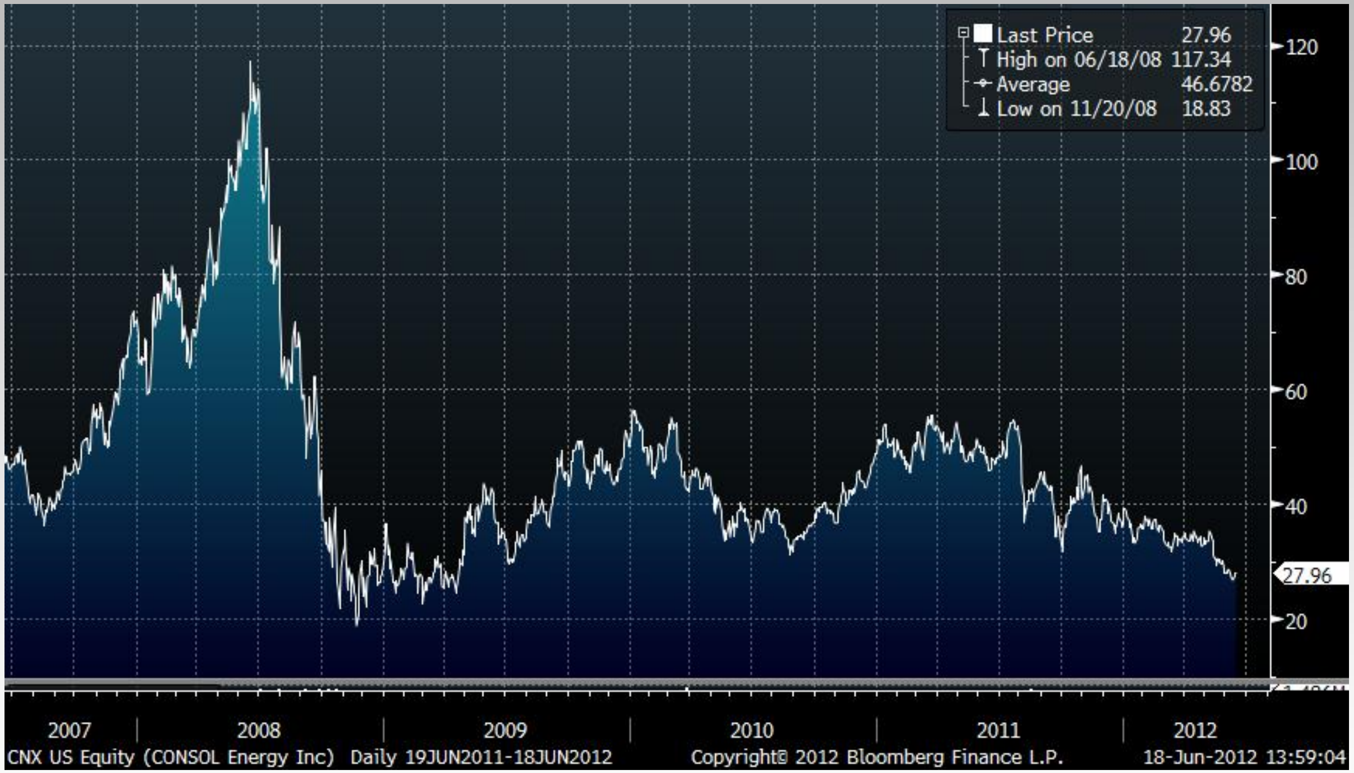


Thermal Coal Price (Northern Appalachia $/ton)



Source: Bloomberg

CONSOL Energy (NYSE: CNX)



Source: Bloomberg

CONSOL Energy (NYSE: CNX)

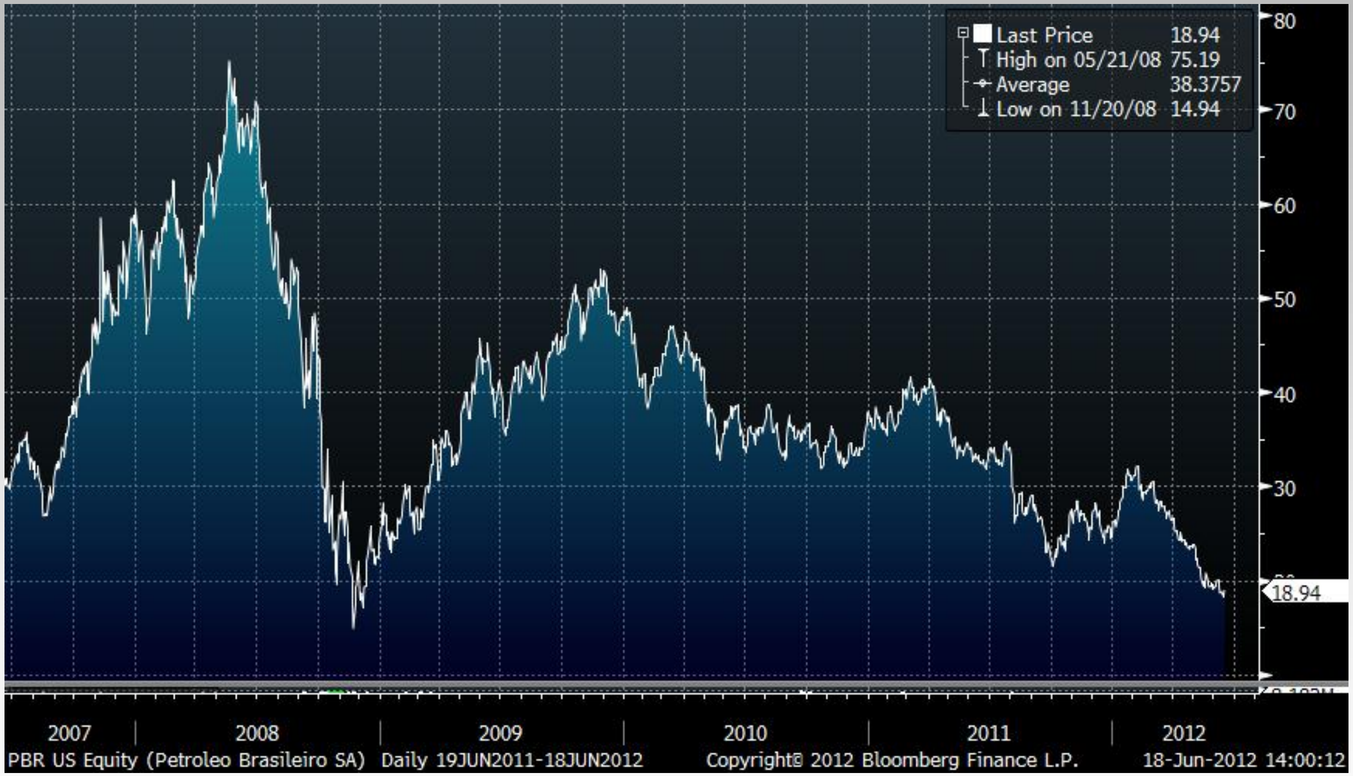
- The “value” story
  - Stock is down over 40% YoY
  - Earnings stream is “diversified”
  - Assets are “low cost” relative to peers
- CONSOL’s businesses face headwinds
  - Thermal coal, 61% of 1Q12 gross profit – pressure from coal-to-gas substitution
  - Metallurgical coal, 25% of 1Q12 gross profit – uncertain Chinese steel demand
  - Shale gas, 14% of 1Q12 gross profit – ongoing domestic overinvestment
- High cost assets relative to international peers
  - Thermal coal exports are competing with low-cost exporters from Australia, Indonesia, South Africa, Colombia
  - Metallurgical coal exports pressured as Australia returns to normalized levels
- Shale gas capital allocation raises concerns: over half of 2012 growth expenditures

Sources: Bloomberg; Company Filings; Note: gross contribution excludes freight, non-owned coal and other

National Oil Company: For the Benefit of the State?

- From China to Brazil, quasi-public is the new model for national oil companies
  - Step 1: Retain a majority stake
  - Step 2: Push ambitious and costly investment strategy
  - Step 3: Keep pump prices low to appease citizens
- China shows how it's done
  - Big three oil companies are theoretically public
  - Overpaying for overseas reserves
  - Downstream margins often negative
- Petrobras seen as a LatAm model
  - In Mexican election, politicians calling to IPO Pemex along similar lines
- Brazil remains a troubling prospect for outside investors
  - Chevron and Transocean face an $11B federal lawsuit and criminal charges for a tiny 3,000 barrel spill in Nov 2011
  - Infrastructure is ~2% of GDP – barely covering depreciation
  - Prosperity has bred complacency and reform has slowed

Petrobras (NYSE: PBR)



Source: Bloomberg

Petrobras (NYSE: PBR)

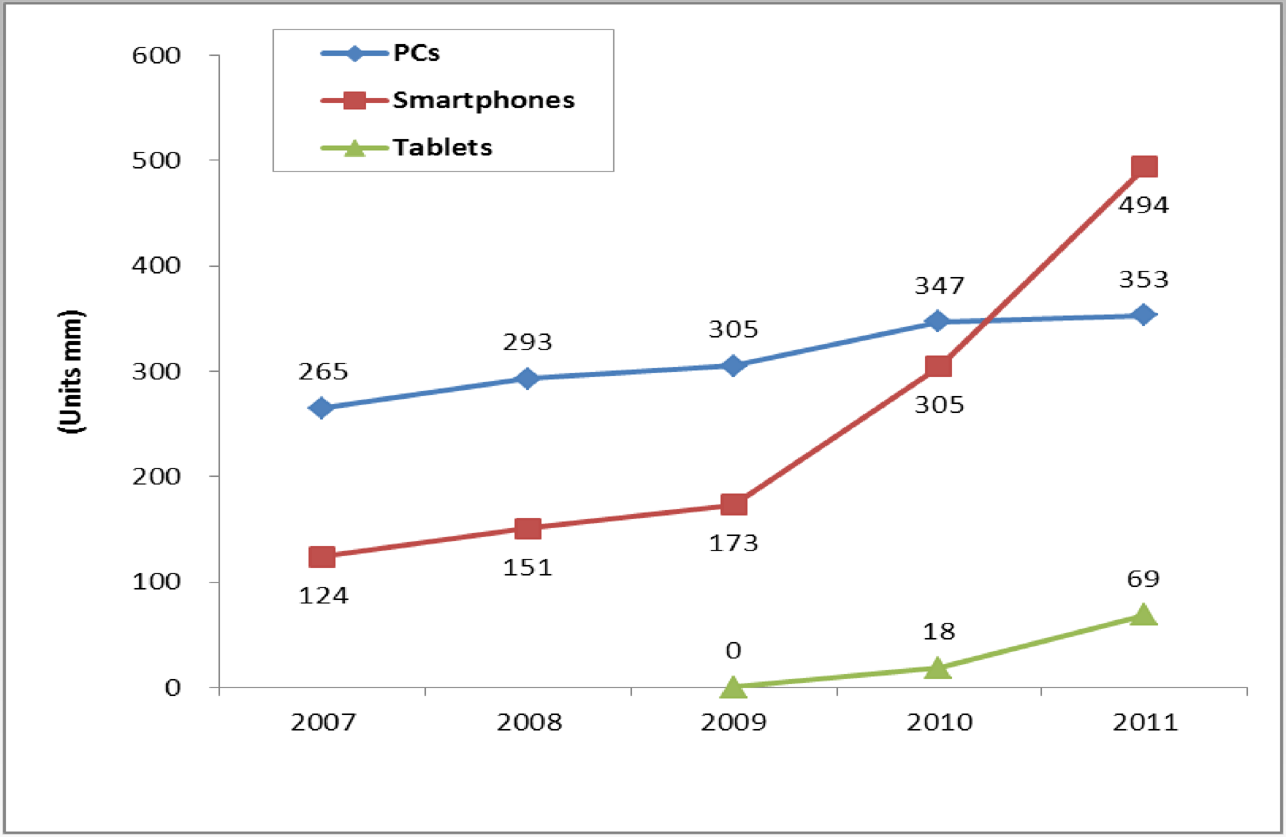
- The "value" story
  - Forward P/E of 8.2x, forward EV/EBITDA of 5.5x
  - Stock price is down more than 45% since January 2010
  - "Pre-salt" offshore oil discovery: the biggest find in Americas in a generation
- Huge capex program
  - $237B over 2012-16
  - Requires $15B of divestments and $85B in additional leverage
- Government intervention reduces inherent value
  - Push for local services:
    - PBR must incorporate 65% of content from local services industry
    - Brazil must construct a high-end shipbuilding industry from scratch
  - Downstream: Domestic fuel prices capped
  - Government domination of PBR
- Social engineering generates poor results
  - Upstream: production growth of 1.4% per year from 2006-11
  - Downstream: $6.6B EBITDA loss in 2011
  - $13B FCF outflow after dividends in 2011

Computing Revolution: Death of the PC?

- The proliferation of mobile devices pressures PC demand
  - Mobile devices have same key capabilities as PCs
  - Apple shipped more iPads in 4Q11 than the largest vendor shipped PCs
  - Shipments of mobile products increased by 79% YoY in 2011
  - Shipments of PCs increased by 2.9%
- Proliferation of mobile devices pressures PC margins
  - iPad bill of materials is ~40% lower than average PC
  - Microsoft's Surface tablet changes traditional Wintel / PC relationship
- Cloud services allow consumers to be device-agnostic
  - Eliminates need for PC as a mass storage device
  - Functionality migrating to the Cloud

Sources: Barclays, IDC, Gartner

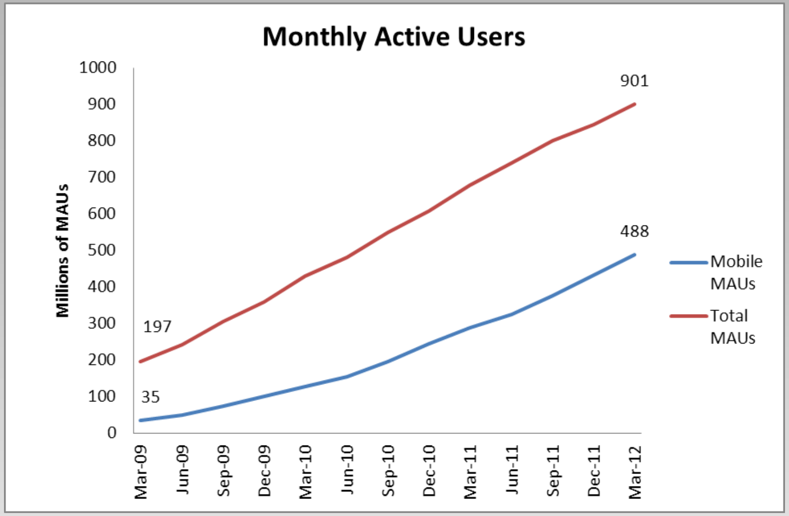
Computing Revolution: Death of the PC?



Source: IDC via Bloomberg

Computing Revolution: Social Media Goes Mobile

- Facebook user engagement is stronger amongst mobile users
  - Total Monthly Active Users (MAUs) at Mar 2012 are 901M, up from 197M in Mar 2009
  - Mobile MAUs at Mar 2012 are 488M, up from only 35M in Mar 2009
- According to comScore data, mobile users spend an average of 441 minutes on Facebook versus 391 minutes for users accessing via PC
- 83M Mobile MAUs access Facebook solely via mobile apps or the mobile website



"Growth in use of Facebook through our mobile products, where our ability to monetize is unproven, as a substitute for use on personal computers may negatively affect our revenue and financial results."

– Facebook Prospectus: Risk Factors

Sources: Facebook Prospectus, comScore

Hewlett-Packard (NYSE: HPQ)

Source: Bloomberg

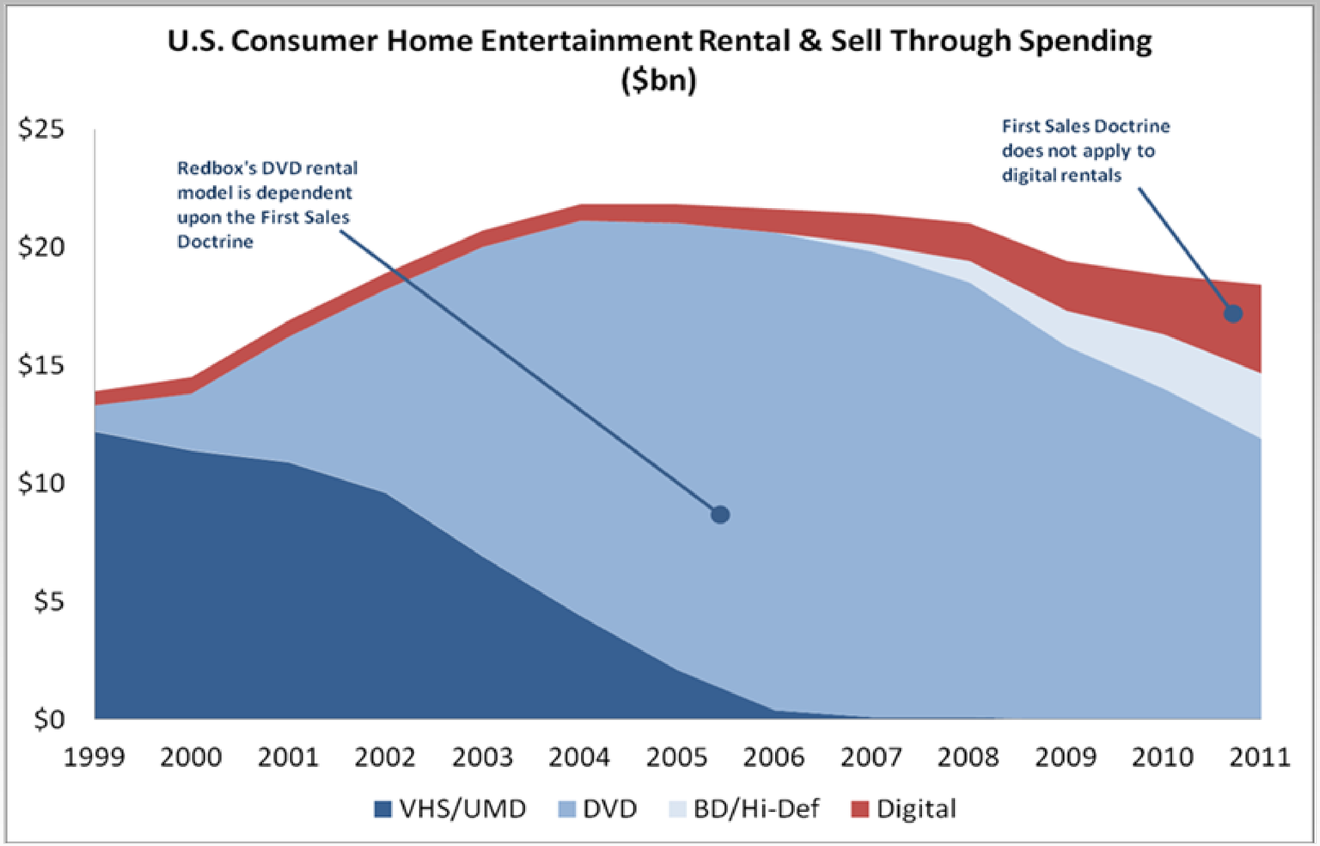
Hewlett-Packard (NYSE: HPQ)

- The “value” story
  - Forward P/E of 5.2x, forward EV/EBIT of 5.6x
  - FCF yield of 10.7% using LTM FCF before share-buybacks and acquisitions
  - $6.3B in share-buybacks and dividends in LTM, equal to 162% of FCF
- Growth through acquisitions has not paid off
  - $36.9B spent on acquisitions since 2007, equal to 82% of FCF
  - Despite acquisitions, LTM cash-flow from operations is 7% less than it was in 2007
  - Total debt at 1Q12 was $30B, up 70% from 1Q10
  - Acquisitions track record: Compaq impairment, EDS restructurings, Palm write-off, Autonomy revenue implosion
- HPQ’s businesses are struggling
  - PCs: LTM operating income down 5% YoY; cannibalization from mobile computing
  - Printers: LTM operating income down 28% YoY; fall in inkjet printing
  - IT services: LTM operating income down 23% YoY; lack of Itanium support from Oracle, falling government spending, competitive pressures
  - Servers/networking: LTM operating income down 19% YoY; fall in UNIX market
- Lack of strategy, as evidenced by 3 CEOs since 2006

Digital Distribution: Physical Media an Endangered Species?

- Twilight of the Gatekeepers
- Physical media retailers are being disaggregated
  - HMV – the last song
    - Unsuccessful diversification attempts to offset music declines
    - Shares at £0.04, down from 2005 peak of £2.73 – “cheap” throughout decline
  - Blockbuster – last of the chains
    - Unsuccessfully competed against DVD-by-mail service and online digital distribution
    - Bankruptcy filing September 2010
    - Continuously shrinking number of stores
- Video is undergoing digital transition
  - Proliferation of digital video distribution outlets, including over-the-top video on demand and streaming services like iTunes and Netflix
  - Proliferation of internet-ready televisions and mobile devices (e.g., tablets and smart phones) are accelerating the shift to digital video consumption

Digital Distribution: Physical Media an Endangered Species?



Source: The Digital Entertainment Group

Coinstar (NASDAQ: CSTR)

Source: Bloomberg

Coinstar (NASDAQ: CSTR)

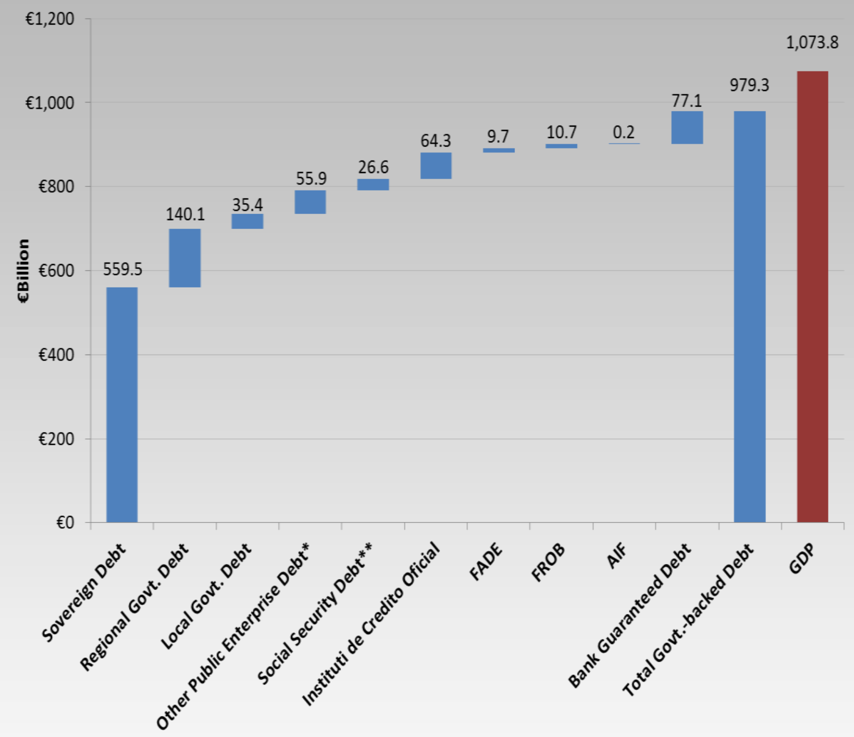
- The “value” story
  - EV to FY13e EBITDA of 4.0x versus 7.0x average over last 5 years
  - Over $7.50 TTM FCF/share in FY11
  - Redbox has been Coinstar’s growth engine
- Reaching saturation point
  - Over 68% of Americans now live within a five-minute drive from a Redbox kiosk
  - Including the acquisition of NCR’s DVD kiosks, Redbox will have 45-50K DVD kiosks in operation by YE12, or 39-44K single kiosk locations, which is near the low end of management’s full saturation estimate of 45K
- Coinstar resorts to unconventional ways to support Redbox growth
  - Recently raised rental DVD prices by 20% to $1.20/night
  - Digital joint venture with Verizon
  - Acquisition of NCR’s ~10,000 DVD kiosks
  - Partnership with Starbucks to roll out thousands of coffee kiosks over the ‘next several years’
- Redbox business model under pressure
  - Movie studios have implemented more onerous distribution windows
  - Implementation of credit card interchange fees will impact Redbox’s transaction-heavy business

Troubled National Balance Sheet: Banking on Spain

- Spain's fiscal house is in disarray
  - Unemployment rate at 24% continues to rise (youth unemployment at 51%)
  - Fiscal debt greater than consensus view
  - Austerity won't solve Spain's on-going economic woes
- Over-reliance on LTRO and ECB funding kicks can down the road
  - €288B in net ECB funding as of May 2012 (83% of total ECB lending)
  - Spanish banks purchased at least €86B in Spanish debt since November 2011
  - Regional government borrowings continue to climb (€140B at year-end 2011)
- Caja collapse adds to problem
  - Problematic loans forcing industry consolidation
  - Government guarantees and incentives required to complete consolidations
- Spanish real estate bubble still on the books
  - €296B of developer loans still outstanding
  - €50B of increased provisions only 17% of total required coverage

Troubled National Balance Sheet: Banking on Spain

Spain's 2011 Debt/GDP +90%, all in – not 60%



* Other central, regional and local public enterprises

** Other public enterprise debt as of 3Q11; govt.-backed bank debt as of April 10, 2012

Note: FADE = Fondo de Amortizacion del Deficit Electrico;

FROB = Fondo de Reestructuracion Ordenada Bancaria;

AIF = Administrador de Infraestructuras

Source: Bank of Spain, Bloomberg

Spain 5-Y CDS: Back at pre-LTRO levels

Source: Bloomberg

Banco Santander (SAN SM)

Source: Bloomberg

Banco Santander (SAN SM)

- The “value” story
  - Trading at P/TBV of 0.9x, P/E of 8.2x
  - Attractive exposure to Brazil
- Significant real estate exposure in Spain
  - Equates to 166% of TBV as of 1Q12
  - 33% of commercial real estate loans are classified as NPLs
  - Residential mortgage NPLs at 2.6% of portfolio
- Brazil exposure a headwind, not a panacea
  - Increased lending as NPLs rise
  - Provisions not keeping pace
- Capital remains an issue
  - Core Tier 1 capital ratio of 10% doesn’t reflect leverage of 27x TBV
  - Listed local bank structure traps capital

Iron Ore Rush: Fuel for China’s Bubble

- Leveraged to Chinese growth
  - Growth in iron ore demand is driven by China’s fixed asset investment boom
  - China’s share of global iron ore imports is 66% (2011) up from 51% (2007) [1]
- China’s credit-driven fixed-asset economy not sustainable
  - Recent signs of a slow down
  - Negative implications for Chinese steel consumption
  - Recent BHP comments consistent: “Steel growth rates will flatten and they have flattened.” – *Ian Ashby, President of BHP Iron Ore, March 20, 2012* [2]
- Iron ore extraction becoming more costly
  - Enormous investment in rail, port and energy facilities required
  - Steel, energy and labor cost inflation in key mining regions
  - Governments targeting the industry as a source of revenue and taxes

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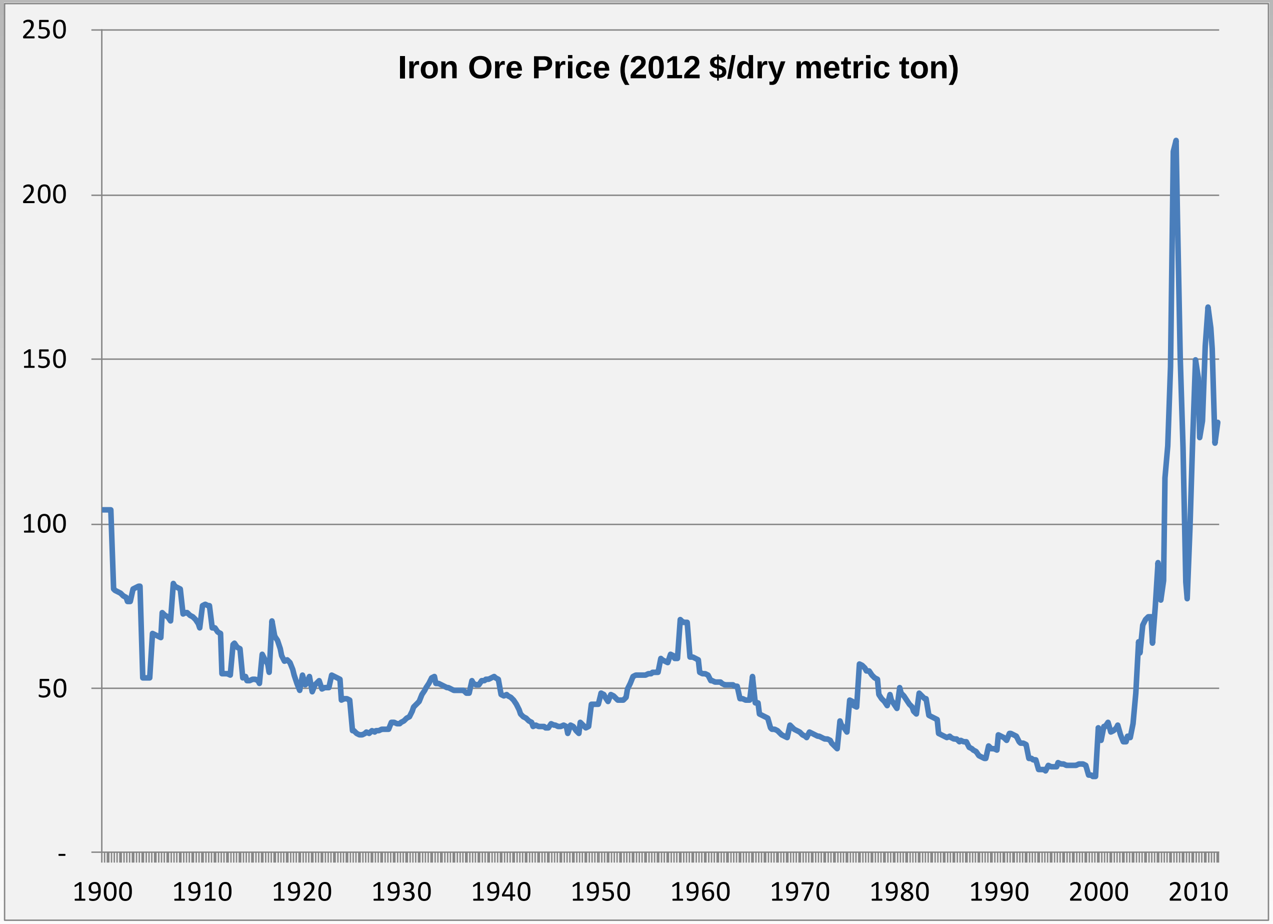
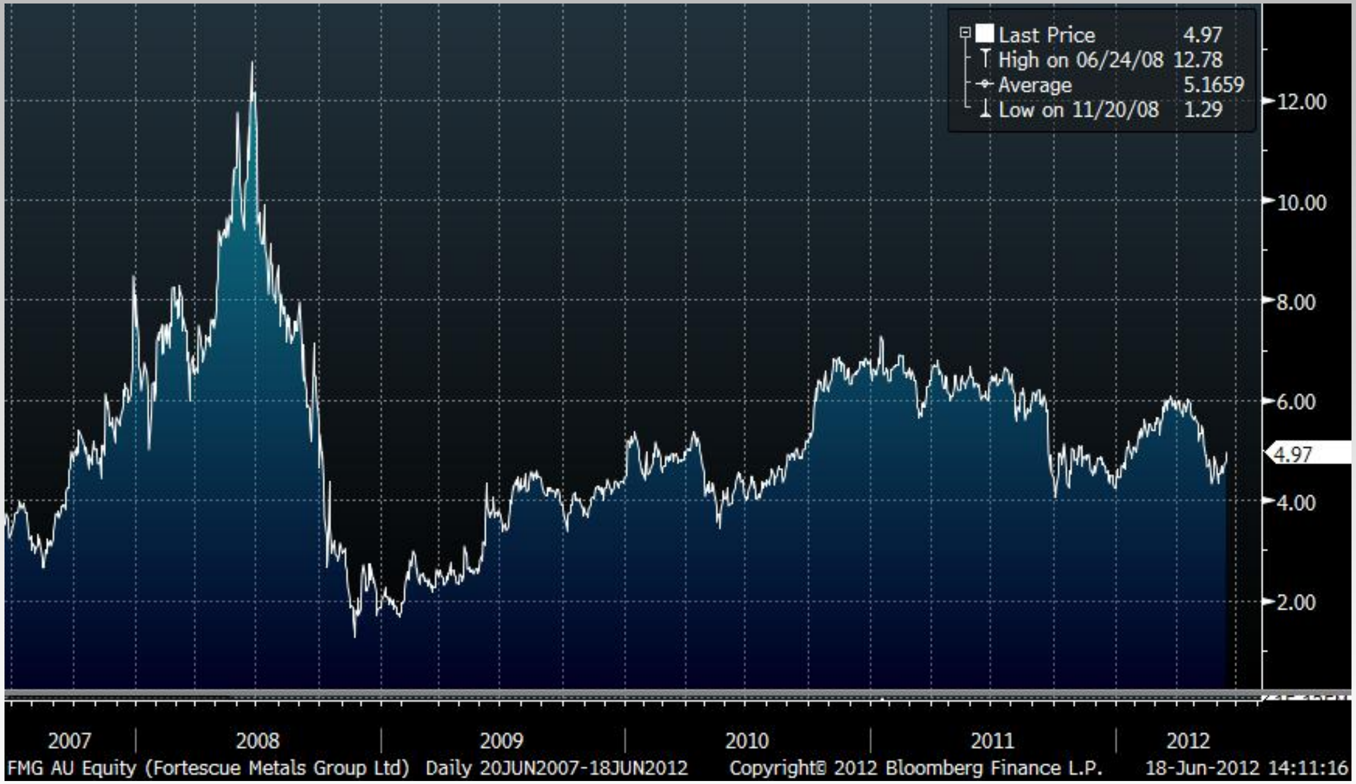
1 Macquarie
2 AJM Global Iron Ore & Steel Conference (March 20, 2012)

Iron Ore Rush: Fuel for China's Bubble



Source: Global Financial Data

Fortescue (ASX: FMG)



Source: Bloomberg

Fortescue (ASX: FMG)

- The “value” story
  - High operating cash flow margins (38% in 2011)
  - Key assets near the bottom of the industry cost curve
  - Plans to increase production capacity to155Mtpa from 55Mtpa by June 2013
- A highly leveraged bet on continued fixed asset investment growth in China
  - 98% of sales from China
  - High level of debt ($6.4B, year-end 2011) exposes company to iron ore price declines
- Cost inflation endemic in Western Australia’s Pilbara region
  - Shortages in labor, accommodation and transportation driving up costs
  - Increasing overburden removal required at existing mines
  - Cost inflation in dollar terms exacerbated by strong AUD currency
- Significant planned volume growth may create oversupply in the iron ore market
  - The four major iron ore producers are all pursuing significant expansions at a time when Chinese demand growth is flattening
  - Increases risk to Fortescue debt-financed expansion

Sources: Bloomberg; Company Filings

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