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Energy Margin Calls- Chesapeake CEO Forced To Sell All His Stock

Posted by Nate Hagens on October 11, 2008 - 10:50am
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As people following our energy situation are aware, many if not most energy stocks are down 60-70% or more from their summer highs. In a bizarre but not completely surprising announcement after the close (we knew someone was liquidating), Chesapeake, (the US largest natural gas producer) CEO Aubrey McClendon has been involuntarily liquidated out of his rougly 30,000,000 remaining shares of CHK in the past 3 days due to margin calls. CHK, which in July was over $70 per share, hit as low as $11.99 today, and then had a 38% rally to close at $16.52 on 5 times normal volume. We don't typically comment on individual stocks or price movements on TOD but this and related NG stock developments could have a significant impact on the industry's future - CHK and XTO in addition to being top 2 gas producers also operate over 12% of our nat gas rigs. In addition to McClendons margin call, Chesapeake also announced further reductions in capex budgets going forward which means lower natural gas production, and thus higher prices, ceteris paribus. To make things more complicated, the majority of complicated financial hedges undertaken by CHK, are at Morgan Stanley, which fell to single digits today. This is all very good news for natural gas prices but bad news for both Aubrey McClendon and the North American energy situation.

Mr. McClendon, who has been recently highlighted in national TV commercials about expanding future of natural gas usage as recently as July held 33,500,000 shares which at one point traded over $70 per share.

> "I am very disappointed to have been required to sell substantially all of my shares of Chesapeake. These involuntary and unexpected sales were precipitated by the extraordinary circumstances of the worldwide financial crisis. In no way do these sales reflect my view of the company’s financial position or my view of Chesapeake’s future performance potential. I have been the company’s largest individual shareholder for the past three years and frequently purchased additional shares of stock on margin as an expression of my complete confidence in the value of the company’s strategy and assets. My confidence in Chesapeake remains undiminished, and I look forward to rebuilding my ownership position in the company in the months and years ahead.”

This news was on top of an announcement to substantially reduce 2009 and 2010 capital expenditures (drilling).

Many (all?)natural gas companies stocks have been in freefall this week, though in hindsight that was perhaps fast money front running the rumour of margin calls on McClendon. But concerns about CHK were real, as pointed out in this Bloomberg story

> Investors are concerned that Chesapeake and other U.S. oil and gas producers have hedging contracts with financial firms and other counterparties that won't be able to pay for their output at the agreed-upon prices because of the global credit crisis, said Robert Goodof, who helps manage $25 billion at Loomis Sayles & Co. in Boston.
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> Chesapeake also has so-called knockout swap contracts on more than one-third of its 2009 production, and those deals don't obligate the buyers to take gas when prices drop to $6.28 per thousand cubic feet of the heating and power-plant fuel, according to analyst Joseph Allman of JPMorgan Chase & Co. in New York. U.S. gas futures dropped to $6.65 today and have plunged 50 percent since the end of June.
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> According to Allman, Morgan Stanley is Chesapeake's biggest counterparty. Morgan Stanley shares fell 39 percent, dropping for a fifth straight day, after Moody's Investors Service said it may cut the investment bank's credit rating.
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> Allman said that if gas falls to $6 per thousand cubic feet, Chesapeake would have to sell $3.5 billion of assets.
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> ``In our view, getting through 2009 is tough, but Chesapeake has a lot of non-producing assets it could sell and discretionary spending it could cut,'' Allman said.

Investors were ostensibly concerned about a natural gas train wreck if Morgan Stanley were to go under, that would cause Chesapeake to follow. I just can't imagine that happening. The government might let Chuck E Cheese go under, but not our largest natural gas producer and rig operator. I was thinking during the day that the financial types that were shorting Chesapeake and other nat gas companies into the ground (and buying Credit Default Swaps just like they did with Lehman and AIG) would pat themselves on the back for making good coin, then go home to find no heat, plastic bottles or diapers. Yet another juxtaposition of money and energy...But it becoming more clear that hedge fund margin liquidations are contributing to the equity sell-off. The margin clerks typically are instructed to start liquidating positions at 3pm if the account hasn't come up with margin - all week the volume in the days final hour dwarfed the trading earlier in the day. This has been a vicious cycle as banks are reducing leverage and increasing margin requirements for clients - more selloff equals more margin calls equals more selloff. Personally, I think its worse 'this time' *because* of the number and size of hedge funds, which became more popular after outperforming the bear market of 2000-2003. But I think we've seen 'peak hedge fund'.

Finally, as discussed 2 weeks ago after the first cap-ex cut by Chesapeake, the marginal cost of natural gas is over $8 per MCF, and the average cost being close to $6 in North America. Natural gas is on average getting more expensive to procure. Now that capital is less available, we are going to see more and more production cuts. We need to analyze what it really means - 5% drop? 15% drop? Aubrey McClendon has been seen on TV advocating the Pickens Plan to use natural gas as a vehicle fuel. I wonder if recent events will change the landscape of our natural gas industry and this plan. At prices during mid-day today, I was wondering if ExxonMobils $40 billion in cash (less $10 billion in debt they could just assume) might be put to work. The landscape has seemingly changed daily. I think even people who have never had an ecology class or never heard of theoildrum understand, or at least have an inkling, that natural gas and oil are more precious than dollar bills. Is it too early for nationalization of the energy industry?

Here are some previous TOD posts discussing the natural gas situation in North America, and although we have 'more' gas recently, it comes at higher costs:

An Update on the Energy Return on Canadian Natural Gas
At $100 Oil, What Can the Scientist Say to the Investor?
Ten Fundamental Truths about Net Energy
The North American Red Queen - Our Natural Gas Treadmill
A Net Energy Parable - Why is EROI Important?
Natural Gas and Complacency

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(EDIT: It seems that the contagion spread to CHKs financial twin, XTO, where it was just announced that their Chairman has been selling stock:

> XTO Energy Inc. (NYSE: XTO - News) announced today that during the past week Chairman and CEO Bob R. Simpson sold 2.8 million shares of XTO common stock. This sale satisfied all considerations for debt, personal interests and family liquidity. As a Company founder, Mr. Simpson continues to own 6.8 million shares of XTO and has options to purchase an additional 4.0 million shares.

Of equal concern is that CHK operates 130 rigs, and XTO 70, which is fully 1/8 of rigs drilling for natural gas. (1600)

And a bigger question is: *WHAT ARE THESE VERY WEALTHY PEOPLE DOING BUYING THEIR OWN STOCK ON MARGIN ?*
Having worked for a decade on Wall St, I know the answer to that, and the mechanisms underlying this behaviour are why I see our current situation as unsustainable, even if we were to find more gas and oil. The dopamine feedback loop for more, culturally defined, is nearly unstoppable.