



Case Study

## Houston Exploration Acquisition or Share Buyback?

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### The Proposal

In May 2006, the Board of Directors of Houston Exploration (THX) was presented with a choice. With even higher prices of energy on the horizon, expansion of the company's natural gas business seemed logical. On the other hand, a vocal minority of shareholders was calling for a share repurchase instead of a growth strategy. The activist shareholders, represented by the hedge fund Jana Partners, made the following points:

- An approximately \$650 million share repurchase will create significantly more shareholder value than using these proceeds to pursue long-lived onshore acquisitions in today's highly competitive M&A environment. As set forth in the attached analysis, we believe that the Company could repurchase approximately 37% of the outstanding shares (slightly less than 11 million shares) paying a 15% premium to the recent market price. This would be achieved by using estimated net cash proceeds of approximately \$520MM from the recent Louisiana Gulf of Mexico sale in addition to \$130 million of debt (leaving the Company with the same leverage ratio of approximately 1.0x estimated 2007 EBITDA that it had prior to paying down debt with the proceeds of the Texas Gulf of Mexico sale).
- The acquisition scenario yields significantly less EPS accretion -- only 14% compared to 45% in the buyback scenario.
- The Company should also implement a comprehensive hedging strategy. By doing so, the Company can place a "collar" on a significant portion of 2007 and 2008 natural gas volumes, which would be beneficial given that our projections are based upon the lower-end of what the Company would likely be able to secure as a floor on such a "collar" transaction. In other words, implementing a hedging program such as this would preserve significant commodity price upside while locking-in cash flows that already translate into a deeply discounted relative and absolute valuation.
- Given the Company's historical underperformance that the Board should explore possible strategic transactions to maximize value, including a potential sale. We believe there are numerous interested acquirers.
- A Board of Directors that "plays possum" in response to shareholder initiatives represents a fundamental misunderstanding of the relationship of a board to their shareholders. Shareholder demands for value maximization are not a threat to be avoided. Instead they are an opportunity to work collaboratively to achieve the best possible returns for the company's true owners, which is a board's highest duty.

### The Analysis

#### *Share Repurchase Scenario*

2007E EPS Impact assuming share repurchase	Current	Buyback	Pro Forma
Cash (including LA GOM proceeds after tax & hedge buyback)	\$520	(\$520)	\$0

Total Debt	\$424	\$130	\$554
Net Debt (Cash)	(\$96)	\$650	\$554
		assume 15% premium	
Share Price	\$52.75	\$61	\$52.75
Shares Outstanding	29.3	(11)	18.6
Equity Market Capitalization	\$1,546		\$981
Total Enterprise Value	\$1,451		\$1,535
2007E EBITDAX	\$522		\$522
EV/2007E EBITDAX	2.8x		2.9x
Proved Reserves (Bcfe pro forma for divestitures & acquisitions)	632		632
Proved Reserve Multiple (\$EV/Mcfe)	\$2.29		\$2.43
2007E EPS	\$6.67		\$9.64
P/E Ratio	7.9x		5.5x
<b>EPS Accretion</b>			<b>45%</b>

**Acquisition Scenario**

	Current	Acquisition*	Pro Forma
Capitalization			
Cash held in 1031 Account	\$590	(\$590)	\$0
Cash (excluding LA GOM proceeds)	\$20	\$0	\$20
Total Debt	\$424	\$0	\$424
Net Debt (Cash) - calculated using after tax LA GOM proceeds	(\$96)	\$590	\$404
Share Price	\$52.75		\$52.75
Shares Outstanding	29.3		29.3
Equity Market Capitalization	\$1,546		\$1,546
Total Enterprise Value	\$1,451		\$1,951
2007E EBITDAX	\$522	\$92	\$614
EV/2007E EBITDAX	2.8x	6.4x	3.2x
Proved Reserves (Bcfe pro forma for divestitures & acquisitions)	632.2	214.5	846.7
Proved Reserve Multiple (\$EV/Mcfe)	\$2.29	\$2.75	\$2.30
2007E EPS	\$6.67		\$7.62
P/E Ratio	7.9x		6.9x
<b>EPS Accretion</b>			<b>14%</b>

Source: JANA Partners LLC

**Notes and assumptions:**

1. We have assumed for purposes of this analysis that the Company would have to pay close to \$2.75/Mcfe (which is in fact below recent comparable transactions) for long-lived onshore assets.
2. We have also assumed an R/P ratio of 13 years for the acquired assets and a cost structure similar to the Company's existing onshore assets - so the EBITDAX multiple would also be at a substantial premium to the existing multiple.
3. Much of the accretion generated in the acquisition scenario is actually attributable to the removal of the large cash position from the balance sheet (which we assume would earn only a 2% return if it remained on the balance sheet).
4. The actual acquisition accretion would in fact likely be even lower given that such a transaction would carry much higher integration and execution risk, which is not fully discounted in our analysis.

**Questions:**

1. Do you agree with all the recommendations? Why or why not?
2. What other choices should the Board of Houston Exploration consider?

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