Siena Market Line
3rd week of April 2015

Chesapeake Energy Corporation

NYSE:CHK

Analyst: Ryan Ahlers
Sector: Energy

BUY

Price Target: $20.20

Key Statistics as of 4/14/2015

Market Price:	$15.11
Industry:	Oil and Gas E&P
Market Cap:	$10,117.2 M
52-Week Range:	$29.92 - $13.38
Beta:	1.19

Thesis Points:

- Improving margins and efficiency
- Increased insider purchases
- Increase demand in natural gas will fuel growth
- Improving financials: Cash balance and Liquidity

Company Description:

Chesapeake Energy Corporation is an oil and gas company engaging in the acquisition, exploration and development of oil, natural gas and natural gas liquids from underground reservoirs in the United States. Chesapeake is the second largest producer of natural gas and the 11th largest producer of oil and natural gas liquids in the United States and holds oil, natural gas and natural gas liquids asset fields in Louisiana, Ohio, Oklahoma, Pennsylvania, Texas and Wyoming, totaling to approximately 45,100 oil and natural gas wells. The company was founded in 1989 and is headquartered in Oklahoma City, Oklahoma.

Thesis

Chesapeake Energy Corporation is a company that has been greatly oversold over the past year, bringing it to a very attractive price. Chesapeake intends to continue cutting cost in an effort to become more efficient, improving their margins. Recently, there has been a lot of insider activity with insiders increasing their positions within the company, implying Chesapeake may have reached its bottom. Data is showing an increase in demand for natural gas in the future which will fuel revenue growth and demand for Chesapeake's natural gas resources. The company also has improving financials with an increased cash balance and liquidity.

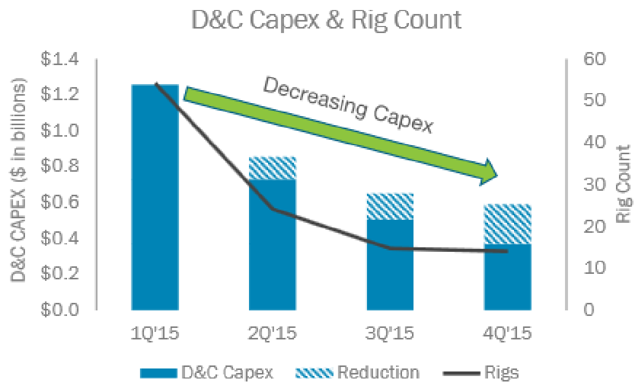
Industry Outlook

The energy sector and the industries within this sector are heavily influenced by the price of oil. Exploration and Production companies are most directly affected by commodity market prices. Over the past 9 months oil prices have plummeted from a high of about $100/barrel to a low of about $44/barrel and oil is at an approximate price of $55/barrel today. This volatility in the market and decrease in oil price puts stress on oil related companies, specifically companies that cannot pay their interest payments. Going forward, it is unclear whether oil prices will decrease further or if the floor has been hit and prices will continue to rebound. Below is the WTI Crude historical price chart starting in mid-2014.

Improving Margins and Efficiency

With the downturn in the commodity market Chesapeake Energy has had to reevaluate the way they operate in an attempt to improve margins and efficiency in the current price market.

Similar with most Exploration and Production companies, the first major step Chesapeake took was to decrease capital expenditure costs. Chesapeake, in total, decreased CAPEX spending by 18% in 2014 to approximately $4.54 billion when compared to 2013 and if acquisitions are excluded, capital expenditures were decreased by 23% when compared to 2013.

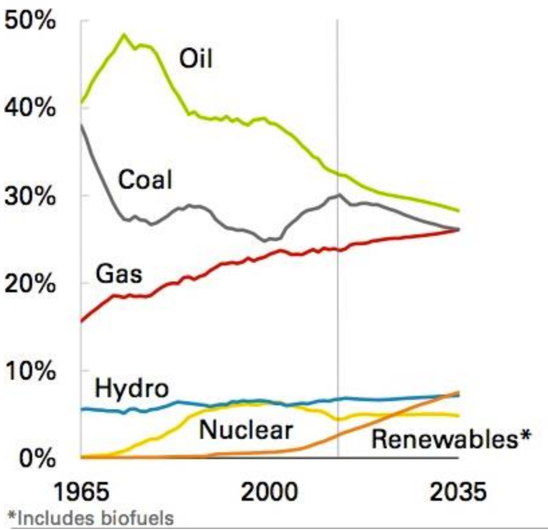


Along with CAPEX cuts, Chesapeake is implementing other cost saving techniques throughout the firm. For example, Executive Vice President and CFO Domenic J. Dell'Osso Jr. states, "As the year progresses, we believe that oilfield service cost reductions will become more apparent, and, as such, we are building in an estimate of around 10% in service cost savings for 2015 before any capital efficiency improvements by our operating teams." As well, Chesapeake's production expenses, production taxes, G&A expense and net interest expense decreased to 7.56 per boe in the fourth quarter of 2014, a decrease of 8% year-over-year.

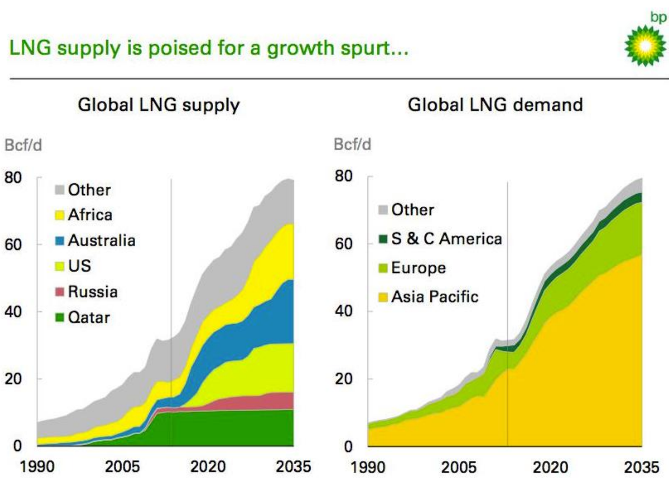
Chesapeake Energy is also implementing operating efficiencies into the company in an effort to perform better in the current pricing market. Since 2012, Chesapeake has improved their capital efficiency from 30% to 60% in each of their major operating areas, driving hundreds of millions out of their associated well costs. This increased focus on efficiency has reduced their drilling and completion expenditures by nearly $1 billion when comparing today's current levels to 2013 levels. The decrease in costs and increase in efficiency should result in Chesapeake's margins to increase, adding value to the firm and shareholders.

Increase Demand in Natural Gas

Chesapeake Energy is the second largest producer of natural gas in the United States. Natural gas is currently the fastest growing fossil fuel with a demand forecasted to increase at a rate of 1.9%/year over the next two decades, according to McGraw Hill Financial. Natural Gas is expected to gain the most market share against all forms of energy over the next two decades, almost reaching market share levels of oil and coal. This can be seen in the table below which was constructed by BP.



Even more specifically, the demand for natural gas is expected to increase tremendously in Asia and Europe over the next two decades. The United States natural gas producers are forecasted to be approximately 20% of the supply for this demand. This can be seen in the table below which was constructed by BP.



With Chesapeake Energy being the second largest natural gas producer in the U.S and the demand for natural gas expected to increase worldwide, Chesapeake and their shareholders will benefit. Chesapeake has the ability to increase their supply of natural gas when needed in the future. President and CEO Robert D. Lawler states, "This company has one of the best gas portfolios in the entire world. And our ability to increase gas production from these world class shale – gas assets is just unbelievable…We've noted that from the existing asset base, we have the capability to grow these assets to a million barrels equivalent per day inside a five-year timeframe." This increase in demand will act as a direct value driver for the company, increasing their revenue every year that there is more demand for their natural gas.

Increased Insider Purchases

Recently, there has been an increase in insider purchasing activity for Chesapeake Energy. The purchasing of shares by insiders in a company is notoriously known as positive news. The idea is that the management team, executives and directors have the most up to date relevant information on their companies' future. It can also be viewed as the companies' insiders feel the current stock price is extremely cheap/undervalued and a great buying opportunity. With that being said, Director Dunham Archie W recently purchased 1 million shares of Chesapeake on 3/27/2015, approximately a $14 million purchase. The total percent change in insider positions has increased 17.58% over the last six months.

Although not an insider, a notable shareholder that increased their position in Chesapeake Energy is Carl Icahn. Carl Icahn has increased his stake in Chesapeake to a total of 11%, up from 10%, purchasing 6,600,000 shares to a total of 73,050,000 shares on 3/23/15.

Improving Financials

Over the past year Chesapeake's financials have drastically improved. During the 4th quarter of 2014 they underwent the divestiture of their Southern Marcellus shale and Eastern Utica shale assets for approximately $5 billion, increasing their cash holdings dramatically. The sale of the assets represented only 7% of the companies' total production and gave Chesapeake a cash holding of approximately 40% of their market capitalization, a high-quality and industry leading ratio. It will be interesting to see what management plans on doing with all the cash that they now have. Management has hinted towards the possibility for acquisitions or altering their capital structure.

Chesapeake has also been granted an unsecured $4 billion credit facility for the first time in the company's history. Related, Chesapeake has received a two-notch upgrade from Moody and S&P, bringing them to one level below investment grade at both rating agencies. The combination of a high cash account and the credit facility makes Chesapeake more liquid than they have ever been. Executive Vice President and CFO, Domenic J. Dell'Osso, Jr., simply states, "With over $4 billion of cash on hand at the end of the year, nothing drawn on our credit facility, and a net debt to capitalization ratio of around 29%, we are in excellent position to weather this current price environment and take advantage of opportunities to add shareholder value."

Conclusion

Chesapeake Energy is currently in a very unique position that makes their share price undervalued. Since the addition of their new CEO Robert D. Lawler in June 2013 Chesapeake has had a new emphasis on efficiency and increasing shareholder value. With the increase in efficiency, shareholders can expect an increase in the companies margins. Many shareholders, especially insiders, have realized the potential of Chesapeake at their current low price which has increased shareholder purchases. Macro-economic conditions for Chesapeake could not be better with natural gas demand expected to increase 1.9%/year over the next two decades, fueling revenue growth, a true value driver. As well, Chesapeake Energy has never been in a better financial position with the largest cash balance they have ever had, approximately $4 billion, and a credit facility, $4 billion, a high amount of liquidity to survive the low commodity market. All of these things will add value to Chesapeake's share price, making them undervalued. For these reasons Chesapeake Energy Corporation is a BUY.

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Chesapeake Energy Corporation	chk	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	Target Return	BULLISH
		Ryan Ahlers	$15.25	$18.94	$20.22	2%	1-y Return: 34.79%	

General Info

Sector	Energy
Industry	Oil, Gas and Consumable Fuels
Last Guidance	Feb-25-2015
Next earnings date	5/6/2015

Market Data

Enterprise value	$21,955.21
Market Capitalization	$10,117.21
Daily volume	15.48
Shares outstanding	663.42
Diluted shares outstanding	772.00
% shares held by institutions	88.30%
% shares held by insiders	1.14%
Short interest	20.43%
Days to cover short interest	6.69
52 week high	$31.49
52-week low	$13.38
5y Beta	1.24
6-month volatility	56.53%

Peers	Market Cap.
Devon Energy Corporation	$27,059.44
Anadarko Petroleum Corporation	$46,820.78
Apache Corp.	$26,308.32
Southwestern Energy Co.	$9,744.72
Noble Energy, Inc.	$20,074.22
Pioneer Natural Resources Co.	$26,309.77
Range Resources Corporation	$9,584.68

Current Capital Structure

Total debt/market cap	114.48%
Cost of Borrowing	0.83%
Interest Coverage	1.3x
Altman Z	1.35
Debt Rating	A
Levered Beta	1.63
WACC (based on market value weights)	6.80%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Lawler, Robert	Chief Executive Officer, President :	$0	$22,423,367	$14,677,377
Dell'Osso, Domenic	Chief Financial Officer and Executi	$7,354,481	$10,484,468	$4,859,383
Webb, James	Executive Vice President, General (	$0	$0	$4,755,185
Pigott, Mikell	Executive Vice President of Operat	$0	$6,052,473	$4,121,085
Doyle, M.	Executive Vice President of Operat	$0	$6,225,869	$4,174,862
Johnson, Michael	Chief Accounting Officer, Senior V	$0	$0	$0

Historical Median Performance

	chk	Peers	Industry	All U.S. firms
Growth	183.6%	12.4%	14.2%	7.4%
ROIC	7.8%	8.4%	16.6%	14.3%
NOPLAT Margin	16.1%	22.2%	15.6%	10.4%
Revenue/Invested Capital	0.49	0.38	1.06	1.37
Excess Cash/Rev.	-3.6%	19.4%	13.5%	12.9%
Total Cash /Rev.	3.0%	19.7%	12.3%	15.2%
Unlevered Beta	0.74	0.90	1.01	0.95
TEV/REV	2.9x	3.9x	5.6x	2.5x
TEV/EBITA	8.4x	17.5x	15.9x	13.1x
PE (normalized and diluted EPS)	6.8x	19.6x	24.7x	23.5x
P/BV	1.0x	1.8x	2.5x	2.2x

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS
Last Quarter	12.8%	-16.2%	-52.2%
Last Quarter-1	25.0%	2.7%	18.8%
Last Quarter -2	9.4%	-2.5%	-18.2%
Last Quarter -3	12.7%	9.1%	22.9%
Last Quarter -4	3.3%	-9.4%	-30.8%

Non-GAAP Adjustments in estimates computations

Operating Leases Capitalization	100%	Straightline	10 years
R&D Exp. Capitalization	100%	Straightline	10 years
Expl./Drilling Exp. Capitalization	100%	Straightline	10 years
SG&A Capitalization	0%	N/A	N/A

Proforma Assumptions

Money market rate as of today	0.58%
Annual increase (decrease) in interest rates	0.1%
Yield Spread accelaration	1.2
Marginal Tax Rate	31.2%
Risk-Free rate	2.6%
Tobin's Q	0.80
Op. Cash/Rev.	7%
Growth in PPE	NPPE Growth follows Revenue Growth
Long term Growth	4.0%
Base Year Unlevered Beta	is equal to 0.9
Long term Unlevered Beta	1.01

Forecast

Period	Rev. Growth	Adj. Op. Cost/Rev	Invested Capital	NOPLAT Margin	ROIC	WACC
LTM	19.7%	68.7%	$27,144.57	12%	9.2%	6.8%
NTM	-26.0%	68.0%	$29,210.83	10%	5.8%	7.3%
NTM+1	2.5%	67.8%	$31,184.10	9%	4.8%	7.5%
NTM+2	5.0%	67.2%	$32,679.90	9%	4.7%	7.8%
NTM+3	17.0%	66.7%	$35,845.41	10%	6.2%	8.1%
NTM+4	10.0%	66.1%	$37,649.76	11%	6.8%	8.4%
NTM+5	8.0%	65.5%	$39,244.38	12%	7.5%	8.6%
NTM+6	6.0%	64.9%	$40,663.38	13%	8.0%	8.9%
NTM+7	5.0%	64.4%	$41,865.60	13%	8.5%	9.1%
NTM+8	2.0%	63.8%	$43,270.77	14%	8.6%	9.3%
Continuing Period	2.0%	63.2%	$36,534.32	12%	10.0%	9.4%

Valuation

Period	Invested Capital x (ROIC-WACC)	Total Debt	Other non-interest bearing claims	Shares Outstanding
LTM	$0.00	$11,582.00	$1,783.51	663.42
NTM	-$395.27	$11,582.00	$3,682.69	663.42
NTM+1	-$787.07	$11,825.30	$4,341.91	663.42
NTM+2	-$964.90	$11,825.30	$4,116.62	663.42
NTM+3	-$625.02	$11,825.30	$4,349.81	663.42
NTM+4	-$559.41	$12,450.70	$3,718.20	663.42
NTM+5	-$420.64	$12,639.10	$2,943.24	663.42
NTM+6	-$328.16	$12,639.10	$1,861.83	663.42
NTM+7	-$237.91	$12,639.10	$260.04	663.42
NTM+8	-$286.56	$12,639.10	-$1,288.44	663.42
Continuing Value	$3,950.31			

Pricing Model

DCF (Weight = 100%)	Relative (Weight = 0%)	Distress (Weight = 0%)	Weighted Average Price Per Share
$19.95	$73.37	$22.71	$19.95
$20.99	$35.84	$22.85	$20.99
$23.79	$35.12	$24.77	$23.79
$27.79	$38.58	$27.46	$27.79
$32.96	$54.80	$31.97	$32.96
$37.98	$68.14	$36.18	$37.98
$42.53	$80.32	$40.03	$42.53
$47.56	$92.99	$44.42	$47.56
$52.91	$107.29	$49.59	$52.91
$56.82	$114.88	$55.57	$56.82

Monte Carlo Simulation Assumptions

	Base	Stdev	Min	Max	Distribution
Revenue Variation	0	10%	N/A	N/A	Normal
Op. Costs Variation	0	10%	N/A	N/A	Normal
Country Risk Premium	7%	N/A	5%	7%	Triangular
Long term Growth	4%	N/A	3%	184%	Triangular

Monte Carlo Simulation Results

	Intrinsic Value	1y-Target
Mean est.	$19.95	$20.99
σ(ε)	$0.32	$0.25
3 σ(ε) adjusted price	$18.99	$20.24
Current Price	$15.25	
Analysts' median est.		$19.32