CHESAPEAKE ENERGY CORP
Form 424B2
January 07, 2004
Table of Contents

The information in this prospectus supplement is not complete and may be changed. This prospectus supplement and accompanying prospectus are not an offer to sell these securities and they are not soliciting an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

Filed Pursuant To Rule 424(b)(2)

Registration No. 333-109657

Subject to Completion, dated January 7, 2004

PROSPECTUS SUPPLEMENT

(To Prospectus dated October 23, 2003)

20,000,000 Shares

Chesapeake Energy Corporation

Common Stock

Our common stock is listed on the New York Stock Exchange under the symbol CHK. On January 6, 2004, the last reported sale price of our common stock was $13.73 per share.

Investing in our common stock involves risks. Supplemental Risk Factors begin on page S-9 *of this prospectus supplement and* *Risk Factors* *begin on page 2 of the accompanying prospectus.*

	Per Share	Total
Public Offering Price	$	$
Underwriting Discount	$	$
Proceeds to Chesapeake (before expenses)	$	$

The underwriters have an option to purchase up to an additional 3,000,000 shares of common stock on the same terms and conditions as set forth above to cover over-allotments.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved these securities or determined if this prospectus supplement or the prospectus to which it relates is truthful or complete. Any representation to the contrary is a criminal offense.

Lehman Brothers, on behalf of the underwriters, expects to deliver the shares on or about January , 2004.

Joint Book-Running Managers

LEHMAN BROTHERS
BANC OF AMERICA SECURITIES LLC
CITIGROUP
MORGAN STANLEY

BEAR, STEARNS & CO. INC.
CREDIT SUISSE FIRST BOSTON
DEUTSCHE BANK SECURITIES
RAYMOND JAMES

HOWARD WEIL INCORPORATED
JOHNSON RICE & COMPANY, L.L.C.
RBC CAPITAL MARKETS
SIMMONS & COMPANY INTERNATIONAL

January , 2004

Table of Contents

TABLE OF CONTENTS

You should rely only on the information contained in or incorporated by reference in this prospectus supplement and the accompanying prospectus. We have not authorized anyone to provide you with different information. We are not making an offer of these securities in any state where the offer is not permitted. You should not assume that the information contained in or incorporated by reference in this prospectus supplement or the accompanying prospectus is accurate as of any date other than the dates of this prospectus supplement or the accompanying prospectus or that any information we have incorporated by reference is accurate as of any date other than the date of the document incorporated by reference.

Table of Contents

PROSPECTUS SUPPLEMENT SUMMARY

This summary highlights selected information from this prospectus supplement and the accompanying prospectus, but may not contain all information that may be important to you. This prospectus supplement and the accompanying prospectus include specific terms of this offering, information about our business and financial data. We encourage you to read this prospectus supplement, the accompanying prospectus and the documents incorporated herein and therein in their entirety before making an investment decision. Unless otherwise indicated, this prospectus supplement assumes no exercise of the underwriters over-allotment option.

Chesapeake

We are among the ten largest independent natural gas producers in the United States, owning interests in over 14,500 producing oil and gas wells. We believe that our internally estimated year-end 2003 proved reserves will exceed 3.4 tcfe, after giving pro forma effect to our recently announced pending acquisitions, including that of Concho Resources Inc. Approximately 89% of our pro forma proved reserves are natural gas, and approximately 79% of our pro forma proved reserves are located in our primary operating area the Mid-Continent region of the United States, which includes Oklahoma, western Arkansas, southwestern Kansas and the Texas Panhandle. We are building secondary operating areas in the Permian Basin region of western Texas and eastern New Mexico and in the onshore south Texas and Texas Gulf Coast regions.

On December 22, 2003, we announced that we had entered into agreements to acquire oil and natural gas assets located in the Permian Basin region, the Mid-Continent region and in the onshore Gulf Coast region for an aggregate purchase price of $510 million. We believe these acquisitions will add an internally estimated 320 bcfe to our proved reserves and approximately 70 mmcfe to our daily production. These acquisitions consist of agreements to acquire privately-owned Concho Resources Inc. for $420 million and two smaller property acquisitions totaling $90 million. Through these three acquisitions, we believe we are acquiring high-quality assets, distinguished by proved reserves that are 75% gas and 67% proved developed and with a reserve-to-production index of approximately 12.5 years. We believe these properties will provide substantial opportunities for additional drilling and improvement of operational efficiencies. These assets complement and significantly expand our existing Permian Basin and onshore Gulf Coast assets. We have closed the smallest of the three acquisitions, and we expect to close the Concho acquisition and the other acquisition by January 31, 2004. There is no assurance that these pending acquisitions will be completed or that our internal estimates of the reserves being acquired will prove correct.

On October 31, 2003, we acquired Laredo Energy, L.P. and its partners interests in certain assets in the Lobo Trend in Zapata County, Texas for approximately $200 million, which added an internally estimated 108 bcfe to our estimated proved reserves and approximately 30 mmcfe to our daily production. We believe we acquired a high-quality asset base from Laredo, distinguished by proved reserves that are 100% gas and 32% proved developed and with a reserve-to-production index of approximately 10 years. We believe the acquisition of these relatively shorter-lived, less-developed properties complements our base of longer-lived, more developed Mid-Continent assets and provides substantial opportunities for additional drilling and exploration activities. There is no assurance that our estimates of the acquired Laredo reserves will prove correct.

We intend to use the net proceeds from this offering to finance a portion of the pending acquisitions discussed above. If we are unable to complete one of these acquisitions, we will use the net proceeds from this offering for general corporate purposes, including the repayment of debt or other possible future acquisitions. Please read Use of Proceeds.

Our executive offices are located at 6100 North Western Avenue, Oklahoma City, Oklahoma 73118, and our telephone number is (405) 848-8000.

Table of Contents

Business Strategy

From our inception in 1989, our business goal has been to create value for our investors by building one of the largest onshore natural gas resource bases in the United States. Since 1998, our business strategy to achieve this goal has been to build a dominant operating position in the Mid-Continent region, the third largest gas supply region in the U.S. In building our industry-leading position in the Mid-Continent, we have integrated an aggressive and technologically advanced drilling program with an active property consolidation program that has focused on corporate and property acquisitions of up to $500 million. We have now started to build secondary regions of importance in the Permian Basin and in the onshore south Texas and Texas Gulf Coast regions, areas to which we believe significant elements of our successful Mid-Continent strategy can be transferred. Key elements of our business strategy are further explained below:

Consistently Making High-Quality Acquisitions. Our acquisition program is focused on small- to medium-sized acquisitions of natural gas properties, primarily in the Mid-Continent, that provide high-quality, long-lived production and significant drilling opportunities. Since January 1, 2000, we have acquired, or signed agreements to acquire, $2.7 billion of such properties (largely through 24 separate transactions of greater than $10 million each) at an estimated average cost of $1.26 per mcfe of proved reserves. The vast majority of these acquisitions either increased our ownership in existing wells or fields or added additional drilling locations in our primary Mid-Continent operating area, or more recently in our secondary operating areas. We believe our recent and pending acquisitions, including Laredo and Concho, are significant steps in building a meaningful presence in these secondary operating areas. Because our primary and secondary operating areas contain many small companies seeking liquidity and larger companies seeking to divest non-core assets, we expect to find additional attractive acquisition opportunities in the future.

Consistently Growing Through the Drillbit. One of our most distinctive characteristics is our ability to increase reserves through the drillbit. We are currently conducting one of the three most active drilling programs in the United States with our program focused on finding significant new gas reserves, primarily in the Mid-Continent. We currently have 37 rigs drilling and 10 other rigs in transit or under contract on Chesapeake-operated prospects, and we are participating in approximately 40 wells being drilled by others. In the Mid-Continent, our drilling program is the most active in the region and is supported by our ownership of an extensive land and 3-D seismic base. We are continuing to increase our drilling activity in our secondary operating areas and we have recently increased our drilling, land and seismic budgets to accommodate greater activity in these areas. Across the company s operating areas, we seek a balanced approach to drilling with approximately one-third of our expenditures focused on targets located at depths shallower than 10,000 feet, one-third on medium depth drilling between 10-15,000 feet and one-third targeting deeper objectives below 15,000 feet.

Consistently Focusing on Building Regional Scale. We believe one of the keys to success in our industry is building significant operating scale in a few core areas. Achieving such scale provides many benefits, the most important of which are lower per unit operating costs, higher per unit revenues, greater rates of drilling success, a lower likelihood of making unsuccessful acquisitions and higher returns on invested capital. We first began pursuing this strategy in the Mid-Continent in 1997. We now believe we are the largest natural gas producer, the most active driller and the most active acquirer of undeveloped leases and producing properties in the Mid-Continent. We believe this region, which trails only the Gulf Coast and Rocky Mountain basins in U.S. gas production, has many attractive characteristics. These characteristics include long-lived natural gas properties with relatively predictable decline curves; multi-pay geological targets that decrease drilling risk, resulting in our historical Mid-Continent drilling success rate of approximately 93% over the past ten years; favorable basis differentials to benchmark commodity prices; generally lower service costs than in more competitive or more remote basins; and a favorable regulatory environment with virtually no federal land ownership. We believe our secondary operating areas possess many of these same favorable characteristics.

Table of Contents

Consistently Focusing on Low Costs. By minimizing lease operating costs and general and administrative expenses, we have been able to deliver attractive financial returns through all phases of the commodity price cycle. We believe our low cost structure is the result of our management s effective cost-control programs, our high-quality asset base and the extensive and competitive services, gas processing and transportation infrastructures that exist in our key operating areas. We believe our recent acquisitions will maintain our low per unit operating and administrative costs because of our existing large scale of operations and the reimbursements we will receive from third parties in the approximately 900 wells we will assume operations of after the transactions close.

Consistently Improving our Capitalization. We have made significant progress in improving our balance sheet since the beginning of 1999. Upon completion of this offering, we will have increased our stockholders equity by $2.2 billion through a combination of earnings and common and preferred equity issuances during the past five years. As of December 31, 1999, our debt to total capitalization ratio was 129%. As of September 30, 2003, after giving pro forma effect to this offering and the application of the net proceeds from this offering, and giving effect to our recently completed tender offer for our 8.5% Senior Notes due 2012, this ratio would have been 54%. We plan to continue making the reduction of the debt to total capitalization ratio one of our primary financial goals.

Based on our view that natural gas has become the fuel of choice to meet the growing demand for a clean-burning, domestically-produced fuel, we believe our focused natural gas acquisition, exploitation and exploration strategy should provide substantial growth opportunities in the years ahead. Although U.S. gas production has been declining during the past three years, we have increased our natural gas production in each of the 14 years since our inception in 1989. Our goal is to increase our overall production by 10% to 15% per year, with an estimated one-third of this growth generated organically through the drillbit and the remainder through our acquisitions. We have reached or exceeded this overall production goal in eight of our ten years as a public company.

Company Strengths

We believe the following six characteristics highlight our most important company strengths, distinguish our company from other independent natural gas producers and help explain our company s track record of delivering value to shareholders during the past ten years and especially the past five years:

High-Quality Asset Base. Our producing properties are characterized by long-lived reserves, established production profiles and an emphasis on natural gas. Based upon current production and reserve levels (pro forma for the Laredo, Concho and other recent and pending acquisitions discussed in this prospectus supplement), our proved reserves-to-production ratio, or reserve life, is approximately 10.6 years. In each of our operating areas, our properties are concentrated in locations that enable us to establish substantial economies of scale in drilling and production operations and facilitate the application of more effective reservoir management practices. We intend to continue building our asset base in each operating area through a balanced approach of acquisitions, exploitation and exploration.

Low-Cost Producer. Our high-quality asset base, our management style and our location in Oklahoma City have enabled the company to achieve a low operating and administrative cost structure. During the first three quarters of 2003, our cash operating costs per unit of production were $0.90 per mcfe, which consisted of general and administrative expenses of $0.09 per mcfe, production expenses of $0.52 per mcfe and production taxes of $0.29 per mcfe. We believe this is one of the lowest cost structures among publicly traded independent oil and natural gas producers. We believe our recent and pending acquisitions should enable us to maintain our low operating cost structure. In addition, we seek to control operations of the properties in which we own an interest. Currently we operate approximately 80% of our proved reserves. This large percentage of operational control provides us with a high degree of operating flexibility and cost control.

Table of Contents

Successful Acquisition Program. Our experienced asset acquisition team focuses on enhancing and expanding our existing asset bases in all three of our operating areas. These areas are characterized by medium- to long-lived natural gas reserves, low lifting costs, multiple geological targets that provide substantial drilling potential, favorable basis differentials to benchmark commodity prices, well-developed oil and gas transportation infrastructures and considerable potential for further consolidation of assets. Since 1998, and including the Laredo, Concho and our other recent and pending acquisitions, we have completed $3.5 billion in acquisitions at an average cost of $1.17 per mcfe of proved reserves. We believe we are well-positioned to continue making attractive small-to medium-sized acquisitions as a result of our extensive track record of identifying, completing and integrating multiple successful acquisitions, our large operating scale, and our knowledge and expertise in the regions in which we operate and the successful execution of our hedging strategies.

Large Inventory of Drilling Projects. During the past 14 years, we believe we have been one of the ten most active drillers in the United States and the most active driller in the Mid-Continent. We have developed an industry-leading expertise in drilling deep vertical and horizontal wells in search of large natural gas accumulations in challenging reservoir conditions. We actively pursue deep drilling targets because of our view that most undiscovered gas reserves in the U.S. will be found at depths below 12,500 feet. In addition, we believe that our large 3-D seismic inventory, much of which is proprietary to Chesapeake, provides us with an advantage over our competitors, which largely prefer to drill shallower development wells. As a result of our aggressive land and seismic acquisition strategies, we have been able to accumulate an onshore leasehold position of approximately 2.7 million net acres (pro forma for the Laredo and Concho acquisitions and other recent and pending acquisitions). In addition, our technical teams have identified over 2,500 exploratory and developmental drillsites, representing approximately five years of future drilling opportunities at our current rate of drilling. The Laredo and Concho acquisitions and other recent and pending acquisitions will add to our existing land inventory and we have identified approximately 900 additional potential drillsites associated with the properties acquired in these transactions.

Hedging Program. We have historically used and intend to continue using hedging programs to reduce the risks inherent in producing oil and natural gas, commodities that are characterized by extreme price volatility. We believe this price volatility is likely to continue and may even increase in the years ahead. We believe that a producer can use this volatility to its benefit by taking advantage of prices when they exceed historical norms. Over the past three years, we have increased our oil and gas revenues by $127 million of realized oil and gas hedging gains through September 30, 2003. We currently have gas swaps in place hedging 69%, 27%, 11% and 8% of our anticipated gas production for 2004, 2005, 2006 and 2007 at average NYMEX prices of $5.32, $5.04, $4.88 and $4.76 per mcf, respectively. In addition, we have 78% of our projected oil production hedged for 2004 at an average NYMEX price of $28.68 per barrel of oil.

Entrepreneurial Management. Our management team formed Chesapeake in 1989 with an initial capitalization of $50,000. Through the following years, this management team has guided our company through various operational challenges and extremes of oil and gas prices to create one of the ten largest independent natural gas producers in the United States with an enterprise value of approximately $6.0 billion (pro forma for this offering). Our co-founders, Aubrey K. McClendon and Tom L. Ward, have been business partners in the oil and gas industry for 21 years and beneficially own, as of September 30, 2003, approximately 14.3 million and 15.8 million of our common shares, respectively. In addition, each intends to purchase $5.0 million of common stock in this offering at the public offering price.

Table of Contents

Other Developments

We recently engaged in a series of transactions intended to improve our capitalization.

Public Offering of Convertible Preferred Stock. On November 18, 2003, we completed a public offering of $172.5 million of 5.00% Cumulative Convertible Preferred Stock consisting of 1,725,000 preferred shares convertible into an aggregate of 10,515,945 shares of our common stock at an initial conversion price of $16.40. We used the net proceeds to repay borrowings under our bank credit facility incurred primarily to finance the Laredo acquisition.

Private Offering of Senior Notes. On November 26, 2003, we completed a private placement of $200 million of 6.875% Senior Notes due 2016. Approximately $113 million of the net proceeds were used to fund a cash tender offer for $106 million in principal amount of our 8.5% Senior Notes due 2012 described below. We used the remaining net proceeds to repay borrowings under our bank credit facility incurred primarily to finance the Laredo acquisition.

Tender Offer for 8.5% Senior Notes due 2012. On December 11, 2003, we completed a cash tender offer for approximately $106 million principal amount of the approximately $111 million outstanding principal amount of our 8.5% Senior Notes due 2012 for total consideration of approximately $113 million. The tender offer will result in a pre-tax charge in the fourth quarter of 2003 of approximately $20 million ($13 million net of income taxes), including a pre-tax non-cash charge of $12 million ($7 million net of income taxes) to write off the value of the call option on our 8.5% Senior Notes due 2012 reflected as a senior notes discount.

Exchange Offer for 8.125% Senior Notes due 2011. On December 1, 2003, we announced an offer to exchange up to $500 million principal amount of our 8.125% Senior Notes due 2011 for new notes. Holders have the option to exchange their 2011 notes for either our 7.75% Senior Notes due 2015 or our 6.875% Senior Notes due 2016. The offer expires on January 12, 2004, unless extended. As of January 6, 2004, we have received valid tenders of approximately $278.2 million in aggregate principal amount of 2011 notes. Holders have the right to withdraw tenders at any time on or prior to January 9, 2004. There is no assurance that the exchange offer will be completed at the current level of participation or at all. If this exchange offer is fully subscribed and closed, we expect we would report in the first quarter of 2004 a pre-tax charge of approximately $6.5 million ($4.0 million net of income taxes).

Pending Settlement of Royalty Owner Class Action Lawsuit. We have reached an agreement in principle to settle a class action lawsuit filed on behalf of Oklahoma royalty owners against us and one of our subsidiaries relating to post-production deductions. The settlement will be subject to finalization of a settlement agreement and court approval, which is expected to be obtained in the first quarter of 2004. In contemplation of this settlement, we expect to incur a pre-tax charge of $5.5 million ($3.4 million net of income taxes) in the fourth quarter of 2003 for litigation and settlement costs in excess of our reserves.

Table of Contents

The Offering

Common stock offered by Chesapeake	20,000,000 shares (1)
Common stock outstanding after this offering	236,784,323 shares (1) (2)
Use of Proceeds	The net proceeds to us from the sale of the common stock offered hereby are estimated to be $259.0 million (assuming a public offering price of $13.50 per share), after deducting discounts to the underwriters and the estimated expenses of the offering. We intend to use the net proceeds from this offering to finance a portion of the pending Concho acquisition and our other recent and pending acquisitions discussed in this prospectus supplement. If we are unable to complete one or more of our pending acquisitions, we will use the net proceeds allocated to such acquisition for general corporate purposes, which may include the repayment of debt or other possible future acquisitions. Please read Use of Proceeds.
New York Stock Exchange Symbol	CHK

(1) Excludes shares that may be issued to the underwriters pursuant to their over-allotment option. If the underwriters exercise their over-allotment option in full, the total number of shares of common stock offered will be 23,000,000, and the total number of shares of our common stock outstanding after this offering will be 239,784,323. We had 216,784,323 shares of our common stock outstanding at December 31, 2003.

(2) Excludes shares of common stock potentially issuable upon the exercise of stock options, which as of November 30, 2003 included 27,417,041 shares potentially issuable upon the exercise of outstanding stock options at a weighted average exercise price of $5.77 and 11,000,641 shares of common stock reserved for issuance upon exercise of future additional options or awards of restricted stock, if granted under our stock compensation plans. Also excludes, as of December 31, 2003:

19,467,513 shares of common stock potentially issuable upon conversion of the 2,998,000 shares of our outstanding 6.75% Cumulative Convertible Preferred Stock at an initial conversion price of $7.70 per share;

22,358,300 shares of common stock potentially issuable upon conversion of the 4,600,000 shares of our outstanding issue of 6.00% Cumulative Convertible Preferred Stock at an initial conversion price of $10.287 per share;

10,515,945 shares of common stock potentially issuable upon conversion of the 1,725,000 shares of our outstanding issue of 5.00% Cumulative Convertible Preferred Stock at an initial conversion price of $16.40 per share;

422,527 shares of common stock potentially issuable upon exercise of warrants with a weighted average exercise price of $14.55 per share; and

5,071,571 shares of treasury stock.

Risk Factors

You should carefully consider all information in this prospectus supplement, the accompanying prospectus and the documents incorporated by reference herein. In particular, you should evaluate the specific risk factors set forth in the section entitled Supplemental Risk Factors in this prospectus supplement and the section entitled Risk Factors in the accompanying prospectus for a discussion of risks relating to an investment in our common stock.

Table of Contents

Summary Consolidated Financial Data

The following tables set forth summary consolidated financial data as of and for each of the three years ended December 31, 2000, 2001 and 2002 and the nine months ended September 30, 2002 and 2003. These data were derived from our audited consolidated financial statements included in our annual report on Form 10-K/A for the year ended December 31, 2002, which is incorporated by reference herein, and from our unaudited consolidated financial statements included in our quarterly report on Form 10-Q for the nine months ended September 30, 2003, which is incorporated by reference herein. The financial data below should be read together with, and are qualified in their entirety by reference to, our historical consolidated financial statements and the accompanying notes and the Management s Discussion and Analysis of Financial Condition and Results of Operations which are set forth in our annual report on Form 10-K/A and in our quarterly report on Form 10-Q, which are incorporated by reference herein.

	Years Ended December 31,			Nine Months Ended September 30,	
	2000	2001	2002	2002	2003
				(unaudited)	
	(in thousands, except ratios and per share data)				
Statement of Operations Data:					
Revenues:					
Oil and gas sales	$ 470,170	$ 820,318	$ 568,187	$ 367,810	$ 951,125
Oil and gas marketing sales	157,782	148,733	170,315	112,334	309,566
Total revenues	627,952	969,051	738,502	480,144	1,260,691
Operating costs:					
Production expenses	50,085	75,374	98,191	71,252	101,664
Production taxes	24,840	33,010	30,101	19,934	57,336
General and administrative	13,177	14,449	17,618	11,930	17,254
Oil and gas marketing expenses	152,309	144,373	165,736	108,836	302,064
Oil and gas depreciation, depletion and amortization	101,291	172,902	221,189	157,731	266,131
Depreciation and amortization of other assets	7,481	8,663	14,009	10,489	12,647
Total operating costs	349,183	448,771	546,844	380,172	757,096
Income from operations	278,769	520,280	191,658	99,972	503,595
Other income (expense):					
Interest and other income	3,649	2,877	7,340	7,343	1,356
Interest expense	(86,256)	(98,321)	(112,031)	(77,779)	(115,891)
Loss on investment in Seven Seas			(17,201)	(4,770)	
Loss on repurchases of Chesapeake debt		(76,667)	(2,626)	(1,353)	
Impairment of investment in securities		(10,079)			
Gain on sale of Canadian subsidiary		27,000			
Gothic standby credit facility costs		(3,392)			
Total other income (expense)	(82,607)	(158,582)	(124,518)	(76,559)	(114,535)
Income before income taxes and cumulative effect of accounting change	196,162	361,698	67,140	23,413	389,060
Provision (benefit) for income taxes	(259,408)	144,292	26,854	9,366	147,841
Net income before cumulative effect of accounting change	455,570	217,406	40,286		