Ninepoint Energy Fund Market View

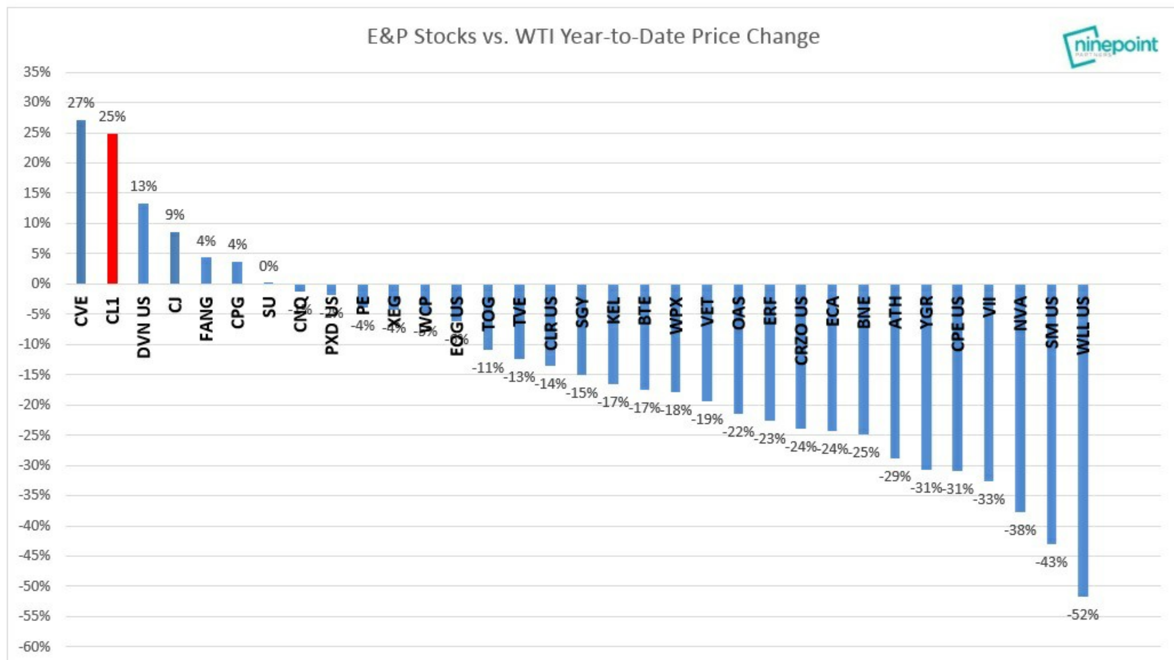
August 1, 2019

Investment Team

Eric Nuttall, CIM
Partner, Senior Portfolio Manager

Time for “Plan B”

To even the most casual market observer, it should be blatantly obvious that the energy sector is broken. Oil stocks no longer seem to correlate with the daily move in oil and have greatly lagged the 25% year-to-date rally in the oil price. All too frequently this year oil equities have posted meagre rallies of 0.2% (or even fallen) on days when oil has rallied by 3%-4% only to get hammered the next day by 6%-8% when oil has sold off on some macro headline (US/China trade stalemate, Iranian truce rumours, weak demand growth, etc.). The agonizing combination of limited upside participation with extreme downside capture has been soul crushing. How did we get to this point and what needs to happen to fix it? When will oil stocks better reflect their underlying value and free cash flow generating capabilities rather than serve as a levered way for quants to bet against a faltering global economy? When will companies admit that the playbook of the past is no longer working and adopt “Plan B”?

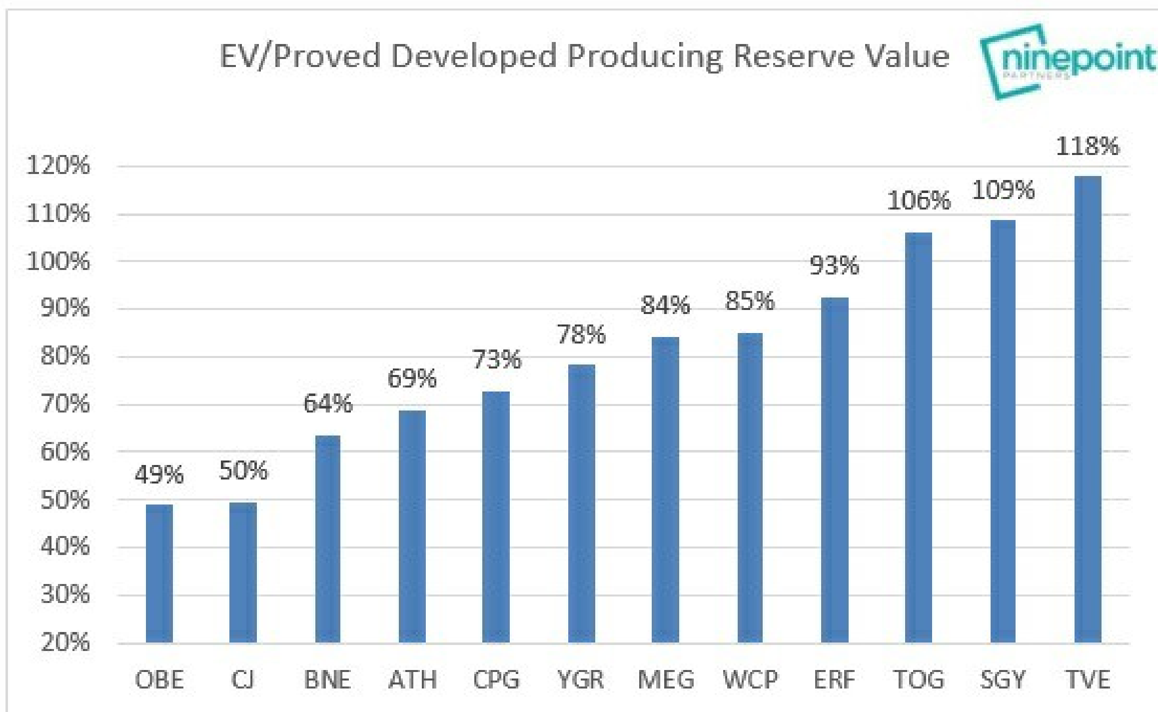


Source: Bloomberg

The energy sector is suffering from one very clear problem: there are NO buyers of energy stocks. Over the past few years the sector has become too volatile and too confusing to justify owning when other sectors and overall markets have been making fresh all-time highs. In addition to these factors in Canada we have had to deal with an incomprehensible inability to build pipelines that are clearly in the national interest, a Prime Minister who said publicly that we need to “phase out” the

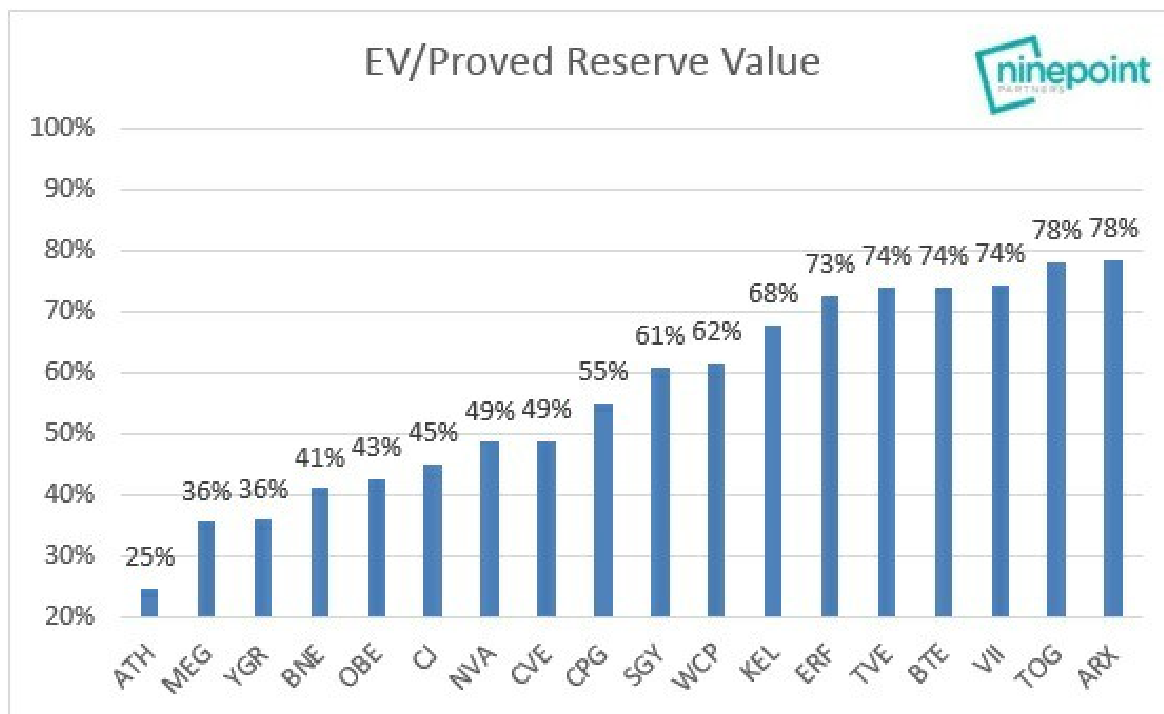
oil sands (~3% of global oil supply), new taxes that erode Canada's competitiveness, and legislation (C-69 and C-48) that is perceived by industry to make further investment in Canadian infrastructure too risky to justify (Enbridge told me they would have to spend $500MM to $1BN scoping out a new project just to get to the point of knowing if they could go forward with it..."why expose that capital? our shareholders would kill us"). In every portfolio review meeting investment advisors are being challenged by their clients to justify having ANY energy exposure. In short, clients, advisors, fund managers, analysts, energy salesmen...EVERYONE is exhausted, angry, confused, and now completely apathetic.

The result? Stocks fall by 5%+ on no news given the lack of depth to the market (it only takes one seller), energy funds shut down due to chronic redemptions (we are still standing and are extremely thankful for our loyal clients), and generalist investors decide that the sector isn't worth the bother. This epic level of apathy has now resulted in valuations falling to their lowest levels in history. The market today is not suffering from massive selling pressure as forced liquidation already occurred last Fall but rather from a total buyers strike. What happens when seemingly everyone stops caring about a sector and disavow committing any new capital to it? Sector weights within indices fall to multi-decade lows and the lack of interest allows valuations to fall to levels previously thought impossible. Today many oil stocks are trading below their liquidation value (ie. proved developed producing reserve value) which means the combined market capitalization and net debt are less than the present value of the cashflow stream from wells that are already on production that have no capital risk and limited geologic risk. When trading at such low levels the market is ascribing ZERO value for proven or probable reserves nor for land, seismic, or infrastructure which in sum are commonly 3-4x the value of the PDP reserves. Today's valuation levels by any measure are truly historic:



Excludes value for land and seismic

Source: Company Reports, Ninepoint Partners



Excludes value for land and seismic

Source: Company Reports, Ninepoint Partners

Given this dynamic, I routinely get asked the same question by every client that I meet with and in every interview that I give: “so what needs to happen for this to change”? To answer this we need to identify the major causes for how we got here in the first place. While other variables such as increased commodity volatility, waffling OPEC policy, pipeline politics, Trump tweet interventionism, a shift from active to passive fund management, and current worries about oil demand growth have impacted investor demand for energy stocks, the three largest factors that have impacted funds flow (and hence valuation) are:

- The energy sector has in recent history been a poor steward of capital – the growth for growth’s sake focus of the past (which is officially 100% dead) combined with excessive management compensation and poor management alignment with shareholders interests led to enormous value destruction due to excessive leveraging of balance sheets to finance chasing absolute growth/inventory aggregation (much of which turned out to be Tier 3 acreage) over return on invested capital
- US shale completely changed the market’s perception of future supply shortages and marginal cost of supply – industry hyped downspacing potential as well as half-cycle break-evens leading the market to believe that the Big 3 (Bakken, Eagleford, and the Permian) have multi-decades of inventory with sub $40/bbl break-evens
- The rise of environmentalism and the ignorant decision of industry to not fight back against uninformed and purposefully misleading propaganda from environmental terrorists sullied the reputation of the oil and gas industry and led to divestment initiatives which have been sadly quite successful. The rise of ESG investing has seen capital flee the sector with endowment funds, State pension funds, and some European banks swearing off investing in hydrocarbons due to ethical concerns (the epitome of hypocrisy as ~80% of emissions are from energy

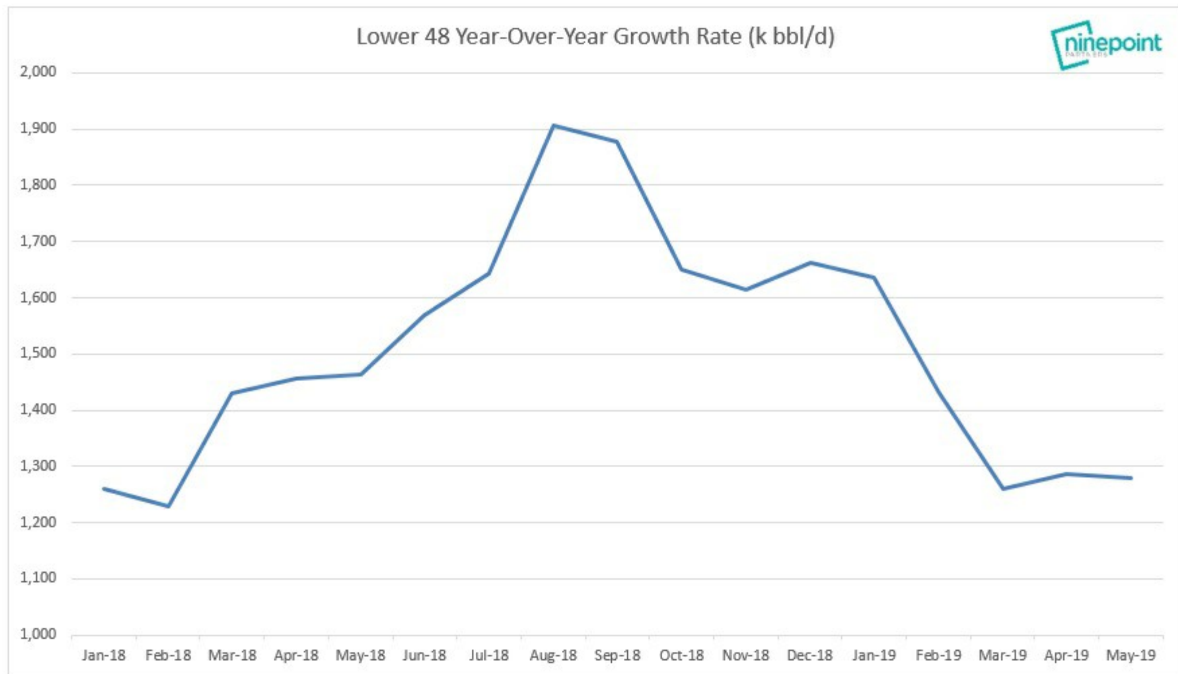
consumption yet these same investors are likely flocking to names like Google and Netflix whom are indirectly larger emitters than the oil and gas industry [video streaming is incredibly energy intensive…pornography video streaming produces ~1.5x more CO2 emissions than the entire Canadian oilsands as an example]).

In short then, there are 2 major events that would neutralize these 3 factors that are impeding investment and would thus allow for funds flow to return and for energy stocks to rerate closer back to historical trading multiples:

- US shale growth rates begin to falter and thus the narrative of US energy independence, the end of OPEC, and short-cycle supply with sub $40/bbl break-evens ends
- Oil and gas companies demonstrate that they are focused on generating more cross-industry competitive rates of return on their capital investments (which translates into free cash flow) as well as changing the narrative on the ethics of investing in oil companies by fighting back against the intentional disinformation environmental fundraising campaigns (like the Tar Sands Campaign)

Potential Sentiment Shifting Catalyst #1 – Is US shale beginning to show signs of maturity?

The US oil shale revolution (which is only ~ 3 years old) was born of two primary factors: vastly improved technology and easy access to funding. Clearly, radical improvements in well designs, proppant placement and pumping rates, chemicals, drill bits, cluster spacing, and figuring out the most ideal well landing zone have meaningfully impacted US shale growth potential. What is not as well appreciated is the role that wide-open capital and debt markets had in juicing shale production growth rates above what would have been considered sustainable in the longer term. Between 2014 and 2018 industry outspent its cashflow by ~$180BN. With equity and debt markets willingly funding this delta E&P companies aggressively drilled their premium acreage resulting in a historical capex: cash flow outspend of around 1.5x. With shale wells exhibiting first year declines of up to 80% this led to some companies having corporate decline rates in excess of 50% (ie. if you stop drilling your total corporate production falls by half in a year). Again, with willing lenders of capital this was not a problem. Fast forward to today where capital and debt markets are completely closed and investors are demanding companies underspend their cashflow to allow for "return of capital" and you have a serious problem (the Lower 48 in aggregate is estimated to have a base decline rate of 37%-39% requiring the spending of ~$80BN just to stay flat with cash flow neutral spending requiring ~ $55/bbl WTI). Is it any wonder then that since January 1st, 2019 the oil directed rig count has fallen from 877 to 776? The result has been a sharp deceleration in year-over-year growth rates:



Source: EIA

Another factor impairing both Permian growth rates and more importantly inventory is the issue of parent-child. Simplistically, industry overpromoted the ability to space wells too tightly and have experienced 20%-30% degradation in production per well when completing an offsetting well (the "child" well next to the original well called the "parent"). During the Q2 reporting season as an example Concho Resources, a well respected Permian player, reported parent-child issues at their Dominator Pad resulting in less production with the same level of capex…CXO fell 23% on the news. Cracks have been forming for some time with companies walking back both fantastical IRR/Break-evens (in 2016 many companies were flaunting sub $40/bbl break-evens even though today at $50+ many struggle to generate free cash flow) and ultra tight spacing which combined would suggest many, many decades of vey low cost inventory. This perverted the oil market's view of the future role of OPEC, marginal supply costs, US energy independence, and even if there was a need for exploration given US supply growth could sustain the world until demand started to peak due to electric cars and the widespread adoption of clean technologies. From Q1 and Q2 company reports we can now see that spacing was likely exaggerated and that the difference between drilling Tier 1 and Tier 2 acreage quality can be immense. As companies struggled to survive over the past few years many were forced to drill their very best acreage and likely exhaust Tier 1 acreage. The result? Same well costs but much lower productivity leading to a higher threshold of spending to maintain the same production growth rates (or even keep production flat). These developments are leading to an increase in some very informed views that suggest shale's hyper-growth days may have come to an end:

Core Labs on their Q2 conference call on July 25:

"the Eagle Ford play is in permanent decline and Bakken production will near its projected peak over the next year or so"

Wood Mackenzie at the Unconventional Resources Technology Conference (URTeC) in Denver on July 22:[1]

Accelerating tight oil decline rates top a growing list of concerns for Permian basin operators, with unexpected production shortfalls prompting producers to consider stepping up drilling investment and M&A activity, Wood Mackenzie's Robert Clarke, Research Director, Lower 48 Upstream, told delegates at the Unconventional Resources Technology Conference (URTeC) in Denver.

As ultra low-cost undrilled locations become exhausted and productivity gains across wider sections of acreage continue to moderate, producers should shift their focus from early production rates to longer-term well performance and production optimization, Clarke said.

The shift is inevitable as the Permian matures, and with it, declines rates are likely to increase over time.

Clarke told delegates “Individual well productivity improvements helped to offset decline rates through 2017, but those gains have weakened over the past two years. No longer do we routinely see operators press-releasing record-setting wells. For wells drilled so far this year in the Midland Wolfcamp, average initial production (IP) rates are down 6% and we see productivity reductions across numerous benches.”

“Steeper decline rates and smaller IPs in the Permian basin will likely result in operators needing to drill more wells than originally planned, if they're committed to hitting previously established long-term targets. This will be especially challenging in the near-term because raising capital budgets today is effectively off-limits.”

Andrew Gould, former CEO of Schlumberger to Bloomberg on July 23:[2]

Productivity in the world’s busiest shale play is being inflated by more than 1,000 wells that were fracked but never reported, according to the former CEO of oilfield service giant Schlumberger Ltd. About 21% of oil wells in the Permian Basin of West Texas and New Mexico that were fracked last year didn’t get reported to FracFocus, a voluntary, non-profit repository of fracking data, according to satellite imagery from data analytics company Kayrros. “It means the actual production per well at the basin level is not as good as people think,” said Andrew Gould, the chairman of Kayrros’s advisory board who spent almost four decades at Schlumberger. “It’s one among a number of words of caution that shale is a fantastic resource, but it’s probably not quite as good or not going to last quite as long as people originally imagined.”

“The fact that a lot of the wells are not reported means that the averages for the basin are calculated with the wrong denominator,” Gould said. “Over time, that’s going to show the individual well productivity is probably not quite as good as people imagined.” For Gould, who once described the state of fracking nearly a decade ago as nothing more than “brute force and ignorance,” the findings were surprising. “I made the Kayrros guys check it 3 or 4 times before we went public,” Gould said. Gould joins a growing number of current and former executives warning that shale faces fundamental obstacles that will slow America’s oil boom. Mark Papa, the former EOG Resources Inc. boss who now leads Centennial Resource Development Inc., warned in March that future production growth will be hampered by crowding wells too close together and deteriorating geological quality. Diamondback Energy Inc. CEO Travis Stice sounded a similar warning just two weeks after Papa in a meeting with investors in New Orleans.”

Many have been too early in calling for the "end of shale" but eroding capital efficiencies, lower well productivity, and companies missing expectations make us wonder if we are finally at (or close to) the point where US shale growth rates start to sharply decelerate…due both to geology and financial constraints. This would have a profound impact on sentiment as the oil market would realize that OPEC is relevant, that limited global spare capacity in a world that is only getting more politically volatile matters, and that the underinvestment by industry over the past several years on non-OPEC/US production will have a meaningful impact on global supplies (that are now back in demand) in 2020 and beyond.

Potential Sentiment Shifting Catalyst #2 – Companies prove to investors that they are not destroyers of capital

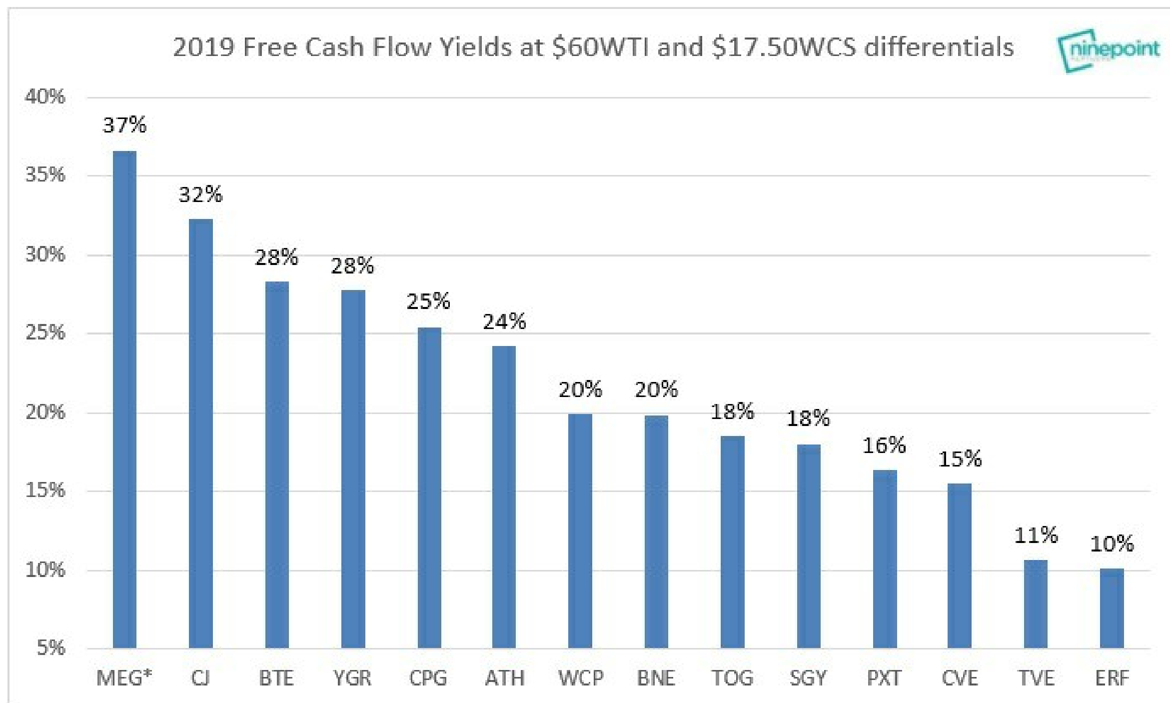
The historical track record of the oil and gas industry at creating value in recent years has not been stellar. Focusing on growth over returns led to historic destruction of many billions of dollars in addition to over-leveraged balance sheets. This past still haunts companies today as despite tremendous success at lowering costs through improved operational focus (doing more with less) and paying down debt the investment public fails to appreciate the underlying strength of oil companies in a $55-60/bbl world. The best evidence of this is in Q2 reporting. Despite the oil price being comparatively lower some companies like Baytex reported their highest operating margins since 2014 (oil averaged ~$92/bbl that year) resulting in highly attractive free cash flow generation. For example, MEG reported free cash flow of $293MM in the first 6 months of the year (equates to 19% of their market cap) and Baytex Energy was able to use their free cash flow to pay down $147MM of debt. Yet, I still get questions from investors like "Will Baytex make it?" Such a question demonstrates how distorted the markets perception is. This ignorance has led to the highest degree of apathy towards the space which has resulted in a complete buyers strike. Time for Plan B(uyback)!

Plan B(uyback)

On March 19, 2019 I wrote an "open letter" to several oil companies which described many of the same dynamics as above. I urged them to use their free cash flow (not debt) to buy back their own shares given that many stocks were (and still are) trading at such depressed levels, that drilling for growth made absolutely no sense, and that balance sheets by and large were in decent shape. Since then stocks have only fallen further. In July at Stampede I used the opportunity to renew the conversation with many corporates and was encouraged by both their level of engagement as well as how widespread the conversation had become. I'm confident that in every board meeting today the topic of buybacks is raised. What is missing is industry wide adoption. Why do we think that all companies that are able to should enact Plan B?

- Stocks are trading at their lowest valuation levels in history with many at a discount to their proved developed producing reserve value (hence the market is implying that any future drilling is actually value destructive and is unwilling to assign value for reserves that are not onstream nor for land/seismic/infrastructure)
- The market is not suffering from tremendous selling pressure but rather a general buyer's strike as investors' patience has been totally and utterly depleted and in today's market it only takes modest selling pressure to cause a stock to fall 5% given the absence of meaningful buying interest therefore a corporate share buyback would help provide a buttress to modest selling pressure

- Balance sheets are generally in good shape with debt:cash flow metrics below 2X at $55WTI therefore deleveraging is not really necessary nor will it be overly rewarded by the market
- The market is not willing to pay for growth and in fact is penalizing companies that announce such plans therefore why spend a single dollar beyond maintenance capex?
- Drilling a single well beyond that which is required to maintain production is not logically explainable if a company is trading at a discount to their PDP reserve value or below their PDP/barrel replacement cost.
- Free cash flow generation at $55/bbl and higher is massive and allows for buybacks without the use of debt



Source: EIA

Since we sent our (very friendly) initial "open letter" we are commonly asked by clients and corporates alike how the reception has been? In general, quite positive. We have since that time seen several companies either announce NCIB's, expand on them, or formally discuss their future buyback strategy:

- Cardinal announced a 10% NCIB and the stock rallied by 8%
- Seven Generations announced a doubling of their NCBIC from 5% to 10% and the stock rallied by ~ 14%
- Tourmaline announced a NCIB (a first for them)
- Baytex discussed that once debt: cash flow falls below 2x that they would be open to buying back shares given the distressed value of their shares
- Crescent Point announced that pending asset sales which should lower their debt:cash flow below 2X that they will commit 20%-30% of free cash flow to buybacks
- Year-to-date SU has bought back $1BN of stock, CNQ $630MM, IMO $733MM, ECA $1.4BN, CPG $25MM, PSK $12MM, VII $44MM, and ERF $90MM

Yet, there are holdouts. For some deleveraging is more important than share buybacks given oil's recent heightened volatility (it is down 8% as I write this due to yet another disastrous Trump tweet about Chinese tariffs) and I can entirely empathize with that view. MEG Energy for example, despite trading at a 38% free cash flow yield (which means that they could privatize themselves with free cash flow within 3 years) is focusing on paying down their debt to get closer to an industry average 2X in the next 2-3 years. It is difficult to find fault with that strategy. Then there are others like Whitecap (a Fund holding) which confuse me. Whitecap is currently trading at 83% of its PDP reserve value so the market is implicitly saying that any drilling activity going forward is value destructive. On my math they are trading at a 12% free cash flow yield after accounting for their dividend (8.6% yield). In the second half of this year they intend to spend $300MM to grow production from 70,611boe/d in Q2 to an exit rate of 77,000boe/d. In order to keep production flat from their Q2 level we estimate $150MM of required capital spending which means that instead of growing production by 9% from Q2 to Q4 they could instead use the discretionary growth capital ($150MM) for share buybacks. At their current trading price that would equate to 37.5MM shares or 9% of their shares outstanding. So which is better…9% production growth which depletes inventory, increases corporate decline rates, and likely generates zero market reaction or a 9% share buyback which extends inventory life, de facto lowers their corporate decline rate, increases their dividend sustainability as there would be fewer shares that would need to receive a monthly payment, helps to put a floor in their share price, highlights with concrete evidence the strength of their business model, and most importantly would achieve 9% PER SHARE growth. The answer to me is rather obvious…how can it not be to others?

Were industry to enact my Plan B it would help to wake investors from their collective comas and nullify the argument that "cheap stocks can stay cheap forever." Stocks trading at 20%+ free cash flow yields is not normal. Companies having the ability to privatize themselves from free cash flow within 3-5 years is not normal. Yet, here we are. Why then are some CEO's hesitant to try something new? Fear of losing their growth investors (they no longer exist)? One criticism that may have some merit is that CEO's that are making $3-$15MM/year do not necessarily feel the same level of anxiety that investors who are down 75%+ do nor the medium-term pressures of some energy fund managers (an endangered species at that). The reality is that energy investors desperately need to make money very soon. To have oil rally by 25% yet stocks fall by 20%+ is no longer acceptable to them. After many years of horrendous performance I am increasingly concerned that many energy investors are on the cusp of (or actively) throwing in the towel. If that trend were to continue what will be the result? Permanently impaired trading valuations, more shares held by index funds versus actively managed funds, fewer sell-side energy research shops leading to greater market inefficiencies, and a much more challenging environment for energy companies to raise capital. We are truly all in this together.

We pose this very simple question yet again to industry at large: If your stock is trading at a discount to your PDP reserve value, you have a strong enough balance sheet to weather crude volatility (sub 2x debt:cash flow at $55WTI), and have the free cash flow availability with which to purchase a meaningful amount of shares and help provide a floor to your share price while demonstrating the strength of your business model that hopefully attracts new inflows, and yet you are still unwilling…then why should I or anyone else?

Eric Nuttall

Senior Portfolio Manager

Ninepoint Energy Fund

The world needs more Canadian energy: https://www.youtube.com/watch?v=7IZHYi0wapU

(1) Source: http://www.worldoil.com/news/2019/7/22/faster-permian-decline-rates-demand-new-investment-ma-strategies

(2) Source: Bloomberg, July 23, 2019 - https://news.bloombergenvironment.com/environment-and-energy/permian-success-inflated-by-bad-data-ex-schlumberger-boss-warns

NINEPOINT ENERGY FUND - COMPOUNDED RETURNS[1]

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	15YR	INCEPTION
Fund	-20.6%	-20.6%	6.5%	-1.5%	-11.6%	-25.1%	-14.1%	-5.9%	-3.6%	-0.5%
Index	-11.1%	-11.1%	6.2%	-1.2%	-9.7%	-11.2%	-7.1%	-4.6%	-0.4%	1.0%

[1] All returns and fund details are a) based on Series F units; b) net of fees; c) annualized if period is greater than one year; d) as at July 31, 2019; e) 2004 annual returns are from 04/15/04 to 12/31/04. The index is 100% S&P/TSX Capped Energy TRI and is computed by Ninepoint Partners LP based on publicly available index information.

The Fund is generally exposed to the following risks. See the prospectus of the Fund for a description of these risks: concentration risk; credit risk; currency risk; cybersecurity risk; derivatives risk; exchange traded funds risk; foreign investment risk; inflation risk; interest rate risk; liquidity risk; market risk; regulatory risk; securities lending, repurchase and reverse repurchase transactions risk; series risk; short selling risk; small capitalization natural resource company risk; specific issuer risk; tax risk.

Ninepoint Partners LP is the investment manager to the Ninepoint Funds (collectively, the "Funds"). Commissions, trailing commissions, management fees, performance fees (if any), other charges and expenses all may be associated with mutual fund investments. Please read the prospectus carefully before investing. The indicated rate of return for series F units of the Fund for the period ended July 31, 2019 is based on the historical annual compounded total return including changes in unit value and reinvestment of all distributions and does not take into account sales, redemption, distribution or optional charges or income taxes payable by any unitholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. The information contained herein does not constitute an offer or solicitation by anyone in the United States or in any other jurisdiction in which such an offer or solicitation is not authorized or to any person to whom it is unlawful to make such an offer or solicitation. Prospective investors who are not resident in Canada should contact their financial advisor to determine whether securities of the Fund may be lawfully sold in their jurisdiction.

The opinions, estimates and projections ("information") contained within this report are solely those of Ninepoint Partners LP and are subject to change without notice. Ninepoint Partners makes every effort to ensure that the information has been derived from sources believed to be reliable and accurate. However, Ninepoint Partners assumes no responsibility for any losses or damages, whether direct or indirect, which arise out of the use of this information. Ninepoint Partners is not under any obligation to update or keep current the information contained herein. The information should not be regarded by recipients as a substitute for the exercise of their own

judgment. Please contact your own personal advisor on your particular circumstances. Views expressed regarding a particular company, security, industry or market sector should not be considered an indication of trading intent of any investment funds managed by Ninepoint Partners. Any reference to a particular company is for illustrative purposes only and should not to be considered as investment advice or a recommendation to buy or sell nor should it be considered as an indication of how the portfolio of any investment fund managed by Ninepoint Partners is or will be invested. Ninepoint Partners LP and/or its affiliates may collectively beneficially own/control 1% or more of any class of the equity securities of the issuers mentioned in this report. Ninepoint Partners LP and/or its affiliates may hold short position in any class of the equity securities of the issuers mentioned in this report. During the preceding 12 months, Ninepoint Partners LP and/or its affiliates may have received remuneration other than normal course investment advisory or trade execution services from the issuers mentioned in this report.

Ninepoint Partners LP: Toll Free: 1.866.299.9906. DEALER SERVICES: CIBC Mellon GSSC Record Keeping Services: Toll Free: 1.877.358.0540