



Ninepoint Energy Fund

December 2018 Commentary

The road back to \$60+/bbl

Let's get this part over with... 2018 was a soul sucking experience for energy investors that for the second year in a row tested both patience and a willingness to endure endless volatility with no reward. What began as moderate optimism in January evolved into euphoric calls for "\$100/bbl oil" by Spring only to see the oil price plunge in October through December by an extent not thought possible by sober minds. Even now with the benefit of hindsight the extent of oil's collapse was impossible to foresee or properly explain. What fundamentally happened in 2018 for the narrative around oil to so violently change leading to the oil price crashing by 45% in only a few months' time?

OIL MACRO

Coming into 2018 optimism was plentiful supported by a very constructive fundamental backdrop: OECD oil inventories were falling by the fastest pace in history and that trend was set to continue through the year due to OPEC's strong resolve to sustain an oil price high enough to allow for them to adequately fund their social and military spending. At the same time global oil demand continued to grow at above-normal rates. WTI traded at ~\$60/bbl to begin the year and in our first commentary of 2018 we called for \$70/bbl by year-end due to our forecast of continued inventory drawdowns (oil hit \$70/bbl on May 7th). As the year progressed and inventories continued to fall sentiment further improved and the market's focus shifted to OPEC's dwindling spare capacity (the ultimate catalyst for meaningfully higher oil prices). In April and May we outlined our "multi-year oil bull market" thesis that largely revolved around:

- 1) OPEC production growth stagnation between 2019-2022+ due to a lack of investment in future production/spare capacity growth due to a need to prioritize social spending over oil investment during the dark days of \$30-\$40WTI
- 2) Non-OPEC/US production that was about to enter a period of multi-year declines due to the greatest implosion in investment on long-lead projects (4-6+ year lead times) in history
- 3) US production growth that while impressive on a micro level could not in isolation grow enough to meet global demand growth and offset global declines
- 4) Demand growth that was set to continue to increase at very strong rates

In short, life was getting better. While energy stocks continued to lag the commodity (by July oil had rallied by 17% yet the XEG had rallied by only 5.6% despite already underperforming oil's 2017 rally by 25%) there were signs of generalist investors FINALLY coming back into the space (a missing critical factor for energy stocks to begin to better reflect higher oil prices). Then 4 things happened:

- 1) Saudi Arabia, the UAE, and Russia (OPEC+'s "haves") began increasing production in June

Investment Team



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amounting to a collective 1.8MM Bbl/d increase by November

2) US production surprised to the upside with L48 production rising from 7.9MM Bbl/d (December 2017) to 9.3MM Bbl/d (October 2018...the latest reliable monthly data)

3) Prospects for the US and global economy soured on the Fed's interest rate recalibration, growing unease around a slowdown in China, and broader concerns due to the impacts of Trump's trade tariffs

4) The US issued waivers to essentially every country that imported Iranian oil despite previous assurances that the State Department's intent was to drive Iranian oil exports "to zero."

The culmination of rising US and global inventories combined with worries about global oil demand growth led to oil falling from a high of \$76.90 on October 3rd to a low of \$42.36 on Christmas Eve (a staggering 45% drop over 2.5 months).

So, let's start at the beginning. Why did Saudi Arabia's production policy take a U-turn so suddenly resulting in a material production increase in what appeared to be an action in direct contradiction to their own self interests? Why would they knowingly destroy the oil price momentum that had taken years to achieve? The answers to these questions only became clear after a few months. On May 8th the Trump Administration announced that the US would withdraw from the Iran nuclear deal and would reimpose trade sanctions on Iran and a few months later it was further clarified by the State Department that the intent of the US sanctions was to drive Iranian exports "to zero." For a country in which 80% of its revenue is from oil sales the clear goal of the White House was regime change. The elimination of Iranian oil exports was immediately viewed as materially positive for the oil market and oil lifted from ~\$65 to a high of \$75. What we did not know at the time is that a clandestine agreement was seemingly struck between Saudi Arabia and the Trump administration: in return for the US coming down hard on Saudi Arabia's arch nemesis Saudi Arabia agreed to raise production (was ~10MM Bbl/d at the time) and use their spare capacity to partially offset the loss of Iranian exports. Given Iranian exports of ~2.2MM Bbl/d an increase of Saudi Arabian production back to prior highs (~10.7MM Bbl/d) would still leave the oil market in a material deficit while also effectively eliminating all of OPEC's spare capacity. It was on this logic that we (and others) began to hypothesize that oil could rally to above \$100/bbl in 2019.

State Dept aims to cut Iran oil exports to zero but leaves wiggle room for some importers

- A senior State Department official reaffirmed that the Trump administration's goal is to get as many countries as possible to cut their Iranian oil purchases to zero by November.
- The administration will not grant broad waivers for countries, but will work with nations actively reducing their imports on a case-by-case basis.
- The tougher-than-anticipated deadline helped send oil prices to multiyear highs when it was first announced last week.

Tom DiChristopher | @tdichristopher

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On November 5th the US dropped a bomb on the oil market: waivers would be issued to every country already importing Iranian oil (albeit at a reduced rate) allowing for the continuation of imports for another 6 months. The oil market (and we strongly suspect Saudi Arabia) felt completely betrayed. It quickly became obvious that Saudi Arabia had been lied to, that the Trump Administration was aware of the potential impact of Iranian export reductions on the oil price, and heading into a November 2nd mid-term election feared high oil prices (and consequently high gasoline prices).

The White House's announcement November 5 that it was granting sanctions waivers to eight countries to continue purchasing Iranian oil wrong-footed OPEC, Gulf delegates told S&P Global Platts on condition of anonymity, after Trump had emphatically said in the run-up that he aimed to bring Iran's oil sales down to zero. The delegates added that they were given no advance warning of the waivers and feel betrayed by the decision.

Source: S&P Global Platts

Rather than preventing an oil price spike the White House in fact orchestrated a price crash as the oil market had become unnecessarily oversupplied due to the WH's false pretenses. The evolution of the WH's thinking can be seen in the following Trump Twitter tirade:



Donald J. Trump ✓

@realDonaldTrump



Looks like OPEC is at it again. With record amounts of Oil all over the place, including the fully loaded ships at sea, Oil prices are artificially Very High! No good and will not be accepted!

♡ 93.9K 5:57 AM - Apr 20, 2018



Donald J. Trump ✓

@realDonaldTrump



Oil prices are too high, OPEC is at it again. Not good!

♡ 108K 6:52 AM - Jun 13, 2018



Donald J. Trump ✓

@realDonaldTrump



Just spoke to King Salman of Saudi Arabia and explained to him that, because of the turmoil & disfunction in Iran and Venezuela, I am asking that Saudi Arabia increase oil production, maybe up to 2,000,000 barrels, to make up the difference...Prices to high! He has agreed!

♡ 149K 6:37 AM - Jun 30, 2018



Donald J. Trump ✓

@realDonaldTrump



The OPEC Monopoly must remember that gas prices are up & they are doing little to help. If anything, they are driving prices higher as the United States defends many of their members for very little \$'s. This must be a two way street. REDUCE PRICING NOW!

♡ 110K 3:46 PM - Jul 4, 2018





Donald J. Trump ✓
@realDonaldTrump



Oil is starting to rise again despite the horrible times. OPEC continues to rip us off. Not worth \$30. New leadership needed.

♡ 14 1:25 PM - Aug 10, 2011



Donald J. Trump ✓
@realDonaldTrump



Oil prices getting lower. Great! Like a big Tax Cut for America and the World. Enjoy! \$54, was just \$82. Thank you to Saudi Arabia, but let's go lower!

♡ 115K 7:49 AM - Nov 21, 2018



Donald J. Trump ✓
@realDonaldTrump



"@twins44: @realDonaldTrump I think you are responsible for lower gas prices, only you had the balls to call out OPEC. Thank you Mr. Trump"

♡ 44 6:53 AM - Nov 28, 2014



Source: Twitter

At the same time as Trump orchestrated a supply-driven price crash fears about the health of the global economy began to emerge (arguably again by the hand of President Trump). Steel/aluminum tariffs began to bite and most importantly the escalation of tariffs between the United States and China ignited fears of a repeat of the Asian Crisis. Coincidentally with the tariff escalation data points from China began to show a marked economic deceleration with auto sales falling for the first time in about twenty years and industrial production in December growing by the slowest pace in 10 years. The combination of too much oil supply and perceived weakening demand was too much for the oil market to handle and oil crashed.

While the unnecessary production surge from Saudi Arabia/UAE/Russia (and better-than-expected production growth from the US) did loosen the market they (along with the perception of weak oil demand growth which we have NOT materially seen yet) cannot explain the 45% collapse in the oil price. The loosening was temporary and history should have given confidence that Saudi/OPEC+

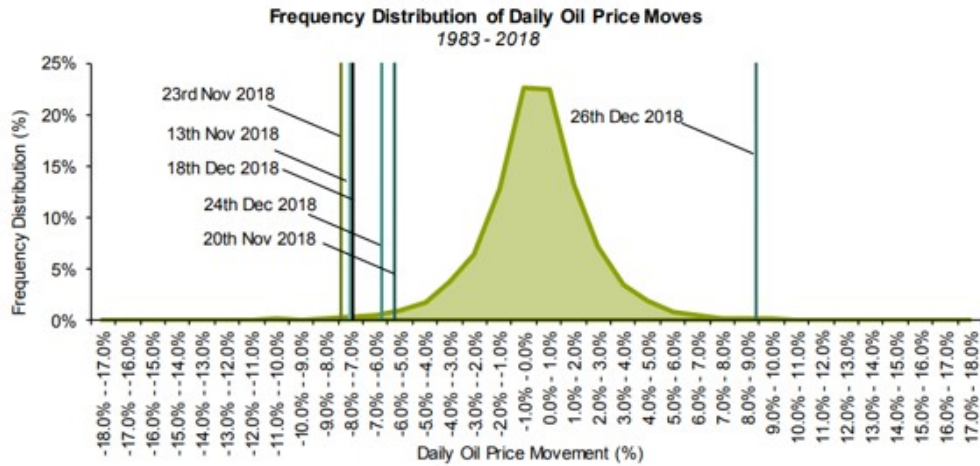
would go into “do whatever it takes mode” to defend the oil price. So if fundamentals cannot explain the price crash what can?

While oil is the largest commodity market in the world at roughly \$2.2TN the financial market for oil is about 30X larger than the physical market. This in the short term can lead to moves that defy fundamental explanation and this is exactly what happened in late 2018. The combination of long liquidation (see below) by algo/quant/CTA's, cross-asset selling (long oil / short natural gas unwind), and then the covering of hedge positions by swap dealers that had sold hedges to producers/sovereigns led to oil falling well, well below what fundamentals would have suggested.



Source: Bloomberg

Two more graphs (one courtesy of Bernstein who does very innovative energy research) further corroborates our view that the “financialization of oil” was largely responsible for the crazy and fundamentally-unexplainable moves we saw in November and December... many of far beyond the historical normal distribution of daily moves for the oil price:



Source: Bloomberg, Bernstein analysis

Exhibit 2: Brent crude oil and the S&P500 rolled over in sync



Source: Bloomberg

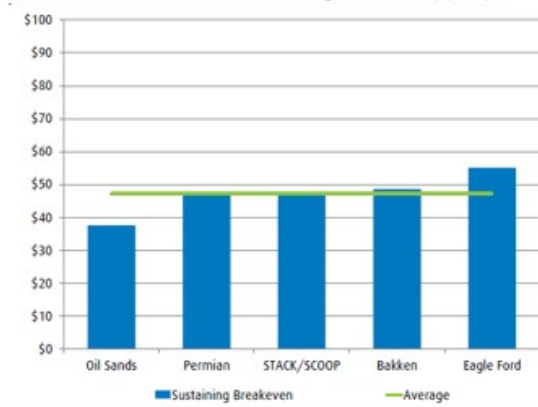
Given this increasingly influential dynamic (momentum and technicals over fundamentals) forecasting oil in the short-term is challenging. We had believed (and still do) that oil is in a multi-year bull market and see the market as being undersupplied (with the help of OPEC's recent curtailment) and remaining so for the next several years. The 1.8MM Bbl/d of excess production from Saudi and friends (June-December) did however push out our more bullish thesis by about 9-12 months as the market's confidence has been severely shaken and months of tangible evidence (ie. OECD inventory drawdowns) will likely be needed before WTI can stage a meaningful rally above \$60/bbl. With oil trading ~\$53/bbl we believe that WTI will trade above \$60/bbl by mid-2019 at which time we will be past refinery turnaround season (oil demand seasonally dips by ~2MM Bbl/d in

Q1), inventory reports will have begun to reflect the OPEC+ production cut announced on December 8th (45-60 day lag due to voyage time from the Persian Gulf), Q4 reporting by US E&P's should reinforce the message of underspending and fiscal discipline, and we will have clarity on whether the US will once again extend Iranian import waivers to the 5 remaining countries (the market is assuming that it will). So long as the global economy does not meaningfully slow further we believe that WTI could end the year ~\$65/bbl given our outlook for the OECD inventories to end 2019 at around a 125MM Bbl deficit relative to the 5-year average.

In the short-term, there are 3 governors on the oil price:

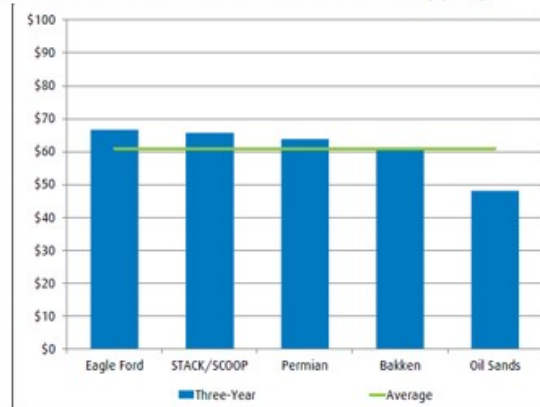
1) The pace of US oil production growth – US shale needs \$50/bbl to stay flat and \$60/bbl to grow. These realities combined with the knowledge that in order to attract generalist money E&P's need to compete on a rate-of-return basis with other industries and to achieve this E&P's must underspend cashflow and prioritize return of capital (dividends and buybacks) over production growth mean that US supply growth will not be as elastic to a rising oil price

Exhibit 1: North American Oil Sustaining Breakeven (\$/bbl)



Source: BMO Capital Markets

Exhibit 2: North American Oil Economic Breakeven (\$/bbl)



Source: BMO Capital Markets

2) OPEC+ compliance to their 1.3MM Bbl/d cut – Saudi Arabia needs \$78/bbl (Brent) to achieve fiscal break even and given the implosion in FDI post the Khashoggi murder and their multi-year draw down of foreign exchange reserves they are well incentivized to repeat their stellar compliance to the cut.

01/28/2019 08:55:44 [BFW]

***FALIH: SAUDI OIL OUTPUT TARGET FOR FEBRUARY IS 10.1M B/D**

01/28/2019 08:56:00 [BFW]

***SAUDI OIL OUTPUT TO STAY WELL BELOW CAP FOR FULL 6 MONTHS:FALIH**

Source: Bloomberg

3) Demand growth – we are modelling a slowdown in demand growth to 1.2MM Bbl/d in our OECD inventory forecasts even though a material slowdown in demand growth has NOT been evidenced widely in the data

POSITIONING

Given the historic dislocation between the oil price and the performance of energy stocks over the past few years the entire energy complex could be considered a “target rich environment” for outsized returns. The question though is where are the MOST mispriced opportunities where we are taking on the least amount of risk relative to the upside that we are targeting and which areas will most likely be first to receive incremental buying when generalist investors do finally return to the sector? Currently the answer to this question leads us to two areas: Canadian heavy oil producers and US light oil producers (mainly Permian).

We wrote extensively in 2018 about our bullish view on heavy oil and our belief that heavy oil differentials of \$40+/bbl were temporary and would fall to ~\$20/bbl in 2019:



Source: Bloomberg



Source: Twitter

Most of the factors that we predicted would narrow the differential for Canadian heavy oil came to pass and the Alberta Government’s decision in December to force mandatory production curtailments (an action that we publicly supported) expedited our forecast. The current backdrop for heavy oil differentials is very positive: crude-by-rail has ramped from a low of 144,000Bbl/d in January 2018 to a record high of 330,000Bbl/d in November 2018 on its way to 450,000+ Bbl/d by September 2019, Line 3 is progressing and will add 370,000Bbl/d of incremental pipeline capacity, heavy oil production is falling in many significant areas like Mexico and Venezuela, OPEC’s ~1.3MM Bbl/d of curtailments largely targets heavy oil, the US is contemplating putting on import restrictions

on Venezuelan heavy oil imports, gasoline crack spreads are very weak due to the continued lightening of the global production stream (shale oil is ultra light), and IMO2020 is increasing the demand for marine gasoil by about 2MM Bbl/d which favours refining a heavier grade of oil (ie. IMO2020 could actually be good for heavy oil given current market dynamics!). Our base case was that WCS differentials would fall to rail economics (~\$20/bbl) and stay there until the construction of greater pipeline takeaway capacity via Transmountain or Keystone XL. We are however beginning to wonder if even we have been too bearish. Given the factors listed above we are beginning to question whether WCS differentials could approach pipeline economics and perhaps even trade close to parity with WTI in 2019 and 2020? The implication of this (and even consensus buying into our \$20/bbl prior call) on the cash flow of Canadian heavy oil producers is extremely significant:

	<u>Cash Flow</u> <u>in 2020 at</u> <u>\$60WTI</u>	<u>Free Cash Flow</u> <u>in 2020 at \$60</u> <u>WTI</u>	<u>EV/CF</u>	<u>FCF Yield</u>
<u>MEG</u>				
\$15 WCS differential	\$1,011	\$681	5.0	42.8%
\$20 WCS differential	\$815	\$485	6.2	30.5%
\$25 WCS differential	\$619	\$289	8.1	18.1%
<u>ATH</u>				
\$15 WCS differential	\$226	\$136	2.8	27.1%
\$20 WCS differential	\$135	\$45	4.7	9.0%
\$25 WCS differential	\$44	-\$46	14.4	-9.2%
<u>BTE</u>				
\$15 WCS differential	\$923	\$273	3.5	22.4%
\$20 WCS differential	\$882	\$232	3.7	19.0%
\$25 WCS differential	\$840	\$190	3.8	15.6%

Source: Ninepoint Partners

With only a \$5/bbl change in assumed WCS differentials a name like MEG can have a 30% change in cash flow. Given how out of favour WCS exposed names became during the Canadian pipeline drama of 2017-2018 we can buy names today trading at 25%+ free cash flow yields with 30 years of proven reserves (ie. they could simplistically privatize themselves 7.5 times before their proved reserves ran out from free cash flow). That is how stupidly inexpensive these names have become if one believes in \$60/bbl oil (the marginal cost of supply globally).

The second area where we have committed capital is in US shale producers, most notably in the Permian Basin. Given the end to the several year long delineation phase of shale exploration E&P's

are now moving into exploitation and optimization which will translate into much improved corporate returns. Companies have now drilled enough delineation wells to secure land tenure and have experimented with enough frac formulas to know the proper frac fluid design, drill bit, sand loading, down spacing, and landing zone required to squeeze as much oil (and returns) out of each well. The need to improve corporate returns was re-emphasized at a major US conference that I attended in early January: oil executives are fully aware of the generalist apathy towards their sector and recognize that the only way to draw capital back is to not only compete with themselves but also other sectors (ie. E&P's needs to generate as good of a corporate return as technology, consumer discretionary, or industrial companies do). This shift in mindset is very significant and not only makes oil and gas companies more investable but also has a profound implication on oil macro in that US production growth will not be as elastic to an increasing oil price as companies in 2019 are generally budgeting \$50/bbl and excess cash flow as a result of higher oil prices will go towards shareholder returns (dividends and buybacks) rather than increase in capital spending so as to not risk overcapitalizing and eroding returns. We are buying companies with 15-20+ year drilling inventories at about half of their historical multiples. Several of our holdings have the best rock in the best play in the world and can grow by 15%+ per year spending within cash flow at \$55WTI. Canadian light oil companies simply cannot compete with many of their US brethren and hence 100% of our light oil exposure is in US companies.

	2020 EV		2020				Target		2020		D/		Target		Target	
			\$60 WTI	EV/EBITDA	D/EBITDA	Multiple	Upside	\$70 WTI	EV/EBITDA	EBITDA	Multiple	Price	Upside			
FANG	\$100.68	\$19,812	\$4,549	4.4	0.7	8.0	100%	\$5,374	3.7	0.6	8.0	\$242.08	140%			
PE	\$18.11	\$7,833	\$2,050	3.8	1.1	6.0	74%	\$2,422	3.2	1.0	6.0	\$38.65	113%			
CDEV	\$12.91	\$3,994	\$1,122	3.6	0.8	6.0	70%	\$1,345	3.0	0.7	6.0	\$26.99	109%			
WPX	\$12.27	\$7,096	\$1,774	4.0	1.5	6.0	56%	\$2,151	3.3	1.2	6.0	\$24.56	100%			
MTDR	\$18.87	\$3,284	\$830	4.0	1.6	6.0	67%	\$983	3.3	1.3	6.0	\$39.43	109%			
CXO	\$116.26	\$26,794	\$5,279	5.1	0.8	8.0	63%	\$6,044	4.4	0.7	8.0	\$220.04	89%			
PXD	\$139.44	\$24,560	\$4,821	5.1	0.3	8.0	57%	\$5,793	4.2	0.2	8.0	\$264.67	90%			
CPE	\$7.94	\$2,852	\$824	3.5	1.5	6.0	104%	\$985	2.9	1.3	6.0	\$20.45	158%			
OAS	\$6.12	\$4,502	\$1,461	3.1	1.9	5.0	129%	\$1,745	2.6	1.6	5.0	\$18.47	202%			
BRY	\$10.98	\$1,297	\$380	3.4	1.0	5.0	68%	\$487	2.7	0.8	6.0	\$30.99	182%			

Source: Ninepoint Partners

In closing, 2018 followed an already poor showing in 2017 for the energy sector. Given the highest sectoral apathy level in history, record low benchmark weightings, near all time low valuations, and the potential for record free cash flow it feels like the worst for both the oil price and energy equities is behind us. While December 2018 was especially brutal with oil falling by as much as 8% in a day (with no fundamental news to explain the move) we are reminded of our experience in December 2015 and January 2016. Then too energy stocks were in free fall and tax loss selling was vicious. Yet, because we were invested appropriately we were able to benefit from the inevitable turn in sentiment and the Fund rallied by 142% from the lows (mid January 2016) by the end of the year. While "the turn" has taken much longer than we anticipated and the lessons of the past can fade in memory we would remind investors that sentiment can turn on a dime and most of the returns are made in the ensuing days and weeks after the shift. As a result of the sector malaise we are able to buy companies with decades of high return drilling inventory at or below their proved developed producing reserve value and therefore we are getting all remaining booked and unbooked upside for free. Provided that we are correct in oil rallying to \$60/bbl (and ultimately higher) if investors continue to ignore the sector then the pace of buybacks will accelerate...stocks trading at 25%+ free cash flow yields will not last forever.

Eric Nuttall

Partner, Senior Portfolio Manager
Ninepoint Energy Fund

NINEPOINT ENERGY FUND - COMPOUNDED RETURNS¹ AS OF JUNE 30, 2022 (SERIES F NPP008) | INCEPTION DATE: APRIL 15, 2004

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	15YR
Fund	-15.7%	37.8%	-0.6%	37.8%	79.9%	55.2%	18.9%	8.4%	2.1%
S&P/TSX Capped Energy TR	-14.4%	42.1%	3.6%	42.1%	68.7%	22.4%	9.5%	2.9%	0.1%

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 December 31, 2018; 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.[†] Since inception of fund Series F.

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