



Ninepoint Energy Fund

March 2019 Commentary

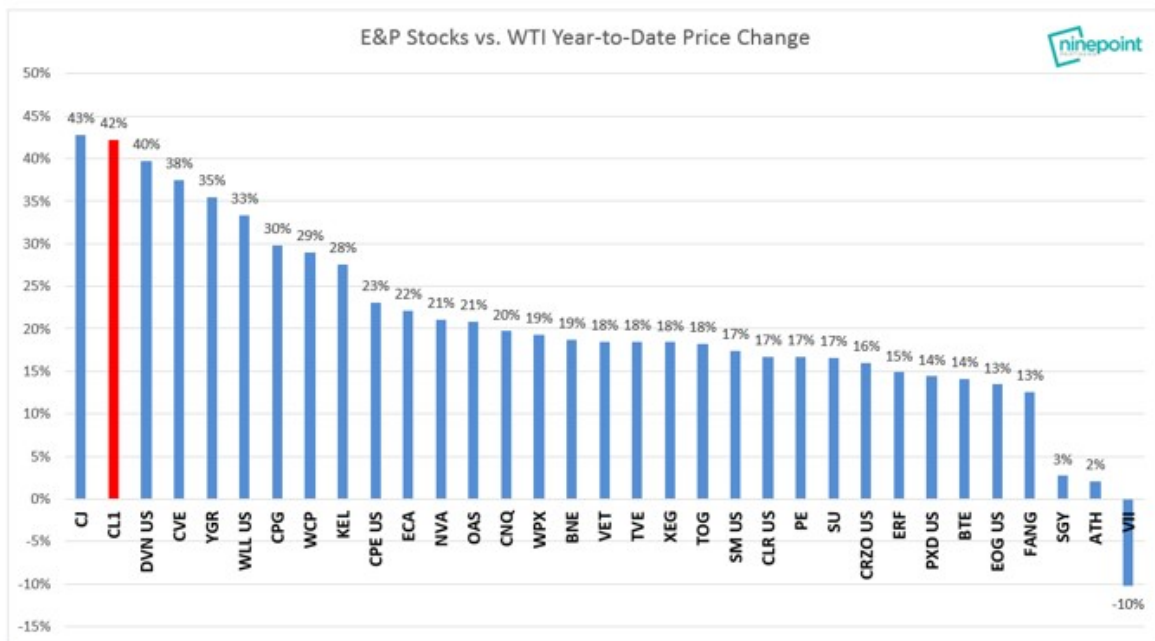
Is the energy sector broken?

The price of oil has rebounded by 40%+ year-to-date due to several factors including the realization that US production growth will be constrained by E&P's underspending their cashflow (and instead prioritizing return of capital in the form of buybacks and dividends over growth) and that OPEC's (ie. Saudi's) necessity for higher oil prices due to budgetary requirements means that compliance to their December production cut will be high and that the cut will likely be extended to the end of 2019. Despite this very meaningful improvement in both sentiment and oil pricing, the stock prices of energy equities have greatly lagged with some barely positive on the year and valuations remaining at their lowest level in generations (large and mid caps trading at 10%+ and 20%+ free cash flow yields). This extreme dislocation has prompted many to ask: "is the energy sector broken?".

Investment Team



Eric Nuttall, CIM
Partner, Senior Portfolio Manager



Source: Bloomberg

The breakdown in the historical relationship between oil and oil stocks can be attributed to one thing: a complete buyers strike. Why is this happening? Most energy investors today are experiencing significant fatigue at having dealt with crisis after crisis (real or otherwise) that always seems to have pushed out the bullish narrative for the sector by another quarter or two. Over the past several years we have had to contend with:

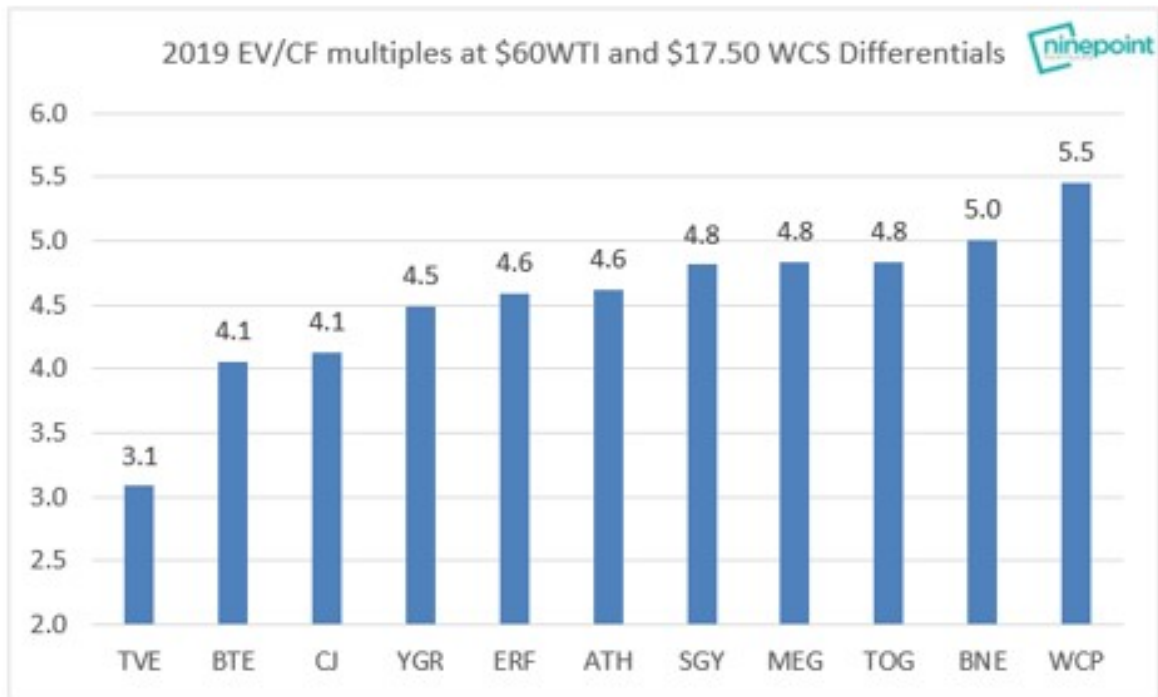
1. Sporadic worries about regional (ie. China) and global economic growth due to Brexit, trade tariffs, and diplomacy via Twitter which are only alleviated with actual data which due to time lags takes several months/quarters
2. US producer discipline which slipped in 2018 as CEO's hadn't yet been beaten over the head

enough to instill the need to maniacally focus on returns which allows for buybacks and dividend growth

3. Sudden shifts in OPEC policy due to falsehoods emanating from the White House about their resolve to drive Iranian exports "to zero" which temporarily loosened the market in 2018
4. Ongoing energy equity selling pressure due to the rise of ESG (Environmental, Social, and Corporate Governance) issues and worries that oil is a sunset industry given the imminent end of oil demand growth (we agree...in two decades)
5. Increased influence of CTA's which have greatly exacerbated daily volatility (remember when oil fell by 8% in December on no news?) leading many to shun the sector due to inherent unpredictability

These primary factors have led to investors leaving the sector in search of less volatile and more predictable returns. The result? Less market efficiency, less trading liquidity (volumes have been running at 70%-80% of average and block volume is down making it harder to transact in non-large cap names), and fewer people willing to proclaim (after many false starts in 2017/2018) that opportunity does in fact exist in the energy sector. You can feel the difference in the energy market today...the phone barely rings with salesmen wanting to talk about energy names, there exists little differentiation in valuations between what was once regarded as "premium" over what is still regarded as "junk", and when investors meet with companies no one wants to talk about well results or new plays as conversations revolve around macro worries and pipeline politics.

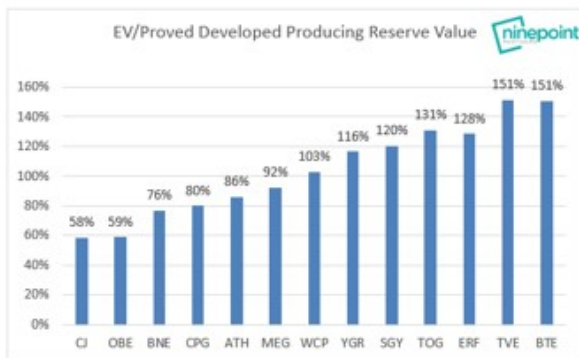
The result of all of this has been a decoupling between historical E&P valuations and the oil price. While there are many ways to measure this our preference is to look at what multiple the market is paying for companies estimated annual cash flow (we use enterprise value...market capitalization plus net debt) and what multiple of reserve value the market is paying for. Using \$60/bbl for 2019 (which is fair given the 2019-2021 strip is now averaging \$60.40) the market is currently valuing companies at 4.5X EV/2019 cash flow. This compares to a historical average closer to 7X-8X. You'll also note the lack of dispersion in valuations with "premium" names trading at the same level as "junk" (you can decide which is which...) reflecting the lack of energy sector participants necessary to provide market efficiency.



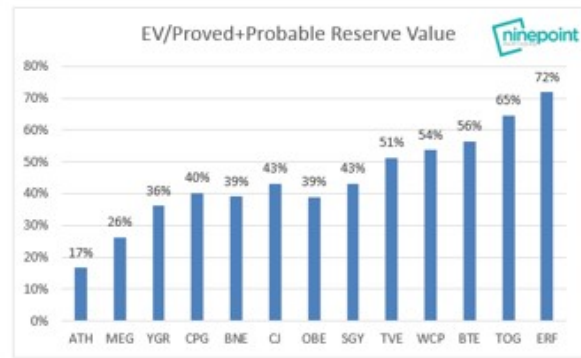
Enterprise Value = Market Capitalization + Net Debt
 *MEG FCF yield is for 2020 and assumes Christina Lake Phase2B expansion

Source: Ninepoint Partners

On a reserves basis when I started my career 16 years ago it was common for companies to trade at roughly 1.2X their proved plus probable reserve value which means the market ascribed value to exploration upside. Today, many names trade at a discount to their liquidation value (the present value of the cash flow stream of wells already on production that require little to no further capital referred to as proved developed producing):



Excludes value for land and seismic
 Source: Company Reports, Ninepoint Partners

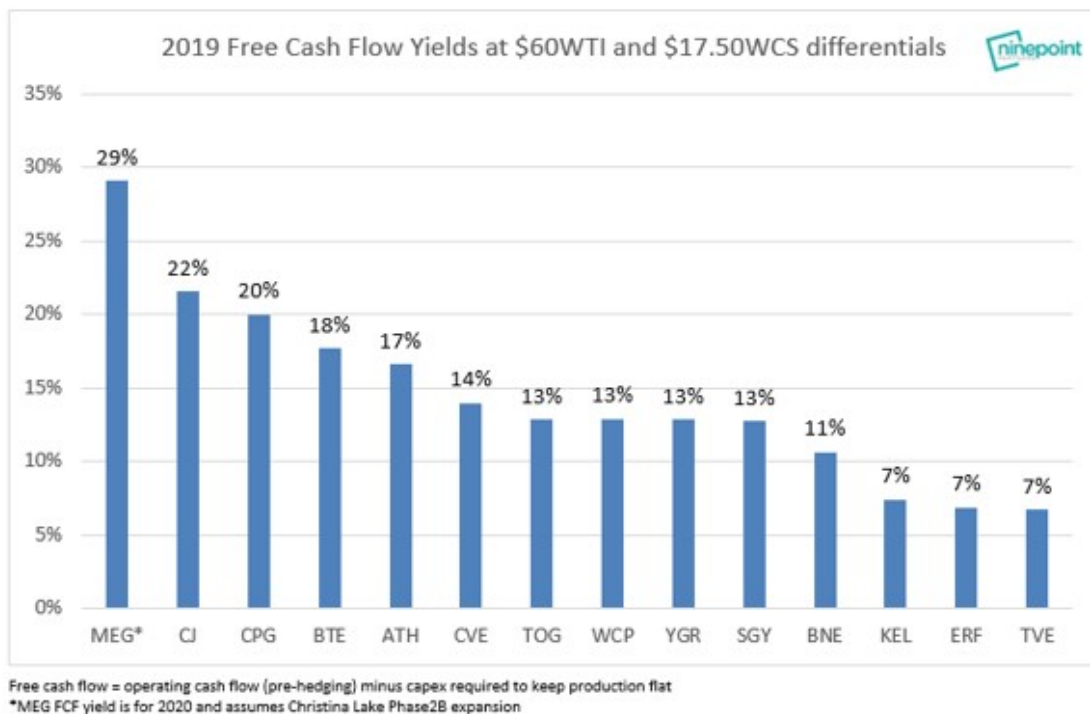


Excludes value for land and seismic
 Source: Company Reports, Ninepoint Partners

What this means is that for Crescent Point as an example, the combined market capitalization and net debt of the company is currently worth only 80% of the net present value of the cash flow stream of existing production thus investors are not paying for \$1.1BN in land and seismic nor for \$8.2BN of remaining booked reserve value (for those not counting that equates to \$9.3BN of free

optionality). Never in my career have I seen so many companies trade at a discount to liquidation value unless their balance sheets were permanently impaired (CPG debt:cash flow is only 2.2x) or the reserve engineer's price deck off of which the reserve value is calculated was vastly too high.

It should be clear that by any metric oil stocks are being valued at historically low valuations but you may be thinking "so what Nuttall...energy stocks can stay cheap forever if no one cares about them." It is this very point that motivated me to draft an open letter to 13 midcap oil company CEOs suggesting a curative for what has become an endemic level of apathy. What is this curative you ask? Meaningful stock buybacks financed from free cash flow. Many companies today have solid balance sheets (sub 2X debt: cash flow), are trading at a discount to their liquidation value, and due to \$60+/bbl oil and vastly improved cost structures from years of cost cutting are generating highly meaningful levels of free cash flow (defined as cash left over from operations after keeping production flat and satisfying interest payments). Given a lack of buying interest it is common for oil stocks to trade at a 10%+ free cash flow yield:



Source: Bloomberg, Ninepoint Partners

So on March 19th I wrote an open letter (attached) urging CEOs and their Boards to immediately adopt the strategy of keeping production flat while devoting every dollar of free cash flow to share repurchases. Effectively my message was if the market didn't want to buy their stock then they should as this would act as a jolt to the collective investor psyche that had lost sight of current insanely low valuations. A question I posed to many of them in private was "if you today are trading at a discount to your liquidation value, have a solid balance sheet, and have the free cash flow to buy back 10%-30% of your shares outstanding and yet are unwilling to do so...then why the %#\$ should I?" There is no legitimate answer to that question. While my letter was the beginning of what will be a longer conversation I'm confident that many companies listed in the graph above will be buying back their shares in 2019.

The other possible outcome arising from such low valuations is the emergence of friendly/hostile takeovers or private equity buyouts. If I had the ability to do so (anyone want to seed me?) I would be buying out several Canadian mid cap oil companies right now. Here are a few examples:

Earlier I mentioned that Crescent Point was trading at a 20% discount to its liquidation value. Today I could hedge CPG's production for the next 3 years at roughly \$60/bbl thereby eliminating any cash flow risk. Given the stock is trading at a 20% free cash flow yield I could harvest the cash flow over the next 3 years and recoup 60% of my upfront non-levered investment while keeping production flat. Over that time frame I would only be using 3 of their 6 years of proved developed producing reserves which have a nominal \$45MM of required capex (versus \$6.3BN of cash flow over the 3 years). At the end of the 3 year term assuming that oil was still at \$60 (conservative in my mind) I would be able to further hedge out another year or two and with \$594MM a year of free cash flow I could payout my entire investment in 5 years and still have 1 more year of zero-capex \$594MM of free cash flow (would make a nice dividend). At that point given that I was able to scoop up the company below PDP I would have \$1.1BN in land and seismic value for which I paid literally nothing as well as \$2.7BN of remaining proved reserve value or \$8.2BN of remaining proved plus probable reserve value. In effect, buying the company today I could payout my entire purchase price in 5 years and be left with \$9.3BN of value at the end of the 5 years versus net debt of \$4.0BN. Not terrible.

MEG Energy, a heavy oil producer is also a highly logical acquisition target. The company will be able to produce 113,000 barrels per day of heavy oil in 2020 (pending \$100MM of remaining capex) of which 2/3 will be sent to the Gulf of Mexico as of the second half of next year (heavy oil that can get to the Gulf of Mexico is current receiving a PREMIUM to WTI). The company has 68 years of total reserves (not a typo) and 6 years of PDP reserves that have associated capital of \$610MM (versus \$864MM of annual cash flow). At \$60WTI and a \$17.50WCS differential the stock is trading at a 2020 free cash flow yield of 29%. Hedging out the next 3 years of production at \$60 (you could do it right now) one could recoup 87% of the initial investment while having 2 remaining years of \$527MM of free cash flow (\$1+BN cumulative). After the 3 year period on top of the \$1+BN of remaining free cash flow and recouping nearly 90% of the upfront investment you would be left with proved reserve value of \$7.8BN and if one wants to dream remaining proved plus probable reserve value of ~\$14BN (inflated slightly by a price deck using \$80+WTI beyond 2026) versus net debt of \$3.4BN.

Baytex would be another at the top of my list. Today the company is trading at free cash flow yield of 20% at \$60WTI with 4 years of PDP reserves that have no required capital expenditures. Using the same approach as CPG I could recoup 80% of my investment over the next 4 years and be left with \$3.8BN of reserve value relative to net debt of \$2.1BN. In addition, Baytex has 255 sections of unbooked land in the East Duvernay play of which they believe they have desrisked at least 30 sections (180 locations) with the goal of desrisking another 60 sections in 2019. This asset has the potential to be worth over \$2BN in time (\$4+/share) and given the current discount to proved reserve value an investor today is getting this optionality for free.

One could say the above examples are simplistic as they represent zero premium M&A...but isn't that exactly what any investor could pay today by buying the shares in the open market?

In summary, the curative for investor apathy is meaningful buybacks on the part of oil companies financed from free cash flow. Given free cash flow yields of 10%+ most oil companies should be buying back their stock aggressively. If they don't and valuations remain at depressed levels CEOs

leave themselves open to continued capital flight leading to further depressed trading levels or the possibility of takeovers given that a buyer today could acquire billions of dollars of value for free with limited risk. I would also mention that it is imperative that CEOs feel the same sense of urgency as what many investors feel. Given several years of wealth devastation 2019 is a critical year for energy investors...they MUST make money this year. With the average Canadian oil company CEO (sample size 20) making \$3.7MM in 2018 (up 4% YOY while on average they underperformed the S&P TSX Capped Energy Index by 9% on a total return basis) it would perhaps be understandable to think that some CEOs might not feel the urgent need to act believing that time is on their side. It is not.

POSITIONING

Given our view that WTI would rally to above \$60 by mid 2019 we were positioned in those names whose cashflow was most likely to be positively affected. This stance has not changed. At the same time, we have remained positive on the outlook for Canadian heavy oil differentials believing that they will likely remain below \$17.50/bbl for the foreseeable future given the buildout of rail takeaway capacity and the Alberta Government's continued role in reducing oversupply into 2020. Additionally, it is our sense that sentiment towards Canada has bottomed and we have been slowly repatriating further capital into Canadian names that are trading at a discount to liquidation value believing that once sentiment shifted that the stocks could quickly rerate. This appears to finally be happening. As we write this Canadian midcaps are finally starting to rally though the bottoms off of which they are moving from are so low that many could double and still be considered attractively valued.

While there have been many head fakes over the past year it feels like the turn is in. Valuations have been on our side for a while...we have just needed sentiment to shift enough to see some semblance of funds flow return to the sector. With sizeable M&A now occurring at large premiums (Chevron is acquiring Anadarko for \$33BN at a 39% premium) such depressed (and depressing) valuations and high free cash flow yields can no longer be ignored...neither by investors nor by corporates themselves.

Eric Nuttall

Partner, Senior Portfolio Manager
Ninepoint Energy Fund

Open Letter sent from Eric Nuttall of Ninepoint Partners to Canadian oil company CEOs on March 19th 2019

Gentlemen,

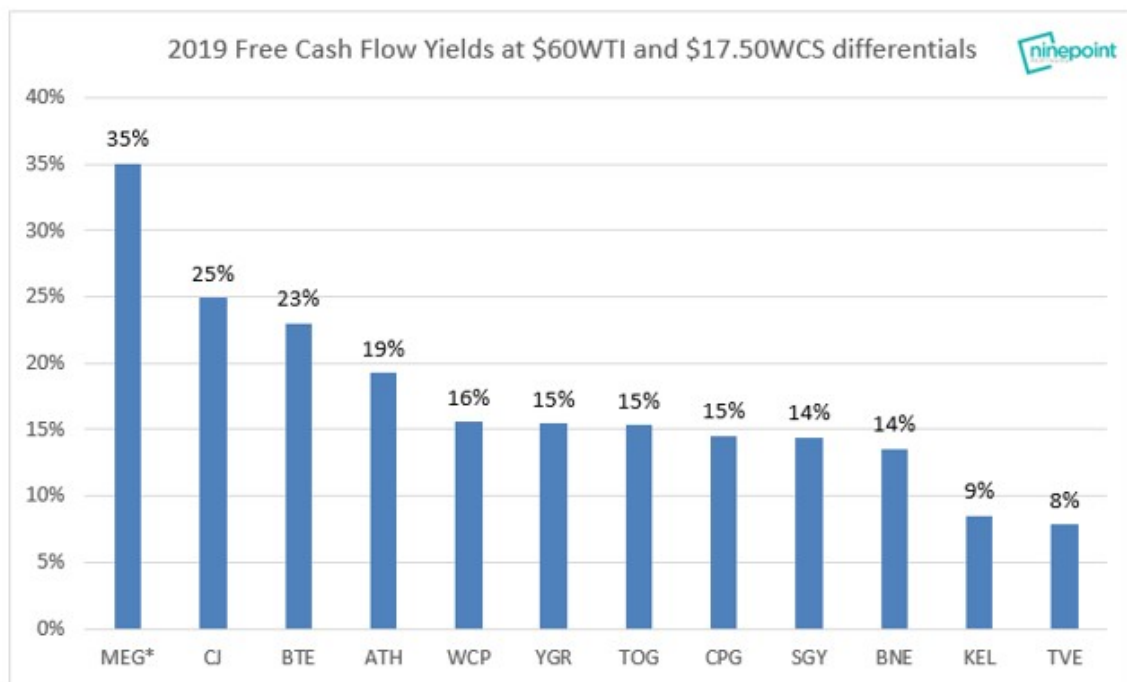
I write to you all regarding a shared common purpose.

We are all aware of how broken sentiment is towards the Canadian E&P sector (most profoundly towards mid and small caps) for reasons which are all too familiar and need not repeating. Investors have simply left the space in search of better, lower volatile returns elsewhere and who can blame them? The performance of the energy sector has been terrible and the patience level of investors, both large and small, has been exhausted. My client base is 100% retail and as such I have fairly good insight into their current collective state of mind. How would I describe it? Profound exhaustion, growing indifference, and anger. Given both the extent and duration of the energy bear

market (the S&P TSX Capped Energy Index has returned -8.5% compounded over 5 years and a meagre +0.6% over 10 years while the S&P500 has returned +16.7% a year compounded over 10 years) Canadian retail investors (and you can count me with them) have a strong desire to make money this year. I am increasingly concerned that if 2019 is a repeat of the recent past and we have another down year that we will see further capitulation that will impair the return of fund flows for years to come resulting in chronically impaired trading multiples.

We all know and feel the level of apathy towards the sector. You see it when you meet with generalist institutional investors and I see it when I market to retail advisors across the country. This lack of interest has led to the cheapest valuations that I have seen in my short 16 year long career (and I would suspect of any of you with longer tenure). We can all sit around and gripe about valuations hoping that something magical will change to improve sentiment (elections, pipelines, oil price rally, etc.) or we could do something about them with one simple curative that each of you have the ability to enact: **meaningful** buybacks financed from free cash flow.

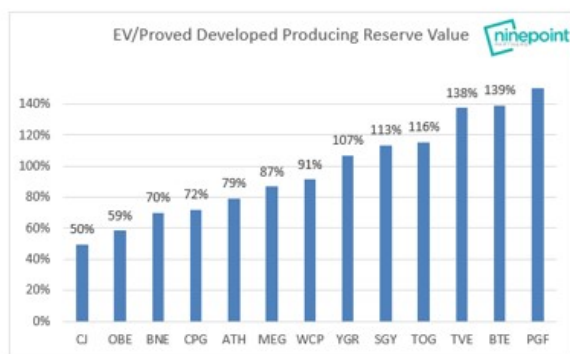
These are 2 sets of graphs in my mind that should not coexist:



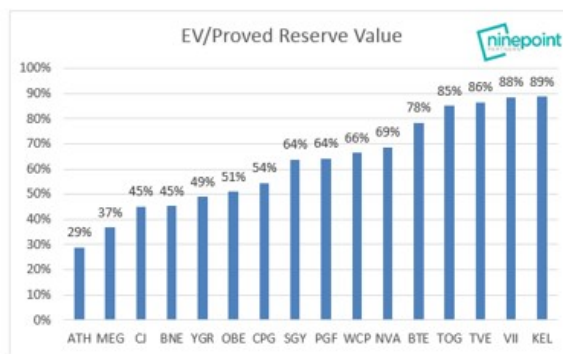
Free cash flow = operating cash flow (pre-hedging) minus capex required to keep production flat
*MEG FCF yield is for 2020 and assumes Christina Lake Phase2B expansion

Source: Bloomberg, Ninepoint Partners

AND



Source: Company Reports, Ninepoint Partners



Source: Company Reports, Ninepoint Partners

I am confused as to why many of you are not using what is now actual (versus modelled) free cash flow to buy back stock when you are trading at discounts to proved and in many cases to PDP reserve value with balance sheets that no longer need repairing. How can anyone justify drilling a single well beyond that required to maintain flat production given these valuations? The market clearly does not care about growth and while I admit that the market's desires can change faster than you can adapt business plans to them the discussion of "return of capital" is only growing south of the border (your largest competitor for investment fund flows).

My belief is that many of you should adopt a strategy of MEANINGFUL (ie. 10%+) buybacks. Having management demonstrate they believe in themselves and their company shares as a good use of capital would reinvigorate interest levels in the sector (beyond just SU and CNQ) and lead to multiple expansion, especially in the context of improving oil fundamentals with 2019 strip pricing above \$60/bbl USD.

I mentioned at the beginning that we share a common purpose. Clearly my own unit holders need positive performance this year but I would also suggest that we are all in the same boat for both obvious (personal net worths) and less obvious reasons. Anger is building. It is inevitable that this leads to both discussions regarding executive compensation as well as actions like HSE's towards MEG...an attempt to capitalize on peak apathy and buy assets at distressed valuations. Some of your companies are trading at such historically low levels that I am confounded as to why private equity has not yet made hostile takeover attempts. With WTI strip near \$59/bbl average over the next 2 years and some of you trading at 20%+ free cash flow yields a private equity buyer could lock in cash flow for the next 2 years and recoup 40% of their upfront non-levered investment from free cash flow while keeping production flat and only exhausting 2 years of PDP reserves versus a midcap average of ~6 years of PDP reserves.

As one of the few remaining advocates of the Canadian patch who is stubborn enough to express their views publicly on a frequent basis I implore you and your Boards to give this suggestion a strong consideration. As overused and cliché as this saying goes it pertains extremely well to our current situation: "the definition of insanity is doing the same thing expecting a different result." The market needs shock and awe in the form of radical action to bring back buyers to the CDN midcap space: lock in floors for your remaining 2019 volumes and commit to a 10%-20% share buyback with your free cash flow. If that doesn't get your stock moving you can blame the guy giving advice from the cheap seats in Toronto.

Eric

BCC:

Scott Ratushny, Cardinal
George Fink, Bonterra
Craig Bryksa, Crescent Point
Rob Broen, Athabasca Oil
Derek Evans, MEG
Grant Fagerheim, Whitecap
Jim Evaskevich, Yangarra
Paul Colborne, Surge
Brett Herman, Torc
Brian Schmidt, Tamarak
Edward Lafehr, Baytex
Dave Wilson, Kelt
Ian Dundas, Enerplus

NINEPOINT ENERGY FUND - COMPOUNDED RETURNS¹ AS OF SEPTEMBER 30, 2020 (SERIES F NPP008)

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	15YR	INCEPTION
Fund	-15.1%	-52.3%	-3.3%	88.7%	-45.3%	-28.6%	-18.8%	-12.0%	-8.7%	-3.5%
Index	-17.5%	-53.7%	-14.1%	10.4%	-49.9%	-27.5%	-14.5%	-11.0%	-7.5%	-3.0%

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 March 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.† Since inception of fund Series F.

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