# Ninepoint Energy Fund

## November 2019 Commentary


Investment Team

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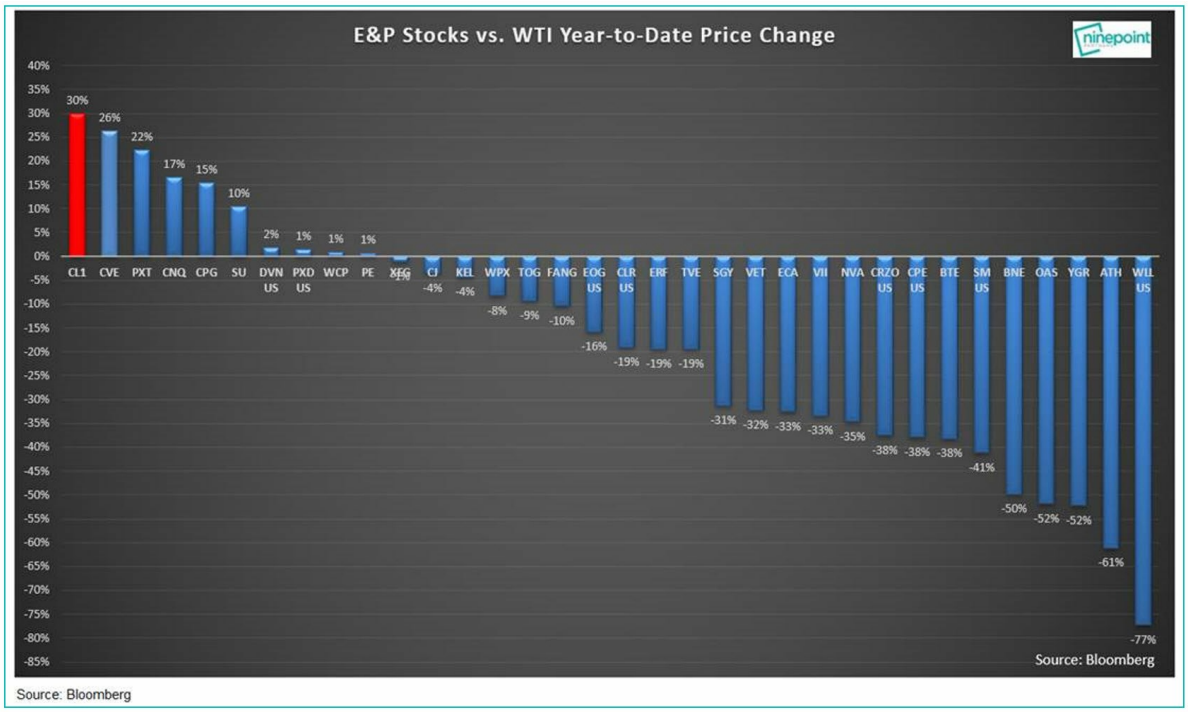
OPEC's decision to further cut 500k bbl/d from the oil market for Q1/2020 (while also improving compliance on the part of 3 cheaters) is a meaningful development. The market had become wary of a 1H'20 oversupply due to one-time project startups from Brazil and Guyana and this concern of potential stock builds had been keeping money from coming back to the sector (despite growing realizations that the oil market is likely to become increasingly tight throughout 2020). Today's action removes the risk of a meaningful short-term oversupply and should provide price support around current levels (contingent on the US/China trade skirmish not escalating further).

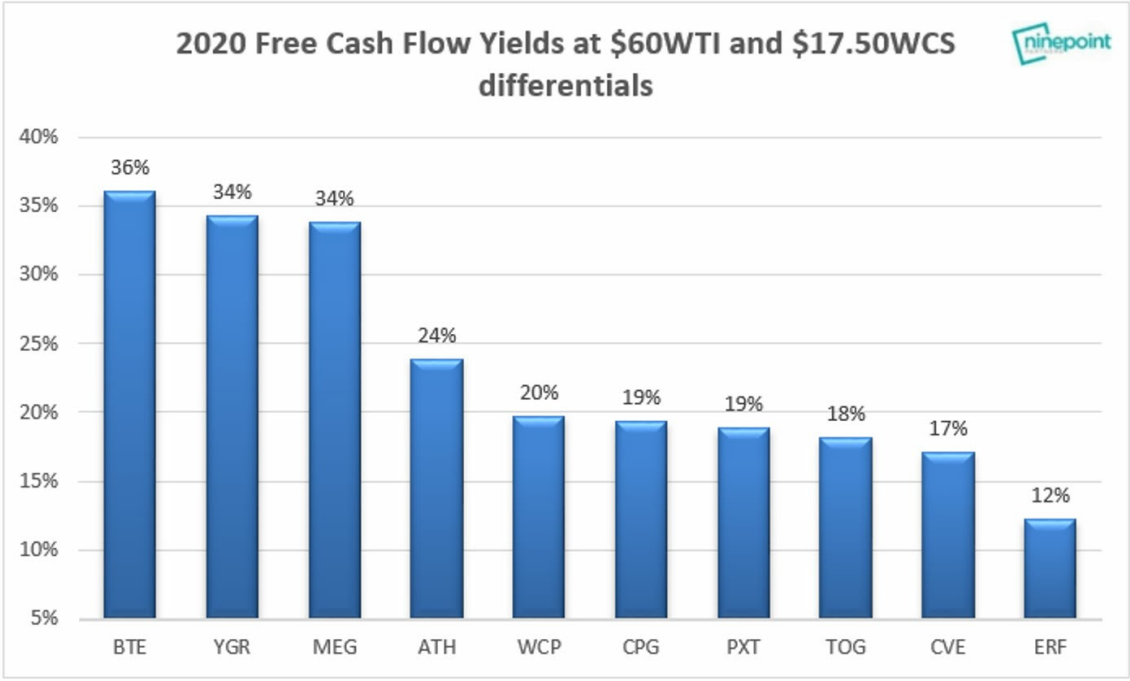
We maintain our call that oil is on the cusp of entering into a multi-year bull market. Importantly, due to the disconnect between energy stocks (exhibit 1) and the oil price (+30% YTD) investors need not believe in further oil price upside from current levels to more properly value energy stocks (exhibit 2,3) but rather need only have conviction that oil is unlikely to precipitously fall. We believe that a price in excess of $60/bbl is supported by fundamentals in the 2H'20 and beyond (reasons for why later on). So what provides the catalyst for a re-rate in energy stocks back closer to historical levels and what would that upside be?

**Exhibit 1**




Source: Bloomberg

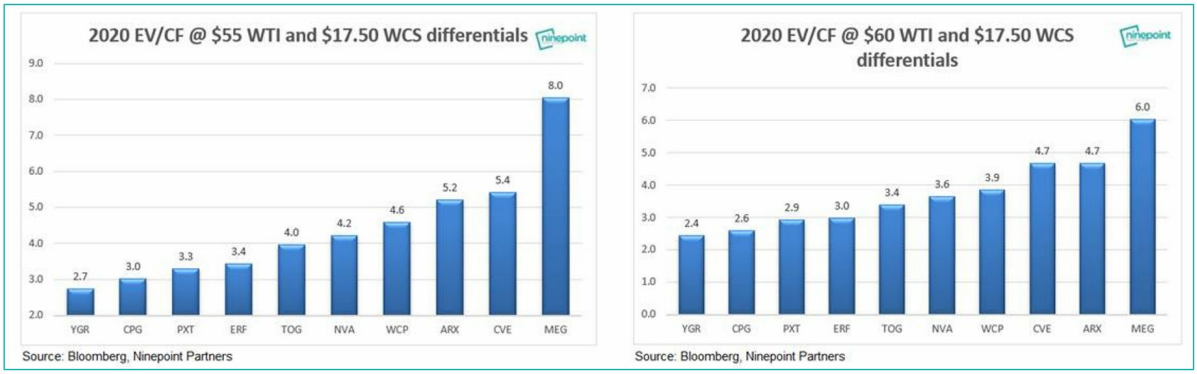
**Exhibit 2**




Free cash flow = operating cash flow (pre-hedging) minus capex required to keep production flat

Source: Bloomberg, Ninepoint Partners

**Exhibit 3**




Currently, the market believes that oil demand in 2020 will be weak due to ongoing trade tensions between US/China and that oil supply growth will be high resulting in an oversupplied market. While demand growth is next to impossible to predict should any semblance of a trade deal/truce emerge it would clearly have a positive impact on demand (and sentiment). As well, certain "one time" events occurred this year that impacted oil demand that hopefully will be non-reoccurring (flooding in the US Midwest prevented plantings which dented demand by ~0.4MM Bbl/d as an example).

More importantly, oil production growth estimates from the major forecasting agencies (EIA, IEA, etc) are simply too high. Despite an implosion in the US oil directed rig count (-25% YTD), structural shifts towards underspending cash flow and prioritizing dividends and buybacks, and a flatlining in well productivity improvement rates, most agencies are still calling for US oil production growth in excess of 1MM Bbl/d in 2020. We believe it will closer to 600k bbl/d (and others have called for as low as 300k bbl/d). So far 13 US public E&P's have outlined their 2020 spending plans and they are

tracking a 16% decline year-over-year. As well, banks have become much more defensive in their lending standards (such as using below-strip price decks in reserve based loans) and a major concern is starting to emerge about companies ability to roll over debt in 2021 and 2022. As a result companies are much more likely to hoard cash (even with higher oil prices) lest the high yield market not open up before they have to begin discussions with their lenders.

Secondly, Brazil was supposed to be a one of the areas of major production growth going forward but on November 28th Petrobras unveiled flat production growth in 2020 (versus expectations of 0.2MMBbl/d or more)...a major disappointment that went largely unreported. Between the US and Brazil this amounts to ~0.5MM Bbl/d less supply and materially swings oil market balances from oversupply to under. Look for the major agencies to true up their forecasts in the weeks and months ahead.

**Why do we believe that oil is about to enter into a multi-year bull market?**

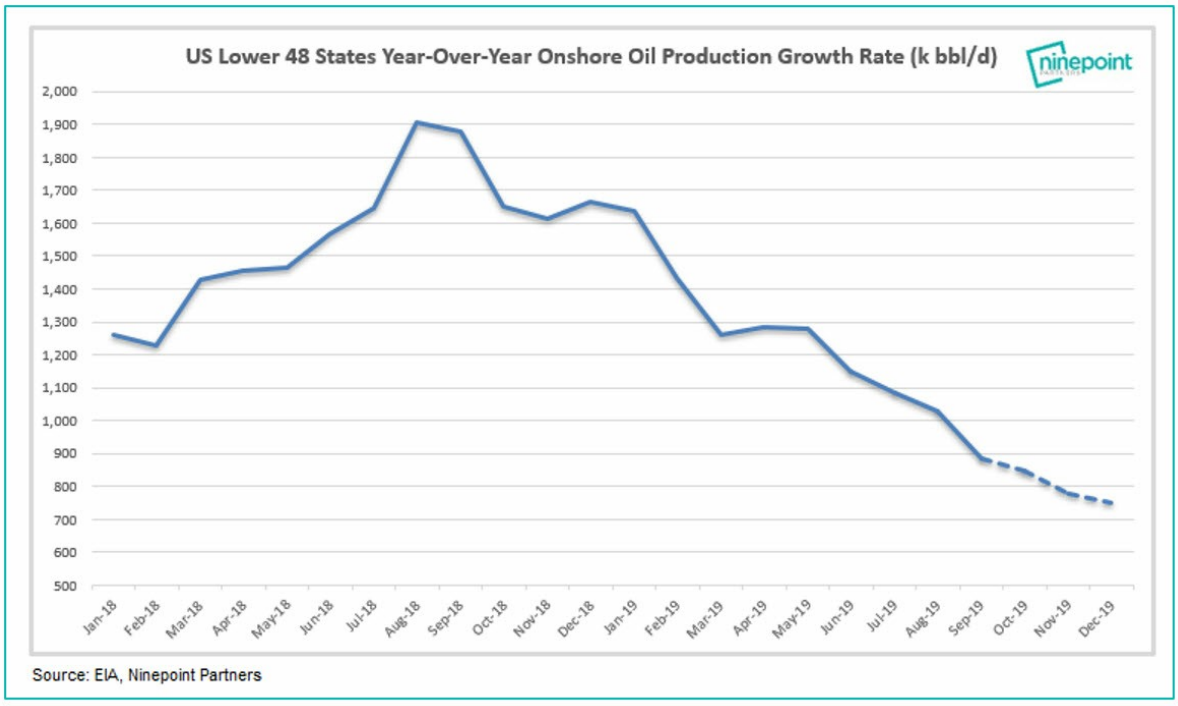
1. US supply growth deceleration (exhibit 4) is structural and geologic

   **a.** Investors are demanding that companies underspend their cash flow and return capital in the form of dividends and/or buybacks = less spending on drilling and less sensitivity of US production growth to oil prices

   **b.** US shale is showing signs of maturity – well productivity rate improvements are flattening and evidence has emerged that companies have been exhausting their Tier 1 acreage (Tier 2... the less productive rock...is only 50% as productive yet has the same well cost = increasing supply cost)

   **c.** As noted before in 2020 and 2021 many shale companies need to preserve liquidity and amass cash as the high yield market is showing signs of distress

**Exhibit 4**

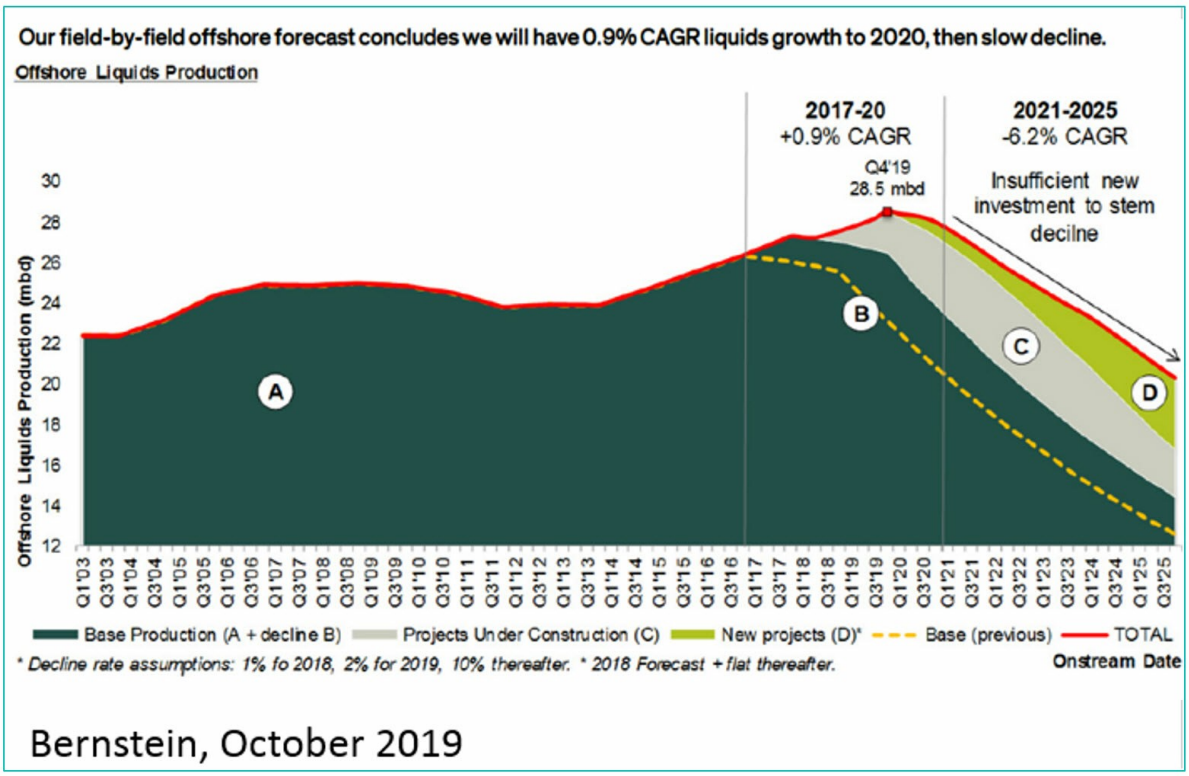


**2.** Global offshore production (25% of global oil supply) is about to go into a multi-year decline (exhibit 5)

**a.** Due to a lack of investment during 2015-2018 few major projects were sanctioned. With Johan Sverdrup coming on in the past month new projects going forward are not adequate enough to offset a 10%+ natural decline. Given 4-6 year lead times from project sanctioning to first oil this trend is unavoidable

**b.** We had called for this 1-2 years ago but the inevitability was delayed with satellite tie backs and likely irresponsible production practices (pulling on wells harder than they should have… Schlumberger had shown that depletion rates of many fields has skyrocketed)…should not be the case in 2020+

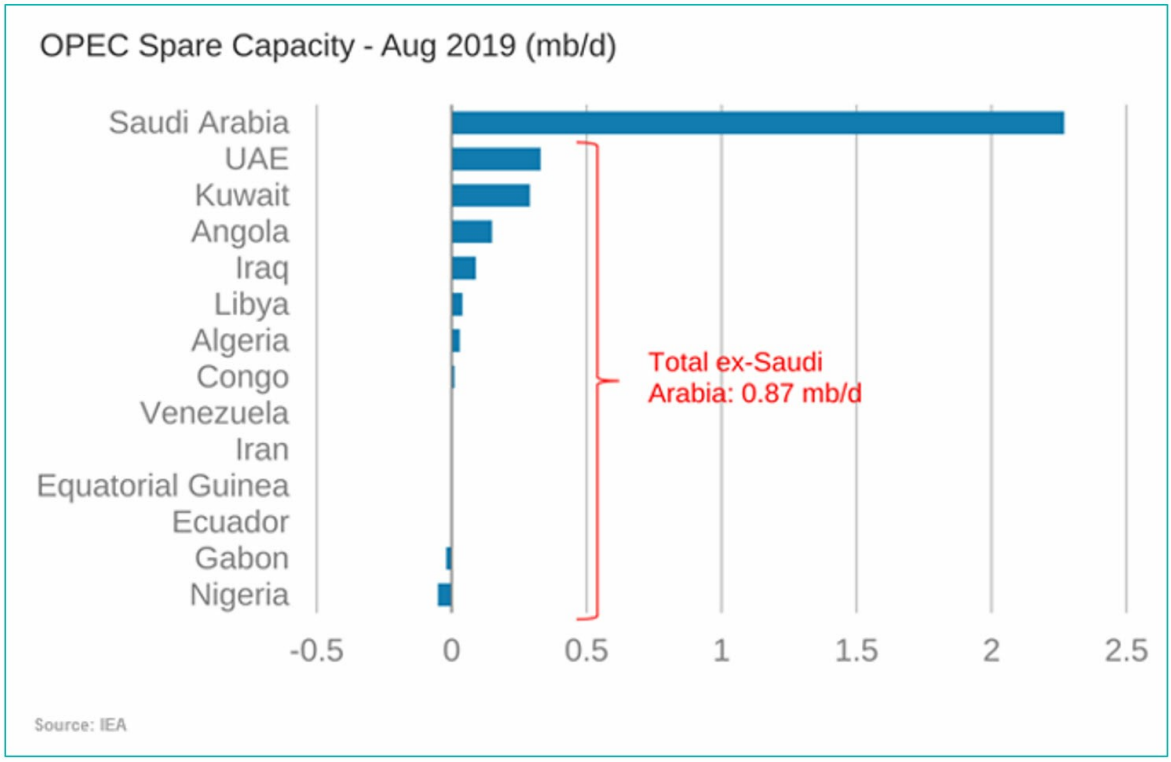
**Exhibit 5**




**3.** OPEC spare capacity is tapped (exhibit 6)

**a.** Excluding Iranian export restrictions of ~ 2.4MM Bbl/d due to US sanctions OPEC's actual spare capacity is likely 2.0-2.5MM Bbl/d. In a 100MM Bbl/d market this is a very thin number and equates to only 2 years of demand growth.

**Exhibit 6**




There are 2 potential events that could defer our bullish oil call by 1-2 years: a global recession or a truce between US/Iran that would allow for a return of pre-sanction oil export levels.

Energy stocks, especially in Canada, remain severely depressed. At current oil pricing many stocks trade at 15%+ free cash flow yields, half of their historical trading multiples, and out of free cash flow have the ability to repurchase 70% of their outstanding shares over the next 5 years (Exhibit 7 for a Fund holding example). As interest is renewed in the sector in the coming months (?) we expect significant multiple expansion albeit likely never to reach old highs. With many stocks trading at ~3.5x EV/CF even a partial re-rate to 5x-6x (versus the good old days of 8x-9x) offers highly meaningful upside (75%-100%+).

**Exhibit 7**

| | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | |
|---|---|---|---|---|---|---|---|
| **$55 WTI** | | | | | | | |
| Cash flow | $625.8 | $625.8 | $625.8 | $625.8 | $625.8 | $625.8 | |
| Free cash flow after dividend | $104.6 | $104.6 | $104.6 | $104.6 | $104.6 | $104.6 | |
| S/O - beginning of year | 420.6 | 396.9 | 373.1 | 349.4 | 325.6 | 301.9 | |
| # of shares able to buy back | 23.7 | 23.7 | 23.7 | 23.7 | 23.7 | 23.7 | |
| S/O - end of year | 396.9 | 373.1 | 349.4 | 325.6 | 301.9 | 278.1 | |
| EV/CF (end of year S/O) | 4.5 | 4.3 | 4.2 | 4.0 | 3.8 | 3.7 | Multiple falls despite flat production and oil price |
| Dividend yield if keep absolute diviend outlay static | 8.1% | 8.6% | 9.2% | 9.8% | 10.6% | 11.5% | Fewer shares outstanding = higher yield each year |
| Cumulative % of stock repurchased | 5.6% | 11.3% | 16.9% | 22.6% | 28.2% | 33.9% | |
| **$60 WTI** | | | | | | | |
| Cash flow | $743.9 | $743.9 | $743.9 | $743.9 | $743.9 | $743.9 | |
| Free cash flow after dividend | $222.7 | $222.7 | $222.7 | $222.7 | $222.7 | $222.7 | |
| S/O - beginning of year | 420.6 | 370.0 | 319.5 | 268.9 | 218.4 | 167.8 | |
| # of shares able to buy back | 50.6 | 50.6 | 50.6 | 50.6 | 50.6 | 50.6 | |
| S/O - end of year | 370.0 | 319.5 | 268.9 | 218.4 | 167.8 | 117.3 | |
| EV/CF (end of year S/O) | 3.6 | 3.3 | 3.0 | 2.7 | 2.4 | 2.1 | Multiple falls despite flat production and oil price |
| Dividend yield if keep absolute diviend outlay static | 8.7% | 10.0% | 11.9% | 14.7% | 19.1% | 27.3% | Fewer shares outstanding = higher yield each year |
| Cumulative % of stock repurchased by YE | 12.0% | 24.0% | 36.1% | 48.1% | 60.1% | 72.1% | |

Source: Ninepoint Partners

While our bullish call over the past 2 years has been deferred by the actions of the US President (first in 2018 by bamboozling Saudi into ramping production and swamping the market under the erroneous belief that Trump was about to become ultra-hawkish with Iran in 2018 and then a US/China trade war in 2019 that impacted oil demand) we see the stars aligned for 2020 and beyond. At current valuations (oil stocks discounting < $50/bbl) investors are getting free optionality on any positive development while being rewarded with E&P's using their egregious levels of free cash flow to pay down debt and/or buy back their shares making those that we own incrementally valuable with each passing month.

Reach out with any questions,

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**Ninepoint Partners**

## NINEPOINT ENERGY FUND - COMPOUNDED RETURNS[1]

| | 1M | YTD | 3M | 6M | 1YR | 3YR | 5YR | 10YR | 15YR | Inception |
|---|---|---|---|---|---|---|---|---|---|---|
| Fund | 11.2 | -1.4 | 15.2 | 2.0 | -11.4 | -25.9 | -14.0 | -4.6 | -2.7 | -0.2 |
| Index | 6.7 | -1.9 | 5.7 | -6.0 | -18.1 | -10.9 | -10.1 | -4.7 | 0.3 | 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 November 29, 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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