



Ninepoint Energy Fund

October 2018 Commentary

What the #@! just happened???

Investment Team



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pur·ga·to·ry

/ˈpɜrɡəˌtôrē/

noun

1. (in Roman Catholic doctrine) a place or state of suffering inhabited by the souls of sinners who are expiating their sins before going to heaven.

Oil Macro

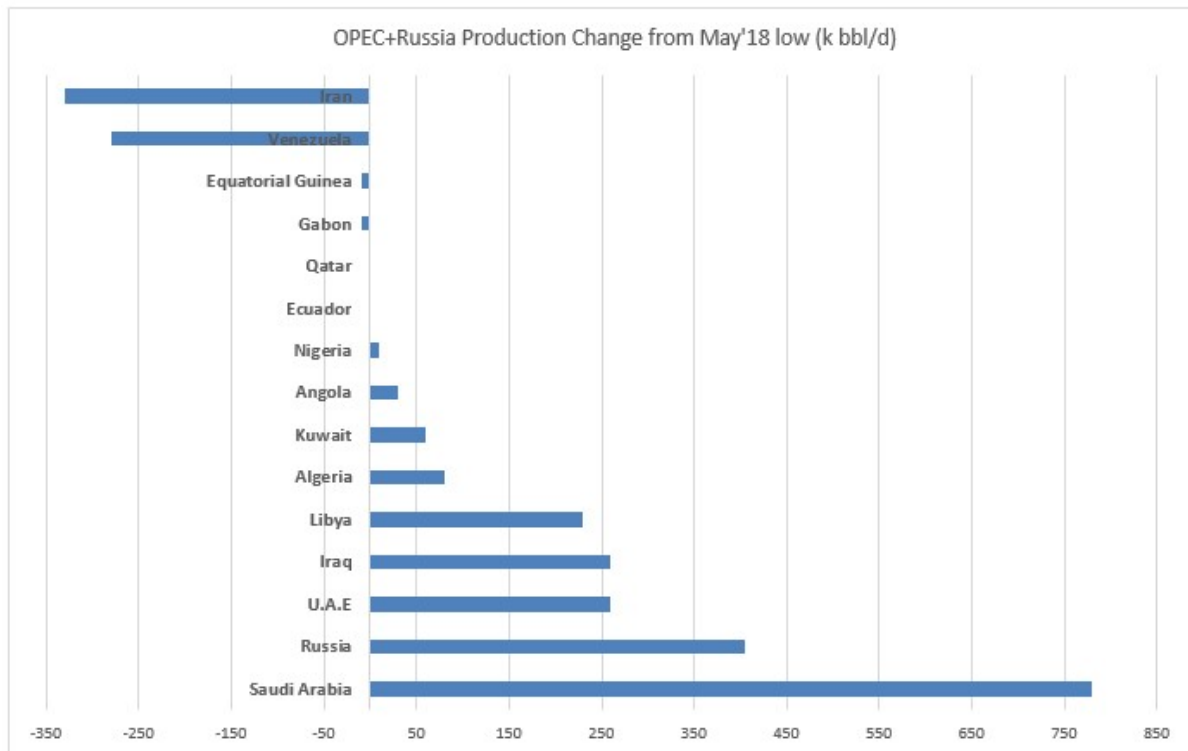
In the past month sentiment in the energy market has taken a “bipolar-esque” U-turn resulting in the price of oil collapsing by over \$13/bbl. Echoes of “\$100 oil in 2019” still rang when new narratives of “demand destruction due to trade wars” and “ineffective Iranian trade sanctions” began to take hold and even one CNBC market commentator has just proclaimed that oil could fall to as low as \$40/bbl (breathe...remember the infamous “we won’t see \$44/bbl oil again in my lifetime” proclamation when oil was at ~\$30/bbl in January 2016?). The rate of change in sentiment has been truly incredible...how did the market swing from universal bullishness to the current level of bearishness in just over a month? In short, what the #@! just happened and how much longer will it feel like energy investors are stuck in purgatory?

To begin, let’s stop and ask “what has actually changed over the past month”? Did fundamentals (or perception?) deteriorate enough to support the steep drop off in oil? Was the sharp liquidation in net speculative length in WTI to a 14+ month low supported by actual significant fundamental change or was it from still fresh wounds of 2014-2016 that resulted in commodity fund liquidation at the first sign of possible softening? How could the financial demand for oil fall so sharply while the physical demand for oil continued to grow and remain at the highest level in history? How could stocks basically flatline with oil rallying by 25% from January to October and then get smashed by 30+% when oil fell?

From our observation two major events led to the collapse in the oil price over the past month:

- 1) Ongoing trade war escalations by Trump increased fears of slowing global growth and with it concerns that oil demand growth was about to fall
- 2) The US issued Iranian import waivers to eight countries and this was perceived as a softening in Trump’s stance towards Iran. OPEC+Russia have already increased production by ~1.5MM Bbl/d from the May’18 lows largely in anticipation of steep Iranian export declines...what happens if

Iranian exports don't fall as much as expected?



Source: Bloomberg

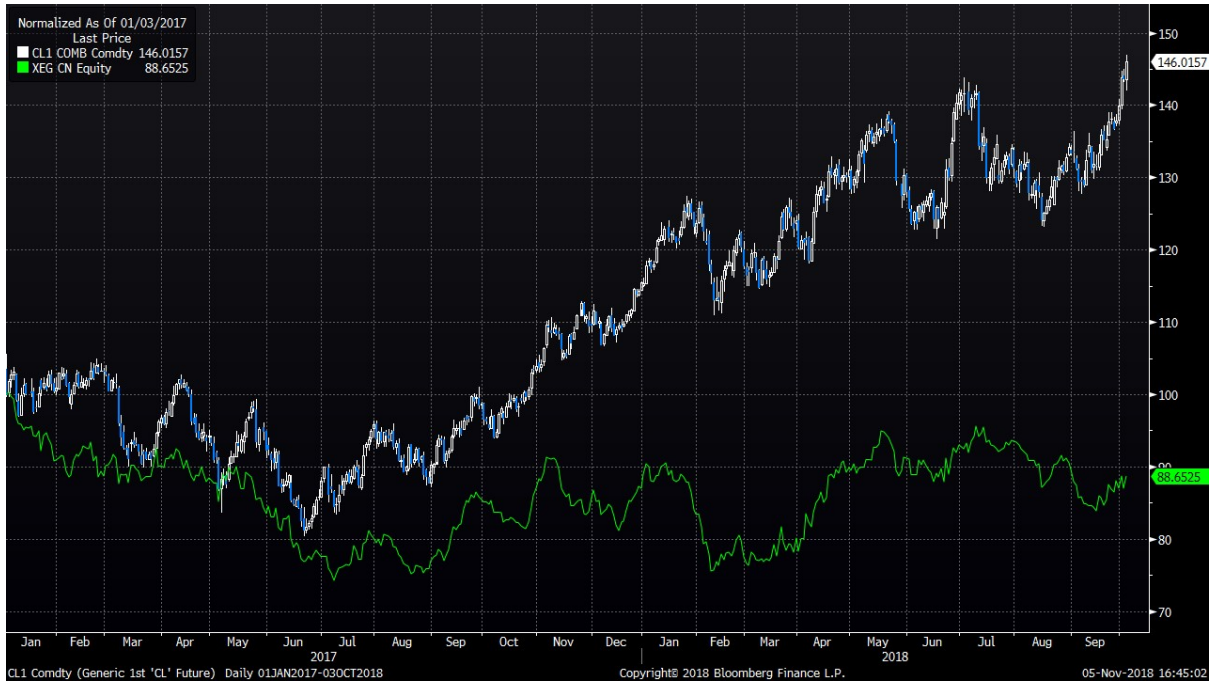
In addition to the above several minor but still sentiment-damaging events also occurred:

- 1) The murder of the journalist Khashoggi in Turkey prompted fears that Saudi would “pump full out” as a means of placating Trump and retaining US support and misinterpreted quotes from an interview with the Saudi Oil Minister seemed to support this fear as it was reported that Saudi Arabia could increase production to 12MM Bbl/d “within a matter of months”
 - 2) The DOE reported that US L48 August production rose 310k bbl/d month-over-month resulting in YTD total US production growth of 1.4MM Bbl/d January-August (we expect the pace of growth to materially decelerate in the final months of the year)
 - 3) The delay of two new Chinese refineries (Rongsheng and Hengli) coming online deferred 0.8MM Bbl/d of crude demand into early 2019 and led to a partial oil buyers strike in Asia as they had prepurchased oil in anticipation of a Q4 startup
 - 4) Global and US refinery turnaround season ended up being much larger than previously estimated - US PADD2 turnaround was the largest since 2012 with runs down ~1.2MM bbl/d versus 0.7MM Bbl/d last year and global CDU outages of ~ 8MM Bbl/d vs. ~6MM Bbl/d last year
- The culmination of the above events led to possibly the sharpest liquidation in net speculative length in the history of the WTI oil contract to levels last seen when oil traded below \$35/bbl:



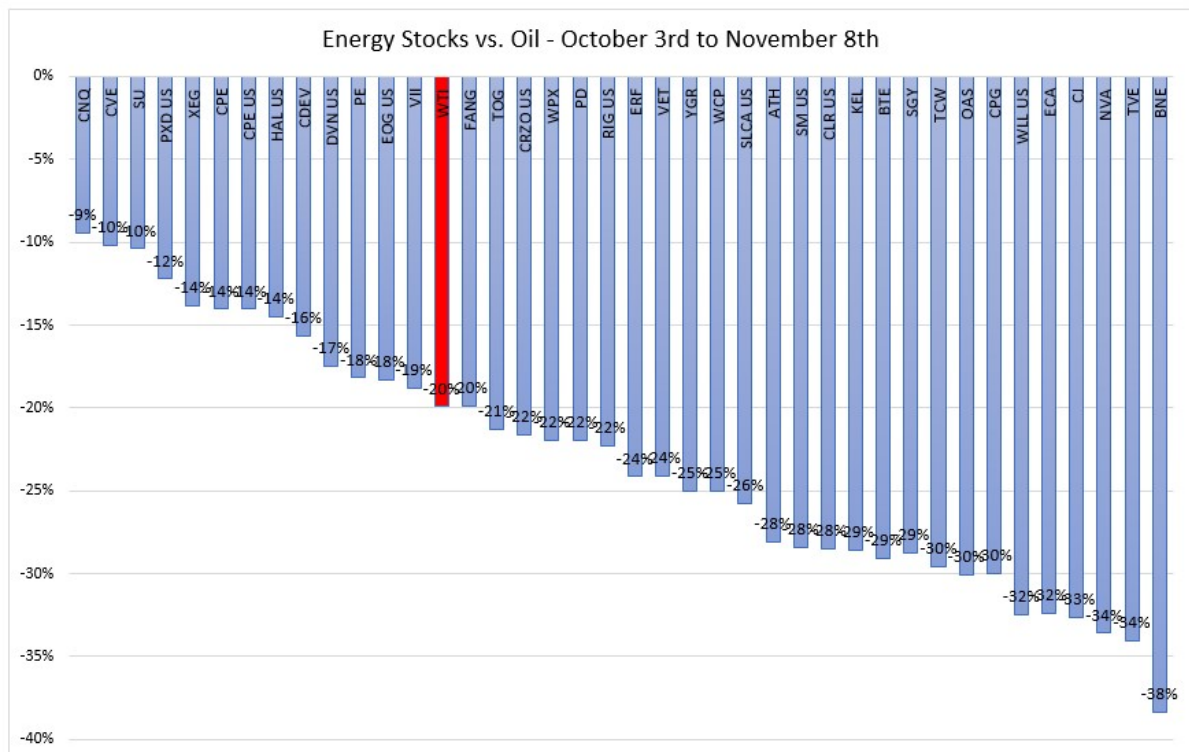
Source: RBC, November 2nd, 2018

What is profoundly frustrating for energy investors is that this past month marks what feels like the 1,000th one-step-forward-two-steps-back event in the past 2 years. From January 1st, 2017 to October 3rd, 2018 (oil's recent closing high at \$76.41) oil rallied by 42% yet energy stocks underperformed this move by the largest extent in history: US energy stocks (XOP) rallied by 7.6% yet Canadian energy stocks (XEG) fell by 10.8%...a 53% 2 year divergence in performance!



Source: Bloomberg

Subsequent to October 3rd due to the reasons listed above the price of oil has fallen by ~20% and energy stocks have been crushed so in short energy investors have captured none of the oil price upside over the past 2 years yet have been destroyed by the current (and temporary) pullback:



Source: Bloomberg

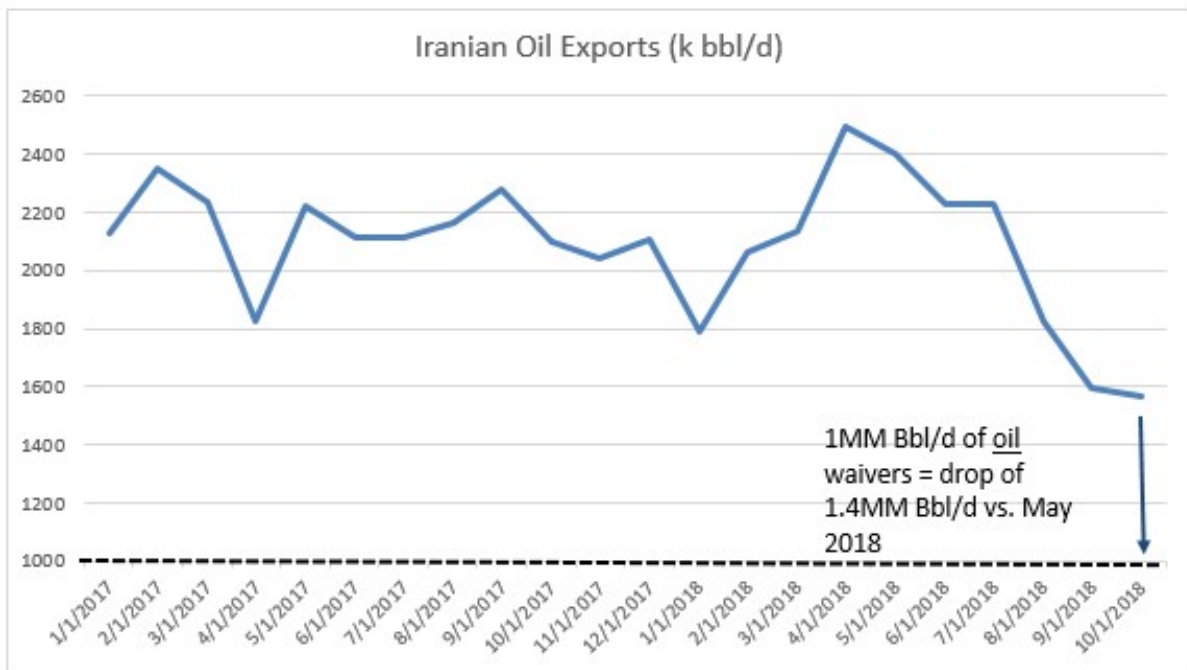
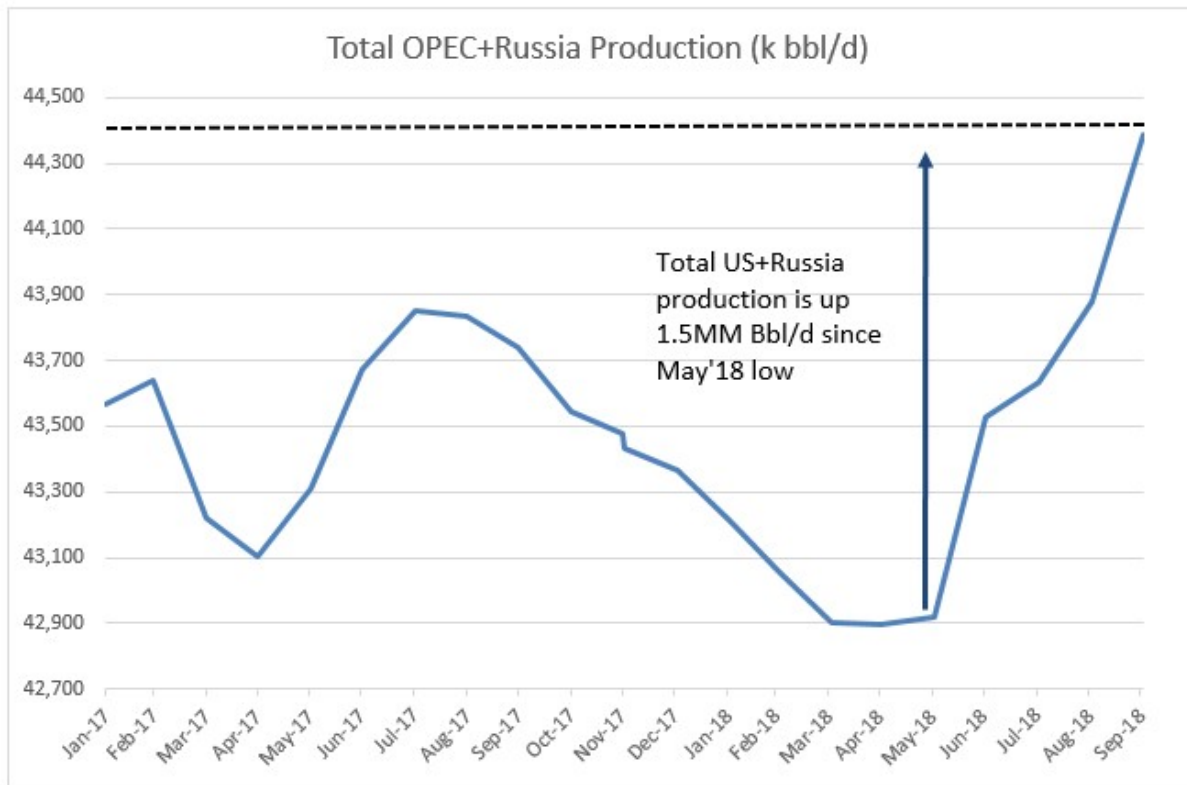
Fears of a global economic slowdown have increased in recent months with softening global GDP expectations and signs from some countries of moderating growth. The IMF in early October cut their 2019 global growth estimate by 0.2% for both 2018 and 2019 to 3.7% due primarily to trade

policy tensions and the imposition of import tariffs. This on the surface would obviously not be overly bullish for crude oil demand however putting a 0.2% reduction in GDP expectations into the context of a 100MM Bbl/d oil market translates into a modest ~100,000Bbl/d demand growth deceleration...but a flesh wound.

While there have been signs of economic deterioration in major pockets of oil demand growth (for example China's Q2'18 GDP growth was the lowest since 2009 and their September industrial production was the lowest since October 2015) many of the YTD signs of demand deceleration can actually be attributed to weather events: low water levels in Europe in Q2 = low refinery runs and monsoons in India and Indonesia = temporary reductions due to harvest challenges. Goldman Sachs on October 31st issued a report specifically on global oil demand and noted that demand has actually accelerated in September over August (September demand growth = 1.63MM Bbl/d YOY vs. August = 1.42MM Bbl/d).

Another consideration is the persistent demand underestimation by the IEA resulting in the market's too low "baseline" off which supply/demand balance estimates are made. The IEA has an infamous reputation for chronic demand growth underestimation whereby they have underestimated demand growth in 9 of the last 10 years. Despite this most Wall Street oil strategists use the IEA as their primary "demand growth model input" due to the extremely laborious process of estimating global demand growth. If one calibrates their 2018 and 2019 demand growth expectations with a growing IEA "balancing item" demand growth could be 0.4MM Bbl/d higher than consensus believes. This differential has an enormous impact on oil balance modelling and determining the extent of 2019 inventory drawdowns.

The second major development over the past month has been the eroding opinion on the effectiveness of US trade sanctions on reducing Iranian oil exports. This is critically important as this was the primary reason for Saudi Arabia and Russia to have increased production by ~1.2MM Bbl/d since May. The market has adopted the belief in recent days that since waivers were issued to 8 countries that allow for a reduced level of imports from Iran (specific levels not divulged) that this must mean the Trump Administration has softened its stance (versus wanting to drive Iranian exports to "zero") and therefore Iranian export reductions will NOT offset the above noted production increase resulting in a loosened market. We do not believe this to be the case: while the issuance of waivers does delay the balancing of the OPEC+Russia production increase (up 1.5MM Bbl/d from May '18) with Iranian export reductions (1MM Bbl/d of oil waivers = a 1.4MM Bbl/d decrease from May '18) Iranian exports should ultimately match the production increase:



Source: Bloomberg, Ninepoint

The very condition for a country to have received a waiver is to have shown a meaningful attempt at having already reduced Iranian imports. It appears to us that rather than the issuance of waivers signaling a fundamental shift in policy it rather indicates a growing awareness on the part of the Trump Administration that adopting their prior uber hawkish approach would have resulted in a spike in the oil price (and materially higher gasoline prices right ahead of a US midterm election):



Javier Blas @JavierBlas · 21h

"I don't want to lift the #oil prices world wide by clamping down 100 percent," Trump says. "It would cause a shock to the market," if we went to zero right away, Trump says | #OOTT #Iran

Source: Twitter, November 5, 2018

"I don't want to drive oil prices up to \$100/bbl or \$150/bbl," Trump said during a news conference at the White House on Wednesday. "You have a monopoly called OPEC and I don't like -- wait -- I don't like that monopoly, I don't like it."

Source: Worldoil coverage of Trump Press Briefing, November 7, 2018

QUESTION: Just the specifics on the secondary sanctions. Bolton said yesterday a number of countries may not be able to go to zero immediately, we want to achieve maximum pressure, we don't want to harm friends or allies either. So just on what you were saying before, who are those friends and allies that you're negotiating with? And have there been any decisions made – I know you said you're in the middle of it, but any decisions made about specific countries on exceptions to Iranian oil sales?

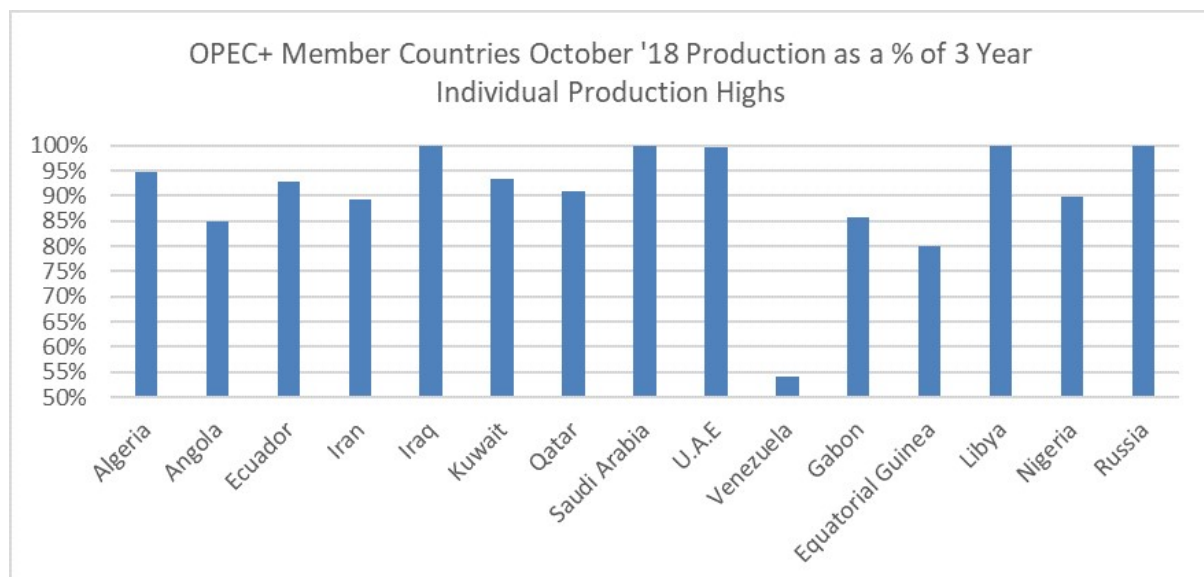
MR PALLADINO: I would just say that we're prepared to work with countries that are reducing their imports on a case-by-case basis, and our goal remains to get to zero.

QUESTION: But you are interested in working with countries not necessarily to get to zero so long as they're showing progress?

MR PALLADINO: We're prepared to work with countries that are reducing their imports on a case-by-case basis. We have an internal process to consider significant reduction exceptions for individual countries and we continue to discuss that. And I'm not going to go into detail, any further detail on what that would constitute.

Source: US State Department briefing, November 1, 2018

We believe the following to be a critical distinction: as a result of OPEC having increased production over the past 6 months to prepare for Iranian export reductions the oil market has transitioned from one that is dramatically undersupplied with adequate spare capacity to a market that is now more balanced but with little to no spare capacity. Which is more bullish for oil? We continue to believe that a major theme in 2019 will be the exhaustion of OPEC spare capacity. Saudi Arabia, the UAE, Iraq, Russia, and even Libya are now all producing at 3-year highs. Collectively we believe OPEC has at best 1MM Bbl/d of further capacity which in the context of a 100MM Bbl/d market would be the lowest level in recent history. As a result OPEC collectively has very little shock absorption capabilities to any geopolitical event (thankfully we live in such a stable world that no political risk premium need be applied to the oil price!):



Source: Bloomberg

Oil Macro Summary

Over the past month the financial demand for oil has fallen to a multi-year low even though physical demand continues to grow strongly and while forward estimates are being revised lower they still exceed 1.4MM Bbl/d and are likely understated due to the IEA's tracking error. While the issuance of Iranian import waivers to some countries was an expected event the apparent magnitude exceeded expectations and increased the risk that OPEC+Russia's production increase would not be matched off resulting in a looser market. We believe that increased clarity around trade tariffs and empirical evidence of Iranian reductions will improve sentiment towards oil. We still believe that inventories will continue to fall in 2019 and approach record low levels in 2020 resulting in a price at or near \$100/bbl. Given that we are past the midterm elections and that Saudi Arabia may have been caught off guard by the level of waivers issued (in contravention of a backroom deal struck earlier in the year for Saudi Arabia to increase production in exchange for the US coming down hard on their mortal enemy?) there lies the likelihood that OPEC will begin to raise the possibility of production curtailments if the price of oil weakens further. OPEC member countries are all driven by their own self-interest and many (including Saudi Arabia) have significantly higher required oil prices to reverse fiscal deficits / foreign exchange reserve drawdowns.



Source: Twitter, November 7, 2018 (the day after the US midterm elections...)

In summary, why do we continue to be bullish on oil and still believe that we are in a multi-year bull market?

- 1) OPEC+Russia have increased production to multi-year highs in 2018 thereby exhausting their spare capacity (ie. the low hanging fruit). Production growth going forward will be harder, slower, and less impactful relative to a 100MM Bbl/d market
- 2) The focus on shareholder returns continues to dominate and investment has not returned to the sector. Projects continue to go unsanctioned and yet exploratory results continue to mark multi-generational lows. Non-OPEC/US production (~40% of global supply) is about to go into a multi-year decline in 2020
- 3) US production growth is increasingly relying on the Permian which is beginning to show capital efficiency erosions and while we model 1.2MM Bbl/d per year of US growth this is not enough to satisfy demand growth and imminent declines in non-OPEC/US production
- 4) Demand worries persists yet are not showing up in the data...there is no substitution for oil in the medium term (2035+) and by that time the majority of US shale and existing conventional discoveries will have been consumed

Investment Strategy

We have been very clear in our investment approach this year and have been using the same playbook we used in 2016 that resulted in a 143% appreciation in our Fund's NAV from February-December 2016. The core of our thesis is to identify opportunities that the market is overlooking due to either laziness, disinterest, or lack of staying power, build a strategic position, and wait for

market fundamentals to validate our view resulting in significant appreciation. We had positioned the Fund accordingly believing that 2018 upside could exceed what we experienced in 2016 provided that:

- 1) Oil appreciated to \$70/bbl by YE'18 (this was our forecast back in January when oil was at \$60/bbl)
- 2) Fund flows returned to the sector to allow for stock valuations to get back to a more normalized level (5x-7x EV/CF)

A month ago it finally began to feel that we were on the right path as stocks were beginning to perform, midcaps were beginning to outperform large caps, and generalist investor interest was beginning to finally translate into buying. Then the oil price imploded.

Given the extreme level of sector disinterest and the outperformance of large caps during the past several years we made mid cap/higher beta stocks a major weighting in the Fund believing that buying companies trading at 5%-10% free cash flow yields and 4X-5x EV/CF multiples (vs. a more historical multiple of 7x-8x EV/CF) offered compelling value with the potential of 100% future returns. We were wrong. Over the past several months those same stocks have become 10%-25% free cash flow yields and now trade at 3x-4x EV/CF. We were clearly early. The "no bid" energy market has not received significant enough funds flows yet to allow stock prices to better reflect long term value and the few remaining energy dedicated funds in Canada are not enough to accomplish this on their own. We need generalist money to come back into the sector.

Clearly there is upside in the entire energy sector given the dislocation between oil and oil stocks. The 2019 WTI strip is \$63/bbl and stocks are trading off \$50-55/bbl oil. Yet, where do we see the biggest opportunities with the highest possibility of a rerate that could see the stocks double to triple? The two areas that we are focused on now are:

- 1) WCS exposed names (or those perceived as WCS exposed) that have gone "no bid" and are trading as if WCS differentials of \$30+ will last forever
- 2) Permian names that had sold off early in the year due to pipeline takeaway shortages in 2019 yet on 2020 under normalized differentials are trading at 3x-4X EBITDA vs. a historical 6x-7x

So why are we bullish Canadian heavy oil names when everyone else hates them? It is because the multi-year narrative of lack of pipeline capacity and the view that Canada is led by a bunch of environmentalist wingnuts willing to sacrifice \$20BN+ per year in lost royalties and taxes in order to placate foreign-backed environmental terrorists has led to mass capital exodus resulting in universal hatred. No one owns Canadian heavy oil names, they are trading at their lowest valuations in my career, and yet if one were to connect just a few dots it would become obvious that the WCS differential will materially tighten in 2019 (and beyond). So why will WCS differentials narrow in 2019?

- 1) Crude-by-Rail (CBR) is ramping faster than what consensus believes
- 2) Producers have announced shut-ins amounting to 160,000+ Bbl/d
- 3) The Sturgeon Refinery will soon become operational and consume 80,000Bbl/d of Canadian heavy oil
- 4) Pipelines will (eventually) get built – Line 3 (380k bbl/d in Nov'19), Keystone XL clarity in early 2019 (830k bbl/d), and likely clarity on TMX (590k bbl/d) before the Fall'19 Federal election

Crude-by-rail is perhaps the stupidest outcome of the foreign-backed environmentalist movement

against Canada/Canadian oilsands production. Rail as a means of transporting oil to the US Gulf Coast is twice as expensive and more importantly significantly more dangerous than a pipeline (ie. Lac-Megantic). However, until Keystone XL and/or Transmountain gets built it is a necessary evil for the industry and a key reason why differentials will fall to \$20-25/bbl by mid-2019. Crude-by-rail loadings in Canada were 229,544bbl/d in August up from 120,000bbl/d in August 2017. Given the current market imbalance of 165k-180k bbl/d an increase in crude-by-rail loadings is critical to reach balance. We believe that CBR will ramp to 455,000bbl/d in mid-2019:

CN Rail: "Crude oil shipments next year will probably surpass the 130,000 carload mark set in 2014"

Source: Bloomberg, October 24, 2018

CP: "We'll move into that sort of 100,000 annual run rate as we get into Q1, get through the Winter, to that ramp-up [to 110,000-120,000 car loads]"

Source: Company Q3 earnings call, October 18, 2018

Combined between CN and CP we expect approximately 250,000 carloads of crude by rail in 2019. Adjusting for the blended mix of crude shipped (CN 80%/20% dilbit/raw bitumen and CP 100% dilbit with 676 barrels per railcar for dilbit and 565 barrels per railcar for raw bitumen) we arrive at our annual forecast of 455,107Bbl/d. This is could be 100,000Bbl/d higher than consensus.

The second component of rebalancing the heavy oil market are shut-ins. This is not the most eloquent solution as these volumes will eventually return to the market but in an environment of \$40-\$50/bbl WCS differentials are necessary. From Q3 reporting we have tallied the following announced shut-ins:

CNQ 45-50k bbl/d	DVN 25k bbl/d	BTE 5k bbl/d
CVE <50k bbl/d (30?)	MEG 10-15k bbl/d	HSE 20k bbl/d
JACOS 20k bbl/d (?)	ATH 5k-8k bbl/d	<u>TOTAL: 160k-173k bbl/d</u>

With CBR ramping from 330k bbl/d to 455k bbl/d (125k bbl/d increase) by mid-2019 combined with (temporary) shut-ins of roughly 160k bbl/d this equates to 285k bbl/d of incremental tightening versus a 160k-185k bbl/d surplus + 2019 production growth potential of ~100k bbl/d Q4'19/Q4'18. In short, the market could balance by early 2019 and Line 3 coming online in November '19 (380k bbl/d) could negate the need for all of the announced shut-in volumes. While CBR will still be necessary for the foreseeable future this tightening of the WCS market should allow for differentials to fall to rail economics (~\$20/bbl) in 2H'19. This will have a dramatic impact on both heavy oil company cash flows (ATH's cash flow at \$70WTI DOUBLES with a \$10 reduction in WCS differentials) as well as sentiment. We own names like ATH and BTE that could easily double to triple from current levels (ATH trades at 3.1x EV/DACF and a 18% FCF yield at \$70WTI and a \$20 differential with a 76 year reserve life while BTE with 43% of their cash flow coming from the Eagleford play in Texas which gets a \$5/bbl premium to WTI trades at 2.8x EV/DACF and a 26% free cash flow yield under the same commodity/differential assumptions).

The other major theme that we have exposure to is the Permian Basin, the epicenter of US production growth. Permian names were weak earlier this year due to a temporary shortage of pipeline capacity as a result of midstream companies having underestimated the degree of success that Permian producers would have in growing production. We see this bottleneck ending by the end of 2019 and this will unencumber many who are being partially impacted in 2019. Many of our

holdings have well over a decade of high quality inventory and at \$70WTI can grow production by 20%+ while spending less than 1x their annual cashflow. Much of the early shale boom was spent on acreage accumulation and appraisal drilling. Now, industry is transitioning into development mode where return of capital can be prioritized allowing for an attractive combination of production growth and buybacks/dividends. Permian names are trading at an average 2020 EV/EBTIDA of 3.4x, P/E of 6.2X, FCF yields of 10%+, and are expected to have ROCE of 16% at \$70WTI. Typically oil names trade at an infinite P/E given they never have earnings and a EV/EBITDA average of 6x-7x. As more infrastructure is built allowing for increased exports we also believe Permian producers will get product pricing more akin to Brent than WTI and this 2020 upside has not yet been discounted into share prices. We see 80%-130% upside in our Permian names.

In the commodity sector bottoms are typically found when:

- 1) Stocks positively diverge from the commodity – we have in recent days see energy stocks up 2%-3% when oil was down by 2% on the day
- 2) M&A picks up – we have seen a flurry of deal activity, both friendly (ECR, PVAC, WRD, NFX) and hostile (MEG, TDG)
- 3) Companies start to buy back their own shares – SU increased their buyback from ~\$2BN to \$3BN, CNQ formalized that 50% of free cash flow in 2019 will go towards share buybacks, some large US companies have bought back 10%-20% of their shares outstanding this year

We cannot speak to when generalist money comes back into the energy sector because we are at a loss as to why we haven't seen it already. Before the selloff stocks were trading at 10% FCF yields and EV/CF multiples HALF of their historical averages. Today we can buy names like Baytex where the stock has fallen by more than half over the past 5 months, trades at a 24% free cash flow yield and 3.2x EV/CF multiple and offer us 150% upside at a 5x multiple and \$70WTI / \$20 WCS differential. Such opportunities should not exist yet here we are. If generalists continue to shun the sector, given how strong the free cash flow yields are in 2019 I would expect more companies to adopt aggressive share buyback programs. That is something we are encouraging all of our holdings to do. We would also expect to see more M&A such as MEG Energy, a former holding which was opportunistically put into play by Husky due to the market's current distaste for Canadian heavy oil names and myopic inability to look through the very near term resulting in an asset changing hands at the worst part of the cycle (for MEG shareholders at least).

Eric Nuttall

Partner, Senior Portfolio Manager

Ninepoint Energy Fund / Ninepoint Energy Opportunities Trust

NINEPOINT ENERGY FUND - COMPOUNDED RETURNS¹

	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 October 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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