

**Letter to Investors in Tarpon Folio
Q4 2014**

“Thoughts on Black Gold”

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Dear Investors,

Value investing works best when there is fear. For the first nine months of last year, there was little fear in the market. Then, lo and behold, the Great Oil Panic of 2014. And there was much rejoicing in Islamorada.

A chart of Tarpon’s 2014 performance looks like it came off a seismograph. In its sixth year, ending in late November, Tarpon increased by 3.5%, lagging the benchmark S&P 500 Index by 13.5% for the year. The recent crash in oil prices hurt our energy holdings’ stock performance, and I am devoting this quarter’s letter to my thoughts on oil – both to explain Tarpon’s recent weakness and, more importantly, to underscore what should be significant strength in the portfolio ahead.

Also notable since my last letter was that in a single day in December, one of our companies jumped 130% in share price, and another received an acquisition offer at a substantial premium. Both eased the sting of the crash in oil prices.

In the below, I am going to attempt to convince you of three things.

The first is that I have not gone insane.

You may see me repeatedly buy plummeting shares of oil and gas companies and think, “This doofus has finally lost it!” I see that same buying as “happily providing liquidity for panicked hedge funds that are puking shares of oil and gas companies.” Tomato, tomahto.

Second – if you have the stomach and are patient, in a year or two, I believe that right now will prove to have been an excellent time to invest in Tarpon.

Finally, oil prices are unsustainably low. So if oil and gas stocks are too volatile for you, I suggest you consider draining that pool and start filling it up with light sweet crude, pronto.

What Just Happened?!?

The global oil and gas market is approximately \$2.7 trillion in size. About \$1.6 trillion was invested in global energy supplies last year. The oil market is without peer in terms of geopolitical significance. And the price of oil does not get cut in half in six months

simply because of a fundamental change in supply and demand that suddenly catches everyone off-guard. It happens because a slew of speculators get caught overextended on some very bad bets.

To be clear, I am using speculators here in the non-pejorative sense, meaning “non-commercial” participants in the oil futures market who don’t work at oil companies. Speculators are critical in a well-functioning oil market, because without them, a hedger cannot hedge. The futures market certainly attracts its share of gamblers, too, but I suspect those weak hands have now been largely culled from that herd.

In either case, speculation did not cause the sudden drop - it just exacerbated it. And my point is that this dramatic price decline in oil has less to do with any sort of meaningful imbalance in supply and demand, and much more to do with forced liquidations and repositioning in the oil futures market.

Certainly some of the current weakness in oil prices can be attributed to a sluggish global economy, including a slowdown in China. A stronger dollar has also dampened overseas demand by making oil relatively more expensive to buy outside the U.S. And given that Saudi Arabia now finds ISIS on its doorstep, empowered by oil, and sees oil-rich Iran on the cusp of acquiring nuclear capabilities, there may very well be a compelling geopolitical motive for Saudi to talk down oil prices.

But correlation is not causality, and what changed in the oil market a few months ago is that global supply began to ever so slightly outstrip global demand. That current surplus was produced primarily by unconventional oil companies in the U.S. Low oil prices will self-correct relatively quickly. It’s just a matter of how long it takes for North American producers to cut back in response to current prices.

The good news is that process is now underway. And therein lies a big opportunity for us.

On Market Panic

The French writer Andre Breton once theorized that most people act not out of fear or madness, but out of fear of having others mistakenly see it in them. Selling shares of oil and gas companies based solely on a sudden decline in the price of oil is foolishness driven by a desire to not appear foolish.

During a panic, investors tend to stare straight down, anxiously awaiting the next tremor real or imagined that may shift the ground beneath their feet. Fear spreads confusion and falsehoods while multiplying inaccuracies. Selling becomes indistinguishable from cowardice. In the throes of self-preservation, most investors latch on to bad news over good, so media narratives emerge that exaggerate the negative.

As a result, stocks that have excellent long-term prospects but little near-term support are often abandoned. Future free cash flow and earnings become unhinged from share price. But make no mistake – for those with the advantage of a long-term time horizon,

like us, this is precisely the best time to invest. And the optimal strategy in the short-term is to grind it out.

The oil market is at an inflection point in terms of the significance of U.S. unconventional production. When it comes to pricing, the global market has yet to differentiate between the dynamics of “tight oil,” supplied by U.S. shale oil frackers, and that of conventional drilling. Specifically, the depletion rate of fracked wells results in naturally modulated output across multiple regional sources of supply. Nonetheless, U.S. tight oil is proving the global oil market to be more contestable than previously believed. The notion that the U.S. may be energy independent by 2020 was laughable as few as five years ago.

But our good fortune will not change the laws of supply and demand. The cost of the marginal barrel did not just permanently shift downward. Global supply outside the U.S. did not just shift upward, either. And the most recent fear in the market - that current \$50 oil prices, down from \$100 six months ago - will not impact the supply growth of U.S. shale is both naïve and untrue.

In the short-term, the price of oil is determined by what happens in both the physical and financial markets. Right now, the financial markets are panicked. In the long-term, however, oil price is determined by the production cost of new oil that enters the market from places outside of OPEC.

Oil prices right now are too low, based on simple math and microeconomics. I would argue that oil prices should also include a risk premium on top of that price to reflect the heightened potential for strife in the Middle East. Yet the market is currently turning a blind eye to all these things. It will not last.

Regardless, we don't need to be smarter than the market when it comes to predicting future oil prices. We just need to be calmer and more disciplined.

Timing Is Everything

The magnitude of the recent decline in oil prices would suggest we are near the bottom, as shifts in production are already happening that will force supply and demand to be back in balance in the second half of this year. Because the data confirming a slowdown in oil drilling is both delayed and backward-looking, there are pundits who will argue that prices have not fallen far enough yet, and that they therefore must fall further. They will be wrong. That adjustment is underway, even if it is not yet visible in the data. And if I had to guess – which is all anyone can do, really – I'd say that within the next month, the market will finally realize the extent to which oil prices have overshot.

You should realize, however, that when it comes to attempting to predict the price of a barrel of oil over short periods of time, everyone is equally horrendous. Confirmation bias runs rampant. And due to recency bias, investors may very well be slow to return to buying shares that have recently plummeted, no matter how promising or cheap. That, too, is an opportunity for us. So if prices should drop further, pay them no mind. Just keep filling up that pool.

In the meantime, thank you for your patience during yet another historically infamous few months in the market. And as usual, please let me know if you have any questions.

- Cale

Cale M. Smith
Managing Partner

Thoughts on our E&Ps and the Oil Market

I'm going to delay any detailed public discussions of our energy companies for the time being. Frankly, I'm not done buying yet. If you'd like to discuss any of our companies privately, however, please call or email and I'm happy to do so. Here is what I am prepared to discuss at the moment:

We currently own four energy companies in Tarpon. Our largest new position is now a microcap oil and gas company. Currently, just under a third of Tarpon is invested in oil and gas companies. That is historically quite high for us, and it may also increase. And what each of these companies have in common is the following:

- 1 - Significant valuation support based on asset value;
- 2 - The investments to acquire and build those assets are substantially complete;
- 3 - Cash costs per barrel are significantly less than the highest cost U.S. producers; and
- 4 - Their management teams have survived previous price crashes. It is nobody's first rodeo.

I'd also note that the dominant issue in my mind when evaluating oil and gas companies right now is not barrels of reserves in the ground, but how financially efficient a company has been - or could be - compared to its competitors.

We do not currently own any of the pure-play tight oil companies which, if you believe the latest media narrative, OPEC is trying to put out of business. To be clear, we could buy shares in some under the right circumstances – we just don't own any currently. From an analytical perspective, a tight oil company is a distinctly different model than a conventional oil producer. It's somewhere between a mining company and a fast food restaurant that is trying to open as many stores as it can, as quickly as possible. So tight oil firms can take a bit longer to get comfortable with.

What we do own in Tarpon are babies that have been thrown out with the bathwater. Three of our four energy companies are "special situations" which, as defined by Ben Graham in 1946, are stocks "in which a particular development is counted upon to yield a satisfactory profit in the security even though the general market does not advance." Our fourth energy company is a more traditional Tarpon investment. It's well-managed

with unique and valuable assets and has become undeservedly and absurdly cheap. I am also looking at others that fit the same criteria.

The companies we own are also U.S.-based. Many of the biggest risks in investing in oil companies can be above the ground – specifically related to foreign governments, currencies, military actions and/or local economies. I'll defer to Retz on that analysis in the Frigate Folio. In Tarpon we are definitely assuming risks in buying right now, from cost- and oil price risk to flow-rate risk, but the point is I know we are being more than well-compensated for it at the moment. In short, it will be worth it.

The Cast of Characters

I am of the opinion that there is no more classically American business than an oil company. Yep, it's even more classically American than Silicon Valley start-ups.

Oil companies are founded by grizzled cowboys with names like Jim Bob Moffett who push all their chips into the middle of the table, betting entirely on their own wits and engineering prowess in a quest to help power the world. And, okay, to make boatloads of money.

But building an oil company is about as pure of a test of capital allocation skill as you can find. Marketing doesn't matter. PR doesn't matter. Engineering matters. Grit matters. Cigars and whiskey matter. Plus, roughnecks wear T-shirts that say things like:

Vegan: a Latin word that means 'can't hunt'

America!

It was American engineering at American companies – predecessors of Chevron and ExxonMobil – that first discovered oil in Saudi Arabia and which was instrumental in the eventual discovery of the massive Ghawar oil field there. In 1957 the U.S. government called the Ghawar oil field "the greatest commercial prize in history."

Top that, Zuckerberg.

It was oil money that modernized the Florida Keys, too. Henry Flagler, the silent partner of John D. Rockefeller, spent \$1.3 billion (in today's dollars) of his own money to build "the eighth wonder of the world" - the Overseas Railroad – opening up the Keys to the rest of the country. Not only was Flagler the true brains behind Standard Oil, which at one time controlled 90% of the U.S. oil industry, but as a second act, he through sheer force of will turned Florida from subtropical backcountry into tourist mecca and agricultural powerhouse. In the history of capitalism, few entrepreneurs have ever accomplished as much as Henry Flagler.

So go on and send that rocket to Mars, Elon Musk. Just know that to truly measure up, you're gonna have to spend your seventies building a 128-mile long railroad over swamp and ocean, across a string of tiny islands while battling hurricanes, a vicious press, thermonuclear levels of heat and mosquitoes the size of small children.

Flag-ler! Flag-ler! Do you believe in miracles?!?

The Reality of O&G Investing

The reality is that as an investor in oil and gas companies, you can't afford to assess them with anything less than brutal honesty. Capital disappears at an alarming rate. Wildcatting can be indistinguishable from hubris. Some projects are too risky and a lot of holes turn out dry. Banks can be too willing to lend these companies money. Key decisions have to be made with incomplete data. And many management teams are overly optimistic, as you might expect from the kind of people who get excited about drilling holes in the ground.

So there is quite a bit of uncertainty in the exploration and production business. Fortunately, we have tools we can rely on. The first is math, and the second is microeconomics.

With regards to the math, here is a dead-simple way to determine the proper theoretical price of a barrel of oil:

$$\text{Price of Barrel of Oil} = \text{Marginal Cost of Production} + \text{Risk Premium}$$

And here is one of the three useful things I learned in economics class:

"A non-perishable commodity will not stay priced below the marginal production cost of the highest-cost unit of production which satisfies total demand."

18 years of school for that, people. And now my six-year-old can find it on Wikipedia in 0.122 seconds.

In any case, here's why that's relevant:

By the end of 2014, the annual worldwide daily demand for oil had increased by about 1.0 million barrels. We also know that global supply for the year was up 1.6 million more barrels per day than last year. And because global oil production for the year - exclusive of the U.S. - was flat compared to last year, we know that oversupply came from U.S. tight oil.

The first thing that may have jumped out at you there is that it is only about 600,000 "extra" barrels of oil per day that are hitting the market right now. That's it. It represents less than 0.7% of total global daily oil production. By way of contrast, Dow Chemical, the largest U.S. chemical company, consumes the energy equivalent of 1 million barrels of oil every day.

Now if you're surprised that such a trivial amount of oversupply triggered a more than 50% drop in the price over the last six months, well, welcome to today's oil market. But what should also be clear is that there is no global oil glut. The market is just trying to clear a little excess supply.

Back to the math. Global demand for oil grows slowly but consistently every year, due to just population and productivity growth around the world. And a year from now, the world will need about another 1.5 million barrels per day of oil. So the question becomes – where will that oil come from?

The Supply To Meet Demand

As it turns out, conventional sources of oil alone won't get us there. Production from typical oil fields declines at about 5% a year on average, meaning a significant amount of new oil that hits the market every year just replaces current flows. For production increases in 2015 to be incrementally meaningful in the global market, supply has to increase beyond the level that will replenish current flows, too. So the world needs oil from places that already have the ability, knowledge and infrastructure to be able to produce high volumes quickly. And that list is pretty short.

Analysts estimate that offshore Brazil might be able to pump another 200k barrels per day this year. We could see similar growth from the U.S. Gulf of Mexico, too. Iraq could in theory reach similar levels – providing civil war doesn't break out. Production from Libya unexpectedly spiked last fall, contributing to the drop in global prices, but that quickly fell back to earth by December, so it's hardly dependable supply.

Nigeria seems too busy containing Boko Haram and harassing me about claiming prizes from the prince to meaningfully boost output in 2015. I won't pretend to know what Putin is thinking, but Russia seems more likely to shut-in their wells to goose the price of oil than pump more right now. And while it's possible Iran could return to the production market this year, the odds seem slim – and regardless, that wouldn't happen until after negotiations over its nuclear program conclude in June in any case.

So there is only about 600k of incremental supply that will be brought online from conventional sources this year – and, mind you, that number assumes stability in Iraq. Otherwise, as you look around the globe, there aren't any other meaningful sources of conventional production supply that can meet expected demand by the end of 2015.

That means of the approximately 1.5 million barrels per day the world will need a year from now, we can get less than halfway there using conventional sources. Where will the other barrels come from? It's gotta be unconventional sources - and the only place in the world with the ability to bridge that gap is U.S. tight oil.

Back of the envelope math, then, tells us that if all growth in U.S. shale oil production ceased this year, then the global economy will face a material shortage of oil. However, it's much more likely that growth in unconventional will slow down instead of disappear. But because growth in U.S. shale oil supply last year was turbocharged, throttling back to even just half of last-year's daily production means those companies will still earn acceptable internal returns. Rumors of the death of U.S. tight oil producers are greatly exaggerated.

North Dakota: Your Face May Freeze, But You'll Get Rich

Here's the other thing to realize about U.S. shale oil wells:

Production decreases naturally, because shale oil wells have a surprisingly brief window of productivity. The industry calls this "asymptotic decline," an old Navajo term that means "falls off a cliff." The amount of oil produced by a shale well declines

precipitously every year. For instance, after two years of production, the average U.S. shale well in North Dakota will have pumped out half of its reserves.

Those decline rates are important because unconventional wells in Texas and North Dakota accounted for nearly half of all U.S. crude oil production last year – about 4 million barrels per day. The Bakken play in North Dakota alone produced 1 million barrels of oil per day in 2014, which was a tripling of production over the previous three years. So to put that in context – that 600,000 barrel per day global surplus mentioned earlier would disappear tomorrow if production from the Bakken was reduced by 40%.

What is also particularly relevant about the Bakken is that in 2014, the number of wells greater than two years old overtook the number of younger wells. And what that means is that due to those decline rates, a slowdown in production growth in the Bakken was already in motion before the price of oil collapsed. This recent price crash will only amplify that reduction even more, as Bakken drillers reduce spending on new wells (and the old ones begin to peter out).

Given the expected worldwide demand for oil in 2015, and recent production trends in North Dakota, a slowing in the rate at which new wells are bought online in just the Bakken – never mind the rigs being idled in Texas and other shale plays - could have an disproportionate impact on the global price of oil – in the other direction, this time.

The oil market is currently schizophrenic on this point. It's gotta be one or the other. Either low prices will quash U.S. unconvensionals, the world will be short of oil by the end of the year, and prices will rise again...or growth in U.S. unconvensionals will slow, in which case oil prices will still have to be high enough to make that production economically worthwhile. But it cannot be both. And Tarpon wins because oil prices are going back up either way.

So small increases or decreases in production from unconventional U.S. oil can have an outsized impact on global prices. Even though decline rates in tight oil wells can make the sustaining of production growth more challenging, U.S. unconvensionals will still play a very important role in meeting global oil demand.

And contrary to breathless media reports, the market is not out to kill off all U.S. shale oil producers. It can't afford to. It just needs growth in U.S. tight oil to slow down from recent sky-high levels, and that is already happening.

I also find it intriguing that in all the panic of late, the market seems to have completely forgotten that as recently as the first quarter of 2014, the consensus among the super major producers was that \$100 oil wasn't going to be high enough to incentivize new supply projects in many regions. Hunh.

Tying It All Together

Finally, if the only place in the world that can meet the last barrel's worth of demand this year are unconventional suppliers in the U.S., then the marginal cost of production in the industry will effectively remain unchanged. And when it comes to triangulating on

that marginal cost, first, take all estimates published by people who completely failed to see the current price collapse coming, or who are trying to sell us something, with a big old grain of salt. Looking at you, Wall Street.

Instead, let's look to the group that will be penalized the most severely if they are wrong about marginal costs - the operators. And what you'll find after surveying a number of the most experienced companies (and agencies) is that the consensus estimate of the marginal production cost for oil is between \$80 and \$90 per barrel. I leave it to you to add whatever premium you see fit to reflect geopolitical risk in the Middle East. The market is currently pricing in nothing.

It's all a bit nutty, no?

Open Questions

The most intriguing question to me about the oil market right now is not, "What's going to happen to the price of oil next week?"

It is, "Will the recent crash in oil prices make U.S. tight oil producers hit the brakes on production a little too hard?"

And the second most intriguing question is, "If production outside the U.S. was flat for the past two years - when oil was at \$100 - given this crash in prices, how many other producers around the world just hit the brakes on their production, too?"

Oh, boy. Keep your arms inside the vehicle at all times, people.

The Long Long-Term

Lastly, let's not forget that we are still early in the globalization of energy demand. The world's appetite for energy will be staggering in the coming years. Oil use in the developed world averages about 14 barrels per person per year. In the developing world, use is approximately 3 barrels per person per year. What do you suppose will happen when billions of people currently consuming 3 barrels per day start consuming oil at even just 6 barrels per day?

Also, for the record, I am not at all opposed to investing in renewable energy companies in Tarpon, instead of focusing on just oil and gas. But, in short, I haven't found any yet that meet my criteria as an investment.

Other interesting data points to consider about the long-term price of oil:

1. In early 2014, historically reasonable industry analysts had rationally forecasted that oil prices would reach \$150 per barrel by 2020 based on nothing more than improving global growth.
2. Of ExxonMobil's potential future project portfolio, 44% assumes a market price of at least \$75 per barrel of oil, and 29% assumes at least \$95 per barrel.

3. Saudi Aramco, the biggest oil company in the world, with proven reserves of 260 billion barrels of oil, is nonetheless in the process of investing \$100 billion to further increase their oil and gas reserves. Don't think for a second they're investing that kind of money because they think they're going to sell it at \$50 a barrel.
4. On average, OPEC countries need oil at \$90 per barrel to balance their budgets.
5. GM now sells more cars every year in China than the U.S. Total sales of automobiles in China could reach 30 million a year by 2020. In the interim, 20 million people a year will continue to move from rural towns to cities, looking for work. And if China consumed oil at the same rate as the U.S., by 2030 China will be using more oil per year than current total annual global production.

In Summary

Oil prices are unsustainably low. The market will fix this, but those same market forces include a disproportionately large number of speculators, so it will take a little time. U.S. oil output will continue to rise incrementally in 2015, as it will take time for management decisions driven by the recent decline in price to affect supply. But without unconventional production from the U.S., the world will soon be unable to meet global demand. So oil prices are going higher again. It's just a question of how soon.

I intend to take full advantage of the current panic. It may be choppy in Tarpon for a little while longer, but hang in there. It will be worth it.

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