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Investment Management

Letter to Investors: Tarpon Folio, Q1 2019

Cale Smith, Managing Partner
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Dear Investors,

At some point late last year, it is entirely possible that I died, went to purgatory, and was sentenced to continuously yell out reasons why oil prices should really be much higher.

I must continue this until oil prices hit $120 a barrel, at which point I get to go to heaven.

Either that, or I am currently in a coma. Diabetic shock induced by stress-eating key lime pies, probably. And all this is really playing out somewhere deep in my medulla oblongata.

As you know, Q4 was brutal. OPEC tried to pre-empt Iranian sanctions that were unexpectedly waived at the last minute, causing a spectacular backfire in the oil market.

We have bounced back a bit since. Tarpon is up 16.4% year to date (through 4/12, unaudited), and though sentiment is slowly turning, equity valuations continue to show a historic lag to oil prices.

For now.

The oil market is rife with opinions, data, bias and fallacy. If everything sounds credible, then nothing is credible. At times this can all be indistinguishable from nonsense.

There is no denying that sentiment and momentum can matter much more in the short-run than the fundamentals we rely on. And that "the short-run" has felt pretty long of late. 2018 was deeply frustrating because oil stocks – all of them, not just ours – lagged oil prices for the first three quarters of the year...and then also got crushed in tandem with oil prices during the fourth quarter. Come on over here, cheap rum.

Nonetheless, fundamentals matter. This market is not all robots in a casino, yet. The combination of OPEC + Russia production cuts, stronger that realized demand, slowing U.S. production growth and, to a lesser extent, an event called "IMO 2020" (more later) means the world is going to draw down on oil inventories – hard – from the back half of 2019 into 2020.

At this point, the only obvious material risk remaining is an unprecedented collapse in oil demand. But there are zero signs of that happening.

I also believe that the size of these draws on oil inventories will signal the inflection in sentiment we have been waiting for when it comes to our companies' share prices.

What Matters Most

Not every headline is of equal importance. These three things in the oil market matter the most today, to me:

1. OPEC continues to execute well on its strategy of reducing oil inventories and driving oil prices higher.

This remains the single most important factor in the oil market today, by far, and it is unequivocally bullish. It is also often forgotten.

For the last two and a half years, OPEC has been explicit about its intent to reduce oil inventories in order to raise oil prices. OPEC oil production is now at a four year low, with Saudi Arabia itself cutting 400,000 barrels a day since the beginning of 2019.

And that is largely because Saudi the dominant member of OPEC, needs \$85 to \$90 oil (Brent price) in order to balance its budget.

Now, the House of Saud is not motivated to balance its budget because they are responsible fiscal stewards. These guys buy mega-yachts with about as much forethought as my dog greets a bucket of wings.

They need money to (1) avoid an Arab Spring, and (2) counter the rising Iranian influence in the region. Both are expensive.

An analytical tool called a comparative inventory analysis shows that the price per barrel of oil that required to balance the Saudi budget, interestingly, also matches OPEC's target level for OECD inventories – approximately 2.7B barrels. And I do not believe it is a coincidence that oil inventories are on track to decrease until the point at which Saudi's budget is also balanced.

In other words, the Saudis are draining oil inventories to drive oil prices higher so that the royal family can maintain its power - which is under increasing threat from a liberalizing regional populace and intensifying conflict with its nearby arch-enemy.

2. Global oil demand is very strong and remains significantly higher than projected by the International Energy Agency (IEA).

History is philosophy, only with examples.

Should there one day be a book written about The Oil Spike of 2020, chapter two will almost certainly describe how the Street was so egregiously misled, yet again, by complicated financial models that did not - and could not - deserve blind faith.

I don't think I'm being hyperbolic when I point out that, among other things, an overreliance on complex Value-At-Risk models on the Street ten years ago crashed our economy, ruined lives, and changed the U.S. political landscape for a generation.

Now, to be clear…this is not that. Not even close, thankfully.

But I do see some striking historical parallels between that past and two of the most important models in the oil market today – and the IEA is the de facto monopoly provider of the one related to global oil demand. But the details of that discussion are for another time.

For now, it's enough to know that everything meaningful in the oil market ultimately intersects at inventories - and that there is a tight inverse relationship between global oil inventory levels and oil prices.

Also, since the fourth quarter of 2014, there are now roughly 700 million barrels of crude oil that are unaccounted for in IEA data. Analysts colloquially call these "missing barrels," though the sheer scope of this problem has been dulled by its persistence. There's no longer anything new, sexy or headline-worthy about this huge modeling error - but it nonetheless remains a material, quiet overhang in the oil market.

Those missing barrels are analytical proof that the IEA chronically and meaningfully underestimates global demand for oil. Because the Street relies so heavily on those same IEA demand estimates, we're in an echo chamber of oil demand numbers that are simply too low.

And if those demand numbers are too low, then so is the estimate for the level of supply needed to balance the market – as is the price at which the market should balance. Which, to me, is a very important point. Because while economists will call what seems likely to happen next a "sudden shift of the demand curve to the right," the rest of us will call it "an oil price spike."

While this sort of thing sounds like it borders on the conspiratorial, or like some sort of "peak oil" fallacy, it really isn't.

Now, there are some analysts who attribute these missing barrels to things like "phantom oil stockpiles" or "oil on the water," squirreled away on, I dunno, pirate ships anchored off obscure coastlines, hidden by cloaking devices from Star Trek or something.

But the reality is that all those missing barrels aren't a mystery. They just represent underestimated demand in that IEA model. And while the IEA does, slowly and quietly, true-up their old demand series numbers, they have a long way to go and are currently still 18 months behind.

The market continues to systematically underestimate global oil demand. The existence of those IEA missing barrels is a big red flag. And one big reason it's been ignored the last few years is also about to change. Which brings me to…

3. Non-OPEC supply is growing at a slower-than-expected pace, and appears unable to solve the near-term supply deficit.

The most analytically important segment of "Non-OPEC supply" is U.S. shale production. I'll focus on that here, and will hit pause on a discussion of the rest of non-OPEC segment, and on that "supply deficit" bit, too. Simple math, but lot of variables, bar charts with surprisingly different heights, yadda yadda.

At the moment, I believe the two most important aspects of that broader point are these:

A. Shale companies are pumping the brakes on growth.

The largest incremental source of new oil production around the globe is slowing down – for a number of reasons. These include temporary pipeline capacity issues in the Permian basin, something called "parent-child well interference," and, perhaps most importantly, the sheer pressure being put on management teams and their boards by big frustrated and disgruntled shareholders.

Related…

B. The market appears either too slow or too skeptical to realize that U.S. shale companies have entered a distinctly new, more mature phase of their lifecycle focused on improving free cash flow and shareholder returns.

And one of the consequences of that transition is that certain shale companies are the cheapest yet most capitally efficient they have ever been.

In other words, the long-term return possibilities for certain shale companies are now arguably as attractive as they have ever been.

I can't explain why this observation seems so little noted by others. It could be that it's being seen, but not believed – or is thought to be a fleeting fad. Plus, many traders were torched by the sector in Q4, and it's easier to tune out than keep digging. And then certain other bears, short-sellers, pair trade jockeys and/or capital structure arbitrage traders are effectively incentivized to ignore it, I suppose – or, in some cases, to actively distract others from seeing it, even.

In the end, I can't explain it. But I don't care, either. I can see it unfolding with my own two bloodshot eyes…

<u>Next Phase of the Lifecycle</u>

The phases of the U.S. shale industry lifecycle look something like this:

1. Exploration phase (pre-2015): the main goal of this phase was to delineate acreage. So, accumulate leases and develop proof of concept in your drilling techniques.

2. Exploitation phase (2015-2018): the goal shifts to maximizing growth with more of an eye on cash flow. Prove up your reserves, refine drilling/completion techniques, and HBP (Hold By Production) your best acreage.

3. Manufacturing phase (2019+): the goal now shifts towards growth and free cash flow through the entire cycle. Get scale and lower costs, improve your balance sheet, reduce your cost of capital, and form better relationships with marketers of your products.

Those bracketed years are approximate; we're really transitioning between Phases 2 and 3 right now. It's not a clean transition, either, due to many of the same reasons that have caused especially volatile oil prices - and the fact that interest rates have been so low for so long. Still, it seems clear to me that the industry is heading predictably deeper into Phase 3...and quicker than most expected.

That increased pace, incidentally, may be the silver lining of the Q4 price crash.

In that Phase 1, shale companies pursued growth at all costs to grab as many leases and lock up as much prime oil land as possible - which among other things led to ugly P&Ls and some crazy high valuations. It was, quite literally, a landgrab among shale companies - which had a tendency to overpay. For everything.

The oil bust that culminated with oil hitting $26 a barrel in February of 2016 was the catalyst that finally drove even the laggards in the industry from the first to the second phase. They had discipline forced upon them, for the first time...whether they wanted it or not.

And now they are being forced further right on the life cycle curve, from Phase 2 to Phase 3. That shift was really already in motion prior to Q4 of 2018 - due to a list of factors including things like higher standards from institutional investors, a lack of top-tier acreage left to be leased, and - perhaps less overtly - a brief spike in interest rates.

So for a number of reasons, shale companies are clearly entering Phase 3, in which they will start showing more traditionally appealing metrics to investors who, like, don't care how many pounds of proppant they use per lateral foot. They just want to see cash flow. Or dividends. Or buybacks.

This Phase 3 "manufacturing mode" is also not unlike a business that produces widgets. Scale and cost structure matter. For shale companies, you also have to factor in specifics like midstream commitments, refinery needs, pretty sophisticated development and finance functions, corporate breakevens and a number of other things...but there is also effectively zero exploration risk in that E&P business model, too.

Which is a new concept for the sector. Among other things, that makes that widget company comparison more relevant than you might think. “Free cash flow yield” doesn’t care what kind of company it comes from.

And actually, it’s a new concept for the country, too, I suppose. Because if you’re still pining over the loss of this country’s once-dominant manufacturing base, the good news is - we’re back!

Only it’s not in Detroit anymore. It’s in West Texas now. Giddy-up.

Anyway, I would also argue that the next phase of all this - Phase 4, not shown above - will be The Consolidation Phase. In which the large number of current companies in shale will either merge and/or be acquired, ultimately leaving the shale industry dominated by a small number of truly efficient and disciplined companies with scale.

That might not be in a traditionally "integrated" model like at an ExxonMobil, either, though. It might not be too long that we start seeing some of the bigger pipeline companies, like a Kinder Morgan, for instance, or maybe an LNG company like Cheniere, start to integrate further upstream by buying stakes in E&Ps to capture more of that value in the system. There are a number of ways all that could unfold. In theory, over time.

My point for now, though, is that U.S. shale companies are not going anywhere. They are, in spite of their stock prices, getting stronger, more respectable, and more appealing to generalist investors.

And while I am emphatically not an apologist for all U.S. shale companies and their many previous sins…I think history has also shown that you should never bet against an American engineer with a profit motive.

These Things Also Matter

Other important factors in today's oil market include the following:

- Sanctions in November have cut Iran's crude oil and condensate exports from more than 2.7 million bopd to ~1.8 million. Though I believe it highly unlikely (more below), ending Iranian oil exports entirely on May 2nd would suddenly eliminate another ~1.5 million barrels per day from the market. And only Saudi Arabia has the spare capacity to make up that kind of shortfall, but has warned it will not do so.

- Unusually high geopolitical risk in Iran, Venezuela, and, more recently, Libya. The Venezuelan oil sector in particular is dissolving in real-time right in front of us - and it is not done.

- OPEC spare capacity is only 1M to 1.3M bopd - which is historically very limited.

- Energy stocks are trading at extremely low valuations – in some cases, lower than when oil was at $26 a barrel in early 2016.

- An unprecedented two-year disconnect between oil prices and oil stocks.

- Venezuelan exports to U.S. are at zero. Canadian pipelines are delayed and significant Alberta production has been voluntarily curtailed. Meanwhile, U.S. oil exports are spiking to record highs and continue to grow strongly.

- Negligence and/or confusion about IMO 2020. Related: misplaced concerns about the quality of different grades of crude oil.

- Plus, the same old bullish factors, like: growing populations in India and Southeast Asia; a relentless decline curve in shale fields; years of underinvestment in conventional oil; and, despite high growth rates and a lot of hype, the negligible displacement rate of internal combustion engines by new electric vehicles.

What Just Happened

Understanding what happened in Q4 is important when trying to assess what it will take for us to bounce back.

Last summer, the White House announced an end to U.S. participation in the JCPOA nuclear deal and an increase in pressure on Iran – specifically by clamping down on oil exports, the country's main source of revenue (~ $250 billion a year). The administration stated ardently and publicly, as recently as the day before sanctions went into effect, that no waivers to receive Iranian oil would be granted.

Twenty-four hours later, however, all eight countries received waivers.

Neither I, nor the rest of the oil market, saw that coming.

This was a problem, because in the months prior to that surprise, OPEC pumped an extra 150M barrels of oil into the market, to pre-emptively fill an expected shortfall in in supply from Iran…which didn't show up. Suddenly, there was extra oil in the system.

The selloff began, and almost immediately got exacerbated by broader market fears of first an economic slowdown, then a trade war…while others suddenly noticed that tech company valuations had gotten a bit frothy, too. Not long afterwards, we then saw a number of two-standard-deviations-from-normal size daily declines in the price of WTI oil, related to something Goldman called "negative gamma" (don't ask). Finally, specifically in Tarpon, buyouts announcing three of our companies were announced. While in more sanguine times, that sort of thing would have been cause for celebration, but instead, given the timing…well, traders just weren't having it.

This next bit may sting, too:

It turns out that if OPEC had not attempted to pre-empt those Iranian sanctions last fall…so if current OECD inventories were now lower by those same 150 million barrels…then the same comparative inventory analysis tool I mentioned earlier would peg oil prices approximately $25 higher today…with Brent pushing triple digits.

Ah, what could have been.

Instead, though, OPEC met in December, and scrambled to come up with a plan to unwind the impact of being misled about those sanction waivers. Which they did, and are now executing on – Saudi more aggressively than agreed to at that meeting, even.

So the oil market is effectively and relatively quickly removing this temporary excess from OECD inventories, a process which should be completed by the end of June.

And that brutal Q4 was a panicked, classic "risk-off" trade – exacerbated to be sure by a couple of other factors, as well as the machine trading that has come to dominate daily volume, also.

It was (pardon my analogy here) a mass puking of all things oil-related. And you can prove that to yourself by overlaying a chart of net speculative length on WTI prices during Q4. Lockstep.

So, Q4 had nothing to do with weak demand from oil from China, OECD inventory builds, nor POTUS tweets about oil prices. And you really can't blame U.S. shale companies, either. While it is true there was a late-year surge in U.S. oil production, that was at least partially attributable to a surge in well productivity – and, ostensibly, management teams who might have rationally believed those Iranian sanctions meant opportunity for their oil, too.

To be clear: I missed it. I did not foresee those waivers, and we got crushed. That's on me, exclusively, forever, and completely. But it wasn't an issue of an analytical macro oversight, nor stock selection, either. We actually saw four more Tarpon companies announce they would be getting acquired in 2018 (REN, GLF, EGC and PVAC) and a billionaire bought 20% of another (MCF).

In Q4, I got blindsided by hardest factor of all for me to handicap in the market – political risk.

Plus, there is also probably a lesson in there about the second order effects that a sudden 40% drop in oil prices can have on management teams that are already under extreme pressure.

More on how I intend to mitigate those risks for us in 2019 below. And I don't want to be cavalier about any of this, but I do think it's important that you know that I view the Q4 meltdown as a temporary problem. Ugly, unpleasant, and unfortunate – but temporary, nonetheless – for all those reasons mentioned earlier.

The Pep Talk

What I am saying to you all is this:

It ain't over.

I mean, I know most of you would really like it to be over…but, nope, not yet, my friends. I remain committed and bullish - because the data is bullish.

And please - let's not refer to ourselves as "unlucky" after that Q4, either.

No, ma'am. Let's check that self-pity at the door. Instead, I prefer to think we are wiser.

And very hard to kill.

Now, you may not fully understand my obsession with oil, but I hope the message boards help – and that if nothing else you agree we are fighting a good fight. Because that's the only way to significant long-term gains. Not the "Netflix should beat estimates by a thousand new subs" kind of gains. The 5x-in-5-years kind of gains that this is all about – to me, anyway.

Otherwise we'd go buy index funds, concede that not even trying is somehow an honorable way to try and accomplish something meaningful in life…and just go fish all day, instead.

Nah.

Resiliency is destiny, knowwhatImean?

So What's The Plan?

Short version:

My plan for Tarpon is to continue to maximize this opportunity in oil to the fullest extent possible.

For those of you weary of all the volatility, however, we are also going to be rolling out some new alternatives later this year that will be less volatile options for growth. We are working on those now and will have more to announce a bit later.

Our thinking there is that if you for whatever reason want or need to shift some funds out of this oil-centric strategy before I switch us all out in Tarpon, then you'll have a way to take an earlier off-ramp - should you so choose.

But it's not time to switch out of oil yet.

Also, I intend to try and help improve sentiment around our companies by cleaning up and then publishing my research on them. You all will see that first on the boards. Stay tuned there, too, please.

That's the abbreviated version of my plan for Tarpon for 2019.

Long version:

The longer, tactical, near-term version of the plan for Tarpon goes like this:

As per all the above, I remain bullish for 2019 and 2020.

I do see three potential minor headwinds for oil prices in the very short-term, however – which seem to represent a good time to make some final Tarpon tweaks.

1. The potential for extended refiner maintenance season, as refiners retool for IMO 2020.

Significant oil inventory drawdowns are coming - but if they don't begin until later in the year then usual, which is possible due to additional work related to IMO 2020 prep, traders are likely to get twitchy.

2. Iran sanction waivers, part 2.

The exemptions from sanctions on those eight countries purchasing Iranian oil will expire on May 2nd. The U.S. will therefore soon announce whether those sanctions will be renewed, reduced or ended.

I am assuming current waivers to all countries will be extended, as-is, or that any strengthening of those sanctions would be minor.

I believe that because POTUS has already fulfilled his campaign promise of ending the nuclear deal with Iran, and has few more votes to gain in 2020 by trying to zero out Iranian exports in May. He also recently designated the Iranian Revolutionary Guard as a terrorist organization, making it easier to signal continued resolve through just a minor tweak to existing sanctions. Plus, Tehran seems unlikely to engage diplomatically in any case.

Also, if the White House does not renew at least a portion of the waivers, oil prices will rise, just as summer driving season starts in the U.S. And that could also further complicate U.S. foreign policy toward Venezuela - and China, too.

So, while the odds would seem to suggest that May 2nd will be anti-climactic, this sort of thing will be catnip for headline-writers, traders, and oil bears.

3. The illusion of Q1 capex misses.

This one takes a little more explaining.

Those of you reading the new investor boards may recall that in the year-end reporting season a month ago, we saw announcements of material reductions to 2019 capital expenditure budgets across the E&P sector. And that this was a good thing.

However, there is some nuance to how those budgets roll out over the year that might be lost on most traders, or exacerbated by shortsellers, as Q1 earnings season kicks off.

Specifically, most of those annual capex budgets are front-end loaded, meaning the biggest quarterly spend of the year will be in Q1. Traders who don't realize this, however, may misread Q1 capex levels as an increase in drilling.

And if that happens, it could spur more histrionic headlines about "capex misses" in the sector from "those crazy shale cowboys" – at the same time lots of eyes are specifically watching for capital restraint from the group. So, again, twitchy traders, in the short-term.

I know. I don't make these rules, folks. I just try to compound here.

And while those three little headwinds would be something I would otherwise ignore, they also make the next few weeks as reasonable a time as any to trim some current positions in Tarpon and add two more new names. In theory.

Those intended tweaks will, I believe, be the last of this cycle for us. Ideally, we're then positioned optimally for what should be a strong second half and beyond. And while I feel no urgency to trim those current positions in Tarpon today, I suppose I am making a conscious effort to add a bit more diversification to the portfolio, and reduce some position sizes, as a slight nod to that political risk that surprised us in Q4.

So, to sum up: trimming three names, that excess cash will sit temporarily, and then I will be done redeploying those proceeds into two new names – ideally to be finished no later than the annual meeting in June.

Then we sit tight, keep our heads on a swivel, and plan for what I believe will be a significant ramp in oil prices into 2020…while in the meantime rolling out some new options for those of you who have had just about all the fun you can stand in the oil market.

Recent Q&A

Q1. Can you update that matrix of expected returns for us?

A1. This question is synonymous with: "Will all this volatility really be worth it?"

That "matrix" is a deceptively simple table (with a lot going on behind the scenes) which summarizes our expected returns in Tarpon, based on the dual inputs of oil prices and company valuations - as measured by EV/EBITDA multiples.

I still owe that to you all. I've got all kinds of excuses, really, but the primary one is that I'd like it to be accurate. For that, I need our positions and percentage weightings to be stable for the foreseeable future.

And as per the above, I anticipate a few more changes to Tarpon over the coming weeks.

But if you'll allow me a bit more time, I will finally present The Matrix at the investor meeting on June 1st. Thank you for the patience.

Q2. Will we ever make back our losses from Q4?

A2. That matrix from #1 will help better answer this, once it's properly updated.

In the meantime, one way to alleviate any anxiety you may have about the likelihood of us bouncing back is to bring up a stock chart, and compare the price of a Tarpon stock today, versus where it traded last October.

While it is true that a decline of, say, 40% means you will need to see 80% gains to recover, if the only variable that changed between now and then was the price of oil, then in theory you should realize those impossibly-large-sounding gains as WTI stabilizes at a price level similar to where it was just six months ago.

And that's highly probable and then some, at least to me, for all those reasons described earlier in this letter.

Our energy companies aren't, say, candy bar manufacturers, where we've gotta sell, like, 3x more candy bars to get a 10% increase in equity value. These E&Ps don't have to do anything other than be patient.

And if you're bumming yourself out with that kind of "how-much-do-we-need-to-gain-back" math, here is a reminder of the math of value investing:

If you make a new investment in a stock that is down 90% from its high, and it then increases in price to a level down 70% from that same high…you will triple your money.

No kidding. Look here:

$100 stock, 90% loss, now trades at $10 a share, when you buy it. It eventually climbs back up to $30 a share - a 70% decline from its prior high - but it's now a 200% gain for you.

There, by the hammer of Thor, you have tripled your money.

You little value investor, you.

That also hints at the rationale behind some of the trades I make.

For example, if the dollars in a Tarpon position that we needed to go back up by 80% to break even, were to triple in value instead in another name…then that short-term pain quite literally could become our longer-term gain.

Which I believe Euclid called, "The Masochist's Proof." Maybe not.

Anyway, never mind the math, even. You can probably intuitively grasp not only the incremental returns that new position represents in Tarpon, but also how that sort of substitute makes us less dependent on legacy positions needing to realize their earlier stock price highs in order for Tarpon as a portfolio to reach its earlier high-dollar-value mark.

It also means you don't necessarily need to have high levels of cash on hand to take advantage of volatility…but that's another discussion.

Anyway, hopefully that makes sense, even without a whiteboard. And yes, that example is chock full of unspoken assumptions, and so disregards the concept of risk that it probably borders on criminal, but my broader point is this:

Don't psych yourself out. We're still in the fight.

Q3. What's your oil price forecast?

A3. Short version:

I expect oil prices to stabilize around current levels for a few months, prior to seeing strong gains in the second half of 2019.

Nonetheless, I am using (not predicting, nor forecasting, just using) $60 WTI for full year 2019, as I would rather err on the side of consensus in our company models.

Also, if I had to guess, unless U.S. shale companies prove much more disciplined than expected – it appears we will likely see oil prices peak for this cycle sometime in 2020. That timing is difficult, obviously, but I still intend to milk this for all it's worth - right up to that peak (and probably a little beyond), whenever that may be.

Q4. What's IMO 2020, and how will it impact us?

A4. It is a mandatory, global shift in the sulphur content of marine fuels, mandated by the International Maritime Organization (IMO), and which kicks in on 1/1/2020. It will have wide-ranging effects on the oil industry, though because it's such a complicated market, granular projections about IMO 2020's impacts are hard to get real confidence in. Nonetheless, it is an important event, and is a discussion we should have. Later, though, as we get closer to it.

For now, know that we are already positioned in Tarpon for IMO 2020. Or at least we are as positioned as I intend for us to be.

While IMO 2020 has the potential to be disruptive, its ultimate impact should be kept in perspective, too.

The original initiation of U.S. sulphur limits on diesel fuel, for instance, impacted far more barrels that IMO 2020, yet no shortages occurred during that transition.

On the other hand, I do believe IMO 2020 represents a more significant headwind for WCS (Western Canadian Select) and heavy oil prices than appears to be widely realized.

In any case, more on IMO 2020 later this year.

Q5. Will our stock prices ever catch up to oil prices?

A5. Yes. In 2016, our equities even outperformed the price of WTI.

The operating leverage inherent in oil companies like E&Ps means price appreciation in WTI will have a disproportionately positive impact on company cash flows and growth. We're fighting some serious recency bias at the moment, however, as both the 2016 and now Q4-of-18 crash are still fresh in a lot of minds. Plus, there are still plenty of bears when it comes to shale companies, service cost inflation, electric vehicles. etc. It's just going to take more time for all oil stocks to earn investors' trust back.

If you assume that the lag between our companies' stocks and oil prices is rational reasons – and if you are tired of hearing me say "negative sentiment" is to blame for that gap – then you could explain that valuation lag by the "backwardation" in the oil curve…i.e. short-term prices are higher than long-term prices.

For E&Ps, long-term prices have a much greater impact on Net Asset Values then today's oil price ("spot prices"). So once the curve moves towards "contango," NAVs should inflate again.

Among the many disappointments in 2018 was that E&P share prices appeared to be starting to close that valuation gap last fall…just in time for WTI to fall off a cliff.

Nonetheless, there is good reason to believe this problem will correct over time.

Q6. Enough. When can we get some free drinks?

A6. That would be at the annual investor meeting here in Islamorada on June 1st. Email me your order. Details to follow soon.

And please let me know if you have any questions on the above.

Thank you for your patience, and hope to see you in June.

- Cale

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