Islamorada
Investment Management

Letter to Investors: Tarpon Folio

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> "So everything is necessary. Every least thing. This is the hard lesson. Nothing can be dispensed with. Nothing despised. Because the seams are hid from us, you see. The joinery. The way in which the world is made."
>
> - Cormac McCarthy, *The Crossing*

Dear Investors,

In the first quarter of 2021, the Tarpon Folio increased 75.6% on an unaudited, after-fee basis.

Over the last twelve months, from the end of March 2020 through March of 2021, Tarpon is up 598.9%. Unaudited, after all fees.

Over the same time periods, the benchmark S&P 500 was up, I dunno, less than that.

Yeah, look, those numbers are ridiculous. If you hadn't lived through the prior thirty-six months in Tarpon, you probably wouldn't believe the last twelve.

Here is the chart, straight from FOLIO - clean, undoctored and rigorously screened for performance enhancing drugs:

That chart obviously includes a significant amount of luck - the good kind, for once. It also does not capture any of the misery we endured before this run began. Nor the hole we were in this time a year ago, as oil prices began to head negative.

And let's not forget: those numbers came at a price.

As mentioned in the second annual meeting video, we took some heavy losses in Tarpon this time a year ago. And those were just the hard costs – before you tally up all the weird new facial tics, blood pressure meds and gallons of espresso.

So let's stay level-headed. This is the energy market, after all, where short-term sentiment can turn on a dime. Eyes on the prize – and that is still a bit further out.

Notable in Q1

We had a terrific quarter because of the prior few years of patience and work and luck.

I made a single trade during the quarter – selling all our shares in QEP Resources before its acquisition by Diamondback Energy closed. We continue to own Diamondback, and will for some time - but we do not need to increase our cost basis nor position size by holding on to those QEP shares post-closing in a stock-for-stock buyout. I am currently in the process of putting that cash to work in a new company.

Also of note - during the first quarter, we officially realized two more "ten-baggers" in Tarpon - stocks whose gains exceed 1,000%. Both Matador Resources (MTDR) and Centennial Development (CDEV) reached that milestone.

That brings our total number of ten-baggers in Tarpon during this oil cycle to four.

Matador and Centennial join a list that includes Clayton Williams Energy and Resolute Energy - both of which have since been acquired.

Now, it is both true and kinda mystifying that any sign of either of those earlier ten-baggers seemed to vanish from Tarpon like a burp in the wind over the last few years - but I don't believe we have seen our last one, either. Stay tuned.

And to be clear, we also have a few laggards in the portfolio. At least on a relative basis. With enough patience, though, that problem should begin to correct itself.

The Case For Sitting Still

I have no plans to sell a single share in any of our current holdings anytime soon.

Nope, negative, notgonnahappen.

If our companies were in non-cyclical industries, I might more strongly consider moving on – as our shares would likely have reached fair value.

But the case for staying patient here rests on two extremely important points:

1. This is a cycle.

   One that is nowhere near its peak. And which - eventually, down the road a few more years, and if the stars continue to align, could even prove to be a…wait for it… supercycle. I'm not ready to make that prediction myself, but that narrative is emerging on the Street.

2. We bought last spring at what were likely once-in-a-generation valuations.

Taken together, both of those factors mean that entertaining the notion of selling out now - for even half a second – should in my humble opinion be considered a Crime Against Compounding. Punishable by parachute failure. Or, say…quarantine. In your living room, for a year. With only cable news, Facebook, and 17 calls every hour from out-of-state robots very concerned about an imaginary warranty.

Too soon?

My point is that the compounding still to come for us could be indistinguishable from magic - if we stay patient. No guarantees, of course, but at the moment I am extremely hard-pressed to consider selling anything currently in Tarpon during 2021 - at least.

Shoot, we're now earning a 54% annual yield on Altus Midstream (ALTM). Fifty. Four. Percent. Per. Year. Forever, probably – or at least until the company is sold.

The hard part was buying last year. Now we can just stare out a window.

For more on the importance of patience when it comes to compounding, using our holdings in Antero Resources (AR) as an example, I would refer you to minute 31 of the second annual meeting video again.

A Fundamental Example

If exponential functions are not your thing, I would note another reason to sit still here in spite of that recent performance is because our companies are just still too cheap. That the Street is too slow to acknowledge the coming inflection in free cash flows across our group - independent of higher oil and natural gas prices. Consensus estimates are still too light.

Let's stay with Antero Resources as an example here.

A good rule of thumb is that every $2 change in pricing will result in another $100 million in very high margin revenue at Antero.

The average price for their NGL (natural gas liquid) barrels sold in 2020 was $21.68.
Today, Antero is selling the same for $41.55.

If today's $41 price ends up being the full year average of 2021, Antero will generate an additional $800M in very high margin revenue this year. On a market cap of $2.7B and enterprise value of $5.6B – for a free cash flow yield (to equity) of 36% and 14% (to the firm).

The company also bought back 13.4 million shares in 2019. They bought back another 28.2 million shares in the first quarter of last year. Clearly the appetite for buybacks is there.

Which is worthy of note to me because, upon reauthorizing another share repurchase program, and assuming every dollar of free cash flow went to additional share buybacks, Antero could in theory buy back every single share it had outstanding…in about 32 months.

So if the market doesn't recognize the value in Antero, the company could - all by itself.

Further, the odds that Antero will realize that average price of $41 per barrel in 2021 are high. The non-ethane portion of their NGL barrel is heavily weighted to propane (56%). Propane was in high demand in the U.S. during the winter (lot of outdoor dining up north), and is in short supply now relative to the previous five years. And as propane demand begins to approach high season, it is currently understored in the U.S.

All of which is a long-winded say to say:

The Street's consensus estimates for Antero are too low. And even if you pick my least favorite metric – EV/EBITDA – then Antero would still be worth $13.50 per share, assuming a very reasonable 5.5x EBITDA multiple on the Street's 2021 estimates. For several reasons, the company should also merit at least a 6x multiple on 2022 EBITDA – so by the time Street consensus for '22 starts getting pencilled in during the third quarter of this year…Antero shares should be worth $16.50 each.

Our weighted average cost basis in Antero Resources shares is $1.31. Shares currently trade at $9.19. By one mediocre but popular gauge on the Street, shares should be worth $16.50 in 2022.

So while they've had a great run over the last year…we're going to sit tight.

And to various degrees, that example applies to each of our companies in Tarpon.

A Technical Reason To Stay Patient

If you're more of a believer in technical signals and momentum trading and reading charts – or, you know, shaking chicken bones to tell the future – then it may be of note that shares in three of our fourteen Tarpon companies will see significant buying by index funds over the next few months. - including Centennial Development (CDEV), which will be added to the Russell 2000 Index this spring.

The relevant math for our position in CDEV is that – due to our extremely low cost basis - every 31 cent increase in share price represents another 100% gain for us.

So an intriguing question to me is…

Will programmatic buying by Russell 2000 Index funds - as well as all the derivative funds that mimic it - eek our position in CDEV up another 31 cents and cause it to double again?

Hard to say, and it's not relevant to our thesis…but I admit I am kinda curious to find out.

And if the question is:

Under what circumstances would you NOT sell a stock that has gone up 1255% in the last twelve months…perhaps one answer is this:

Right before a warehouse full of computers starts a predictable, indiscriminate, non-price-sensitive buying spree in those shares.

The Macro Case

If none of the above inspired you to stay emotionally disciplined here, then please consider that we are likely to begin to see the biggest jump in global economic growth in history beginning this summer – as the world comes out of pandemic lockdown.

Here in the U.S., when you combine mass vaccinations with historically large fiscal stimulus, we're likely looking at real GDP growth of 5.3% this year – and 4% in 2022.

Meaning that among other things, demand for oil and natural gas will soon begin to move meaningfully higher.

Head On A Swivel

The silver lining of negative oil prices a year ago was that the period of rapid production growth in the U.S. shale patch is now dead.

In my opinion, the biggest remaining downside risk for the oil market in 2021 is Iran. Specifically, a return to the JCPOA nuclear deal by a new U.S. Administration, which would allow Iran to resume oil production. Eventually.

While preliminary indirect talks towards that end began in Vienna this past week, I do not anticipate an imminent return of Iranian barrels to the market – though sentiment will clearly be sensitive to that risk.

I am not overly concerned about Iranian barrels impacting our holdings for the following reasons:

1. The ramp-up in Iran oil exports already started. China has been importing notably more. So the actual number of new Iranian barrels the market would have to absorb may be significantly less than expected six months ago.

2. The return of Iranian barrels is already a foregone conclusion in the oil market. There's no surprise element, and the math is straightforward.

3. Much more diplomatic progress will be needed before normalization. As a reminder it took six months between reaching a deal on the original JCPOA and the day it was implemented. And the longer it takes, the more post-COVID demand will return – and the less impactful those Iranian barrels will be.

4. OPEC+ will help accommodate the return of Iranian barrels. Saudi has been pretty clear about this point: backwardation - whatever it takes. There is no indication that stance will change in the least due to Iran.

Because the return of Iranian barrels is not a surprise to the oil market, it's not in the same universe of the previous geopolitical risks we have seen in this cycle. In the end, it's much more an issue of timing.

And while the specific day and week that sanctions might be lifted will be of considerable interest to speculators, we have the great luxury of not being on a clock. Especially now, considering the cost bases we have in our group.

Simple But Not Easy

If last June's letter to you was The Big Pep Talk, consider this next part The Let's Not Get Cocky Speech.

Which goes like this:

We are going to have to steel ourselves for more volatility. It will show up again - guaranteed.

The pressure you are going to feel to want to skip the next round of volatility - whenever it arises - will be hard to withstand. In large part because of what we went through a year ago: investing PTSD.

Nonetheless, my advice is this:

Ignore it.

And gird those loins, folks.

Because if we stay patient, there should be much more to come in Tarpon over the next few years.

I mean, sure, as an investor in oil and natural gas companies, you're still gonna be living in a state of potentially irreversible social scorn and be forced to watch teenage imbeciles get temporarily rich on sketchy stock tips from something called Reddit...and, you know, my apologies.

But rest assured that at some point, the market will humble them, too.

Diamond hands, people. You all have suffered enough. It's time to win. But you can't win if you don't play, knowwhatImean?

Thoughts On Electric Vehicles

The most common question I've gotten the last few months has been about the impact of the new U.S. Administration on the oil and gas sector.

I addressed that in more detail during the annual meeting videos, but as a quick rehash: anything that restricts or hinders the production of oil and/or natural gas in the U.S. will, by definition, lead to higher prices in those commodities – and for the assets that produce them, too. That paradox has no doubt played a role in our recent returns, too.

The second most common question I get is with regards to EVs or electric vehicles - specifically on their impact on our companies – or, more broadly, the demand for oil.

First, know that I come to neither praise nor bury EVs. Teslas are amazing vehicles. The stock, however, appears extremely overvalued to me.

I also feel pretty strongly that we are witnessing a speculative bubble when it comes to the stocks of many EV and renewables companies. But that's an issue of valuation, not politics. I am keenly interested in the former and have zero interest in the latter.

I suppose my own bias is that I look forward to one day driving around the Florida Keys in an electric pick-up truck.

But (a) that day is going to be a long way off, and (b) that's probably just my irrational fondness for pick-ups.

Shoot, I'm 6'3". Unless you're a chiropractor, get outta here with that coupe.

Also, the main reason I look forward to one day having an electric truck is that Ludicrous Mode will help me put all these tourists in my rearview a whole lot faster.

Hahaha kidding. Tourists are always welcome in Islamorada - of course!

Except for the ones that feed seagulls.

Anyway, I say all that to say this:

EVs are being over-hyped. They're not likely to significantly disrupt oil demand for at least another decade - and probably even further out. And though their growth rates sound impressive, those numbers you often see quoted are off of a tiny base.

For instance: it is true that in 2019, 40% more electric vehicles were sold than in the year prior.

But in raw numbers, that was 2.1 million EVs. Which should be compared to the 80.7 million ICE (internal combustion engine) vehicles sold that same year.

And while that 40% jump in EV sale meant there were then 7.2 million total EVs on the road, they were also sharing those roads with 900 million ICE automobiles already driving around.

And it's estimated that those electric vehicles driving avoided the consumption of just 600,000 barrels of oil products per day in 2019.

Versus the 101 million barrels of oil used every day that year – the highest in history.

Which means that in 2019, EVs displaced just 0.6% of total oil demand.

EVs aren't just competing against today's ICE cars, either, though. They will be competing against tomorrow's ICE cars, too. And it is going to be a long, brutal fight.

The World Bank believes approximately two billion people in emerging market economies will likely be lifted out of poverty by 2035. That coming increase in prosperity and living standards - in some of the most populous countries on the planet - is only going to drive further increases in the global demand for oil.

For instance, S&P Global Platts Analytics sees global oil demand peaking in 2040 at around 115 million barrels of oil per day (bopd). That's 15 million barrels a day higher than the historical peak in 2019. And in spite of the rapid growth of EVs over that same period of time.

BP's Energy Outlook 2035 forecasts growth in electric cars over the next two decades from 1.2 million vehicles to around 70 million in 2035 – nearly a 60-fold increase. Which sounds bullish for EVs and bearish for oil…until you realize that - due to those increased living standards in poor countries - the total number of autos with internal combustion engines around the globe is expected to double over that same time.

In which case, we would see another 900 million ICE cars on the world's roads by then, in addition to the current global fleet - of the same size.

And while fuel efficiency standards will no doubt get stricter over time, unless those 70 million EVs can somehow completely displace the oil needed every day to fuel 1.8 billion ICE cars…the total oil demanded by automobiles every day will still increase. Even if the number of EVs grows 60x between now and then.

I will leave it to you to determine how realistic that may be.

The adoption rate of EVs will depend ultimately on consumer demand – but from all consumers, all around the world - not just high income earners in the West currently buying them in small quantities. That demand will in turn be dependent on affordability, charging times, charger locations, and perhaps most importantly, advances in battery technology – as well as avoiding some extremely challenging bottlenecks in the supply of commodities like lithium and cobalt that are critical future supply chains for those batteries.

My point is this:

The path for EVs to reach critical mass around the globe is going to be more difficult – and take much longer - than the headlines might lead you to believe. Even with significant shifts in government policies.

And as relates to Tarpon, we don't need to worry about EVs materially impacting oil demand anytime soon. It's unlikely to happen until well after the next peak in this oil cycle.

The Big Picture

A year ago, COVID ratcheted up an investment crisis in the oil and gas industry that became unprecedented in the history of the modern energy market.

Investment in oil and gas effectively died when oil prices went negative a year ago. At least on a relative basis. It was whimpering along in 2019, and then COVID hit. Prices have rebounded significantly since - but let's not confuse today's per barrel oil price with the level needed to reinvigorate investment in global oil production, either.

As a reminder, the world has to replace almost all of today's current oil production by 2030...just to hold production levels still, given annual decline rates.

If the world is unsuccessful in replacing that production, then the price of oil will rise until it reaches the point where it has incentivized the capital expenditures that will be needed to create the supply that is in turn needed to meet global demand.

That's not a prediction, mind you - it's just how markets work.

At the same time, large portions of Western civilization seem to be going "energy blind."

Plastics, lubricants, pharmaceuticals, fertilizer, clothing. It all starts with crude oil.

It's literally everywhere and in everything...yet it's as if most people have no idea.

In an industry as capital-intensive as energy is, you simply cannot stop investing in the supply chain that delivers such a critical global energy source and which has no immediate material substitutes.

That's a prescription for significantly higher commodity prices - especially for oil.

Yet that's what we've done.

And if you couple that lack of critical investment with a widespread misunderstanding about the degree and speed with which renewable energy technology can actually replace oil and natural gas…then, in my opinion, it sure seems like another bull cycle in energy is inevitable.

Please let me know if you have any questions, and thank you for your continued patience.

- Cale

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