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Investment Management

# Letter to Investors: Tarpon Folio

*Cale Smith, Managing Partner*
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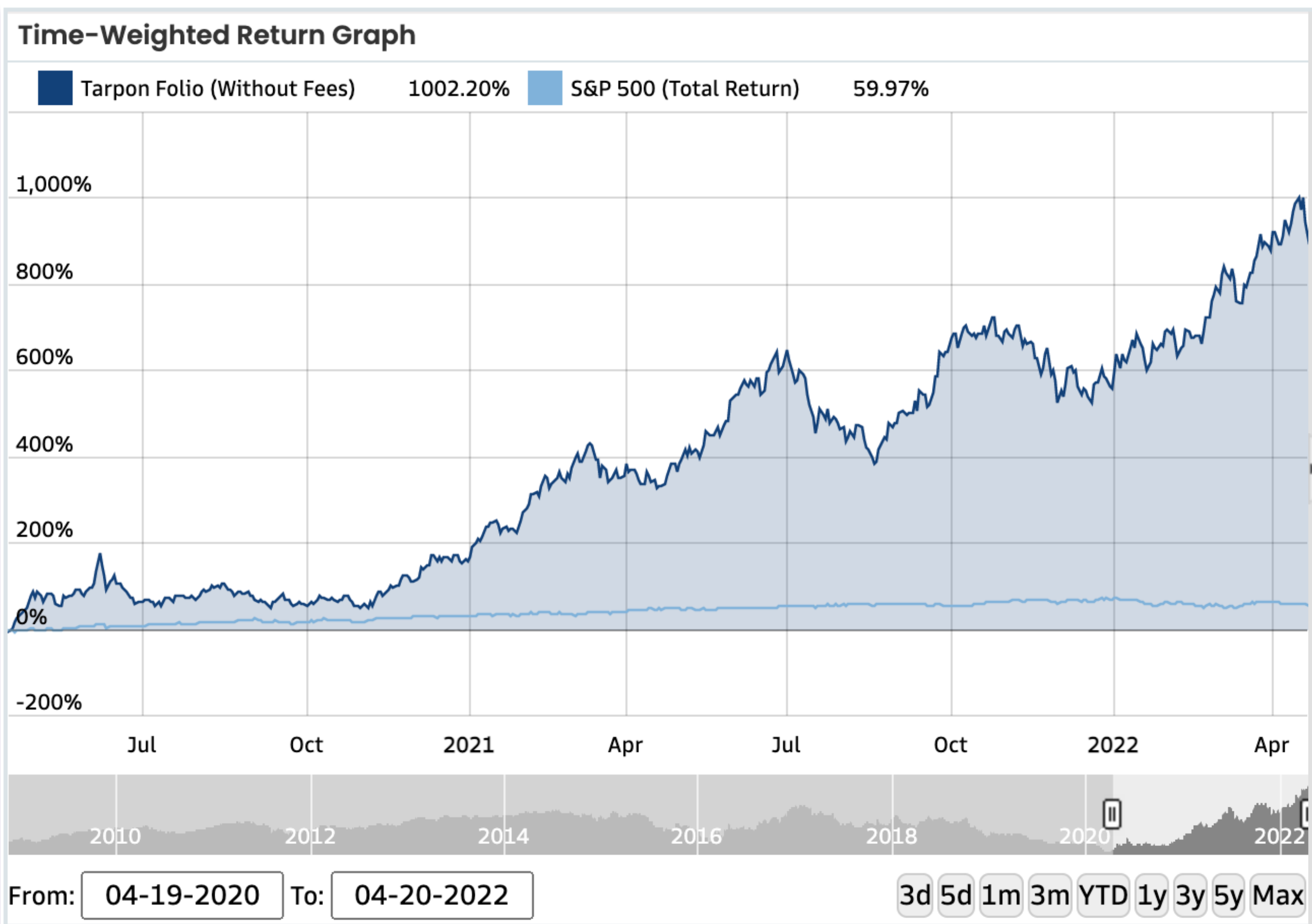
**Dear Investors,**

From the first of this year through last Friday, Tarpon is up approximately 44.2% on an unaudited, after-fee basis.

After an extraordinary 2021, Tarpon continues to see significant gains.

Here is a two-year chart of Tarpon, from the day oil prices went negative on April 20, 2020:




Over that time, Tarpon has been a ten-bagger. Thank you for the patience.

And whether by luck or fate, the investment case for owning energy companies has gotten stronger of late.

But let's not get cocky.

Because that chart also came at a price. The ticket we had to buy to take this ride was extreme volatility off the left border of that snapshot above.

Nonetheless, it's a mistake to let the fear of yesterday's volatility influence decisions today.

Coach Lasso has it right:

Let's be goldfish.

**The Case for Continued Patience**

What's going on in European markets is not just an energy crisis.

That's too narrow a frame, in my opinion.

It's the latest sign of a years-long crisis in capital investment.

So, to be clear – the West does not have an oil company problem.

We don't have a price-gouging problem.  Nor do we have an OPEC problem.

And despite the complaints, gasoline is one of the few non-tech products that - until very recently - has not gone up in price over the past fifteen years.

What we do have, in my opinion, is an investment problem.

Capital expenditures in global upstream production remains one-third below the levels required to help rebalance acute market tightness in both oil and natural gas.

And the only thing that end this particular crisis is more capital investment - from the capital markets, global banks, and the commodity markets - to increase oil and natural gas supply.

Yet that capital is still nowhere in sight.

How long will it take to see that capital investment arrive?

History would suggest that it could take three years.

Based on the last oil supercycle, in which we saw oil prices inflect higher in 2003 - capital didn't return to the sector until 2006.

And that was, you know, before the pressures of ESG ("environmental, social, and governance") mandates, before trillions in cheap capital had been lit on fire by imaginary internet coins named after dogs and $12 million jpegs of monkeys…and before investors all but abandoned non-capital-light businesses to over-emphasize fast-growing tech companies they would apparently buy at any price.

So when does that capital arrive…given the peculiarities of this cycle?

That's hard to answer by pointing to a calendar or chart.

In more qualitative terms, though, that answer may best be determined by a paradox:

In order to get oil prices to come back down, those making the capital investments required will have to believe oil prices will never come back down.

And in spite of how far we have come, that belief is not yet widespread.

**On the Russia-Ukraine War**

In late February of 2022, the relationship between Europe and Russia changed, permanently. That may prove to be one of the most significant events for global energy markets in the last 50 years. Russia accounts for 10% of world oil supply and one third of European gas supply. And even before Russia crossed the border into Ukraine, both oil and nat gas markets were tight.

Three aspects of this war strike me as notable:

**1. Russia is being isolated from global energy markets at an especially precarious time.**

The oil market already had a structural supply problem caused by seven years of reduced capital investment. Russia's invasion of Ukraine will only underscore the consequences of that underinvestment cycle – from which it may now be too late to fully recover – while at the same time potentially re-setting market psychology around a new normal for long-term oil prices.

**2. The war has increased the already high probability of a supercycle in LNG.**

The LNG (liquified natural gas) market appeared notably undersupplied from 2023 to 2027…before the Ukraine war.

At the end of 2021, it appeared global LNG demand would increase from the current 380 mtpa (million tons per annum) to 450 mtpa by 2025 and 580 mtpa by 2030. By looking at current LNG supply, new already-commissioned projects, and natural declines, an incremental 100 mtpa would be needed to come online by 2030 from liquefaction projects not yet sanctioned.

Further, due to project deferrals caused by COVID, we could expect slower growth in sanctioned LNG supply projects over the next five years of ~15mtpa…versus growth of ~25mtpa *in the second half of the last decade*.

Given the lag of two to three years between the start of project construction ("FID" or Final Investment Decision") and the start-up of LNG liquefaction terminals, one could reasonably expect project FIDs to remain strong over the next three years – and that the LNG market would nonetheless remain tight through 2026…until newly sanctioned projects can come online in the second half of the decade. It takes considerable time and expense to build LNG facilities.

So, on the back of under-investment and LNG project delays, we were entering an air pocket in LNG supply growth next year - due to a limited number of FIDs over the past five years – *before the Russia-Ukraine war*.

Previously, Russia had also been targeting supplying 15% of the global LNG market by 2035 – equal to 80 to 140 million tons per annum.

Clearly, a significant portion of that future Russian supply is now at risk. And the math of undersupply above became even more pronounced this February.

More near-term, the EU has devised a 10-point plan to cut natural gas imported from Russia by two-thirds, in just a single year.

While that target is unrealistic – pipelines and LNG capacity take years to build – the 6.9 trillion cubic feet (Tcf) of Russian natural gas current flowing to Europe is nonetheless an opportunity for U.S. natural gas producers.

The desire to move away from Russian gas in Europe alone could lead to 4 - 6 Tcf of incremental annual new demand from U.S. producers. And because the U.S. currently produces 33.5 Tcf of natural gas annually, that is a meaningful uplift. Plus, even if there is a truce between Russia and the Ukraine tomorrow, it is hard to see how the EU still doesn't migrate supplies to friendly sources like the U.S. as fast as humanly possible.

Much like the oil market, the natural gas (and LNG) markets are also suffering from underinvestment in capital projects during the last half-decade. And the restriction of incremental natural gas supply from as important a supplier as Russia has bullish ramifications for a number of our companies in Tarpon including Antero Resources (AR), Range Resources (RRC), and Kosmos Energy (KOS) - but perhaps none more than NextDecade (NEXT).

NextDecade represents what I believe is our best way to arbitrage the stranded natural gas here in the U.S. and the rest of the world. The company is building a toll bridge between cheap, plentiful Permian natural gas from Texas and the global LNG (liquified natural gas) market - a market that is suddenly very motivated to pay higher prices for the security and stability of U.S natural gas supplies.

I expect NextDecade to soon sell-out liquefaction capacity in their proposed Rio Grande export facility – and then, once fully online later this decade, to return more in cash flows each year than the company's current market cap.

Finally, the most under-reported aspect of the Russia-Ukraine war:

**3. It may really be all about energy.**

I have zero insight into the psychopathy of Vladimir Putin, but it is notable that Russian troops are concentrated in the parts of Ukraine that hold 90% of its energy resources. Russia has seized the Donbas, controls Luhansk and Donetsk, and lines the coast of the Black Sea. If the fighting stopped today, it appears Putin would control all of Ukraine's offshore oil, critical ports on the Sea of Azov, much of the Black Sea coastline, and effectively all of the country's most critical energy and exporting infrastructure.

Acquiring control of Ukraine would also give Putin the second-largest natural-gas reserves in Europe - worth more than $1 trillion today – as well as oil and condensate worth as much as $400 billion. Ukraine is also home to the sixth-largest coal reserves in the world. When combined with control of the ports, a successful Russian war would put Putin at the center of global energy supply to Europe and the immense Asian markets for decades.

Despite the recent imposition of sanctions, European Union imports of Russian energy continued unabated. Europe is now paying Russia more than $100 billion a year, and is on track to import 90% of the energy it consumes by 2030.

It also appears this war could continue for some time. In spite of the criticality of Russian energy exports to Europe, revenues from natural gas are still a relatively small part of the total Russian foreign balance. Even if the West were to restrict all of Russia's energy exports, the country still appears to have enough non-energy exports to cover most of their import needs, before dipping into reserves. In other words, while these sanctions from the West are both morally and strategically justified…they may also not inflict as much pain on Russia as might be hoped.

In the interim, with commodity markets already tight, any interruptions in Russian exports may cause more disruption for the rest of the world than for Putin. Before factoring in any price increases.

So even the most powerful energy sanctions the West could impose on Russia are unlikely in the near-term to deter a very resource-motivated Putin in Ukraine – a very large, populous country equally determined to defend itself.

And though I, too, can't help but think first of the humanitarian consequences of an extended conflict, a secondary consequence is that elevated oil and natural gas prices may soon become more enduring than most investors realize.

If so, the market is making a mistake in continuing to price oil and natural gas companies at currently low valuations.

## On Our Companies

The primary reason to sit still in Tarpon is this:

**Our companies are making more money than ever - yet are even cheaper than at the start of the year.**

Despite significant gains in our companies, their valuations remain compelling. Other investors still do not seem to care in the least that our group will be a free cash flow machine over the next few years.

Our FCF yields have *increased* year-to-date - due to oil and natural gas prices rising more rapidly than equity prices.

Prompt and strip oil and natural gas prices are at levels few thought possible at the start of the year. Our companies in Tarpon are paying down debt, buying back shares, and paying record dividends, while maintaining and in some cases growing volumes - with far less capital than in prior cycles.

Q1 earnings reports saw our lesser hedged companies realize their highest free cash flows ever, and underscored a high rate of improvement in their internal economics - as the more efficient use of capital continues to drive further expansion in free cash flows and dramatic improvements in balance sheets.

Meanwhile, our companies are trading at valuation levels more appropriate for oil prices closer to $60 - and natural gas prices suggesting something under $4.

Assuming WTI oil prices of $75 in 2022 and $100 in 2023, natural gas prices of $3.85 and $6.00, and NGL prices of $47 and $39, our companies currently sport FCF yields of 21% in 2022, and 24% in 2023. I would also estimate our group is only pricing in approximately $60 WTI and $3.75 nat gas in 2023 and beyond – which leaves further room for catch-up in the stocks versus the commodities.

More recently, and after extraordinary performance since the start of 2022, our oil weighted E&P's have effectively stalled within a narrow range – a reflection, I believe, of a steeply backwardated oil price – and which also explains extraordinary free cash yields on valuations that have greater dependence on the long end of the curve.

Notably, however, I suspect we will see multiple expansion this year, finally, in our group - as margin expansion driven by higher-for-longer energy prices and declining emissions intensity kick-off a fundamental re-rating during this extended period of undersupply.

On a look-through basis, Tarpon is now approximately 60% tied to the price of oil, and 40% to natural gas and NGL prices.

And that's largely due to the performance of our position Antero Resources – currently trading at $32, significantly above our cost basis of approximately $1.31 per share – and which is trading at a 23% free cash flow yield on expected 2022 numbers. Or, if you prefer, at just 5.5x TEV/EBITDA on expected '22 numbers…an artificially high multiple, given flat year-over-year growth that is a function of steeply backwardated prices and few hedges. My own estimate of Antero's value is closer to the Street's high estimate of $56 per share.

The point being that the valuations of our companies in Tarpon still have the capacity to increase significantly. Still.

**To Recap Where We Are**

Our companies are performing very well and near-term fundamentals remain favorable. Oil and natural gas demand is rebounding, supplies of both are getting tighter, yet production growth is slowing. While it is true that oil demand given recent China COVID lockdowns may be recovering slower than thought three months ago, it also appears that will be more than offset due to lower supply from Russia. And in the meantime, a new Iran deal appears effectively dead, global SPR (strategic petroleum reserve) releases are the equivalent of burning furniture to keep the house warm…and OPEC+ spare capacity continues to diminish.

And as discussed earlier, longer-term fundamentals have recently grown increasingly bullish, too.

The world will have even fewer energy supplies to meet future demand now than three months ago…and there still aren't any good, near-term solutions.

In the meantime, I anticipate we will continue to benefit from two virtuous feedback loops.

The first is related to the balance sheets of our companies. As debt paydowns continue and balance sheets strengthen, equity values will become less volatile.

The second tailwind at our backs is a concept known as a "volatility trap."

Specifically, volatility in the prices of oil and natural gas discourages capital investment by producers. Yet without that investment, volatility only increases – further discouraging that much-needed capital. And so on.

So while significantly more investment in commodity production is required to resolve the current shortages - the volatility in underlying prices is all but ensuring that will not happen anytime soon, at anywhere the scale needed.

Meanwhile, we appear a decade away from peak global oil demand – and even further out for natural gas.

To be sure, volatility in commodity prices is here to stay for the foreseeable future.

Nonetheless, the era of cheap energy prices these past seven years is over.

And it appears $100 oil has become the norm. Again.

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

- Cale

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