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Investment Management

Letter to Investors: Tarpon Folio

Cale Smith, Managing Partner
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Dear Investors,

The Tarpon Folio is up 76.2% this year through the market close last Friday, on an unaudited, after-fee basis. Over the same period, the S&P 500 is down 15.1%.

The third quarter was volatile, as crude prices fell nearly 20% during the quarter, a significant retreat from the $120 per barrel we saw in March. Nonetheless, our group squeaked out a positive 1% return during the quarter.

Our companies in Tarpon have finished Q3 reporting season. Commentary on their results can be found on the investor boards at this link. Among the highlights: we are now earning a 64.5% annual yield on our shares of Permian Resources – previously known as Centennial Development - purchased back in March of 2020. More of our companies should also announce inaugural dividends in 2023, with the potential for similarly outsized yields. All dividends we earn from here out in Tarpon will accumulate as cash to redeploy opportunistically over time.

Each of our companies continues to maintain a strong focus on free cash flows versus growth. Our management teams are bullish with regards to long-term pricing of both oil and natural gas, though with a little more caution on 2023 natural gas pricing - and are wary of recent political rhetoric directed at the industry. Our companies continue to move towards – or surpass - their previously established debt reduction targets, and are re-directing their record free cash flows to share buybacks and dividends. Capital budgets in 2023 will be geared once again towards maintenance, rather than growth, and while many E&Ps are seeing 10% to 20% service cost inflation, the majority of our companies are at the lower end of that range, as prior supply chain issues appear to be slowly improving, as are certain labor costs.

Tarpon has significantly outperformed the S&P 500 over one, three and five-year periods. While there are a number of factors driving that outperformance, I'd summarize them as this:

Valuations matter.

Especially when the rest of the world ignores them.

The world continues to sleepwalk into an energy crisis, and I continue to be bullish on our companies' prospects. That is not to say they are without risk. However, the current imbalance between supply and demand - for both oil and natural gas - will very likely persist for years. The supply risks are greater than the risks to demand. And our companies our positioned to significantly grow free cash flow per share for an extended period of time - with no external capital required.

We are not alone in that outlook. Warren Buffett continues to buy shares of oil companies. Berkshire Hathaway now owns approximately $30B of Chevron and $15B of Occidental Petroleum. Together, those two oil companies would be Buffett's second largest stock investment – behind only his six-year-old stake in Apple.

Read into that what you may.

The rest of letter will be dedicated to answering the two most common questions I've gotten lately. If you missed my macro mailbag videos from a few weeks ago, you can find them here at this link. I'll also be holding an informal investors-only Zoom on our Investor Boards at 3:00 ET on Thursday, December 15th. If you'd like to join, please see the boards for details, or email me for to login. I'll also post answers to other recent questions on the boards the next week or two.

Now, on to the two most popular questions I have gotten lately…

Q1. How much upside is left in Tarpon?

The short version: a significant amount, I believe.

Oil and natural gas prices have increased faster than the valuations of our companies.

So, in spite of their recent share price performance, they remain undervalued on a fundamental basis.

Our group continues to trade as if disconnected from the underlying commodities. Prompt and strip oil and natural gas prices are at levels few analysts predicted at the start of the year. Our names are rapidly paying down debt, buying back shares and paying record dividends while maintaining and in some cases incrementally growing output with far less capital than ever before. Nonetheless, their valuations are at levels implying oil prices roughly 40% below current levels - with valuations of our natural gas names implying something closer to $4, despite a spot price north of $6.

Here is a list of near-term bullish catalysts for the sector:

- The end of the largest SPR (Strategic Petroleum Reserve) release in history
- Refineries emerging from maintenance season – with distillate inventories already historically low
- Tepid U.S. shale growth
- The continued draining of U.S. commercial oil inventories due to those three factors above
- Normalizing Chinese oil demand as COVID lockdowns ease
- An OPEC willing to defend $100 oil with production cuts if needed

Three deadlines also loom over the oil market – each supportive for prices.

On December 5th, the European Union will ban most imports of Russian crude oil - and bar companies from insuring and financing Russian oil anywhere in the world. A U.S.-led cap on Russian oil prices is also due to kick in on the same day, allowing those companies to facilitate Russian oil shipments if the crude doesn't trade above a (yet-to-be-determined) price. Then, on February 5th, the EU is expected to impose the same restrictions on Russian refined fuels - such as diesel and gasoline – and also subject them to a price cap.

The problem, however, is in the likely Russian response. Putin has repeatedly stated that Russia, in response to those efforts, will voluntarily restrict its exports – which will increase the global oil price – including prices received on other Russian barrels, sold outside those sanctions. Attempts to effectively 'price cap' a global commodity based on the country of origin are likely to prove naive.

Regardless, our companies remain significantly undervalued. Our names also have yet to see multiple expansion – an increase in valuation reflective of investors' desire to pay more for the same level of profitability. That, too, should change as the market realizes oil and natural gas will continue to see healthy demand for the rest of this decade, and as the operating leverage in energy companies becomes more apparent. As per recent analysis by JP Morgan, for every 1% rise in revenues, the average energy company realizes an 8.9x increase in operating income, by far the highest of any sector.

Assuming economic growth slows into 2023, then, and earnings estimates for the S&P 500 reset lower, the choice of biggest-bang-for-the-invested-buck seems clear. And that's even before valuation comparisons based on TEV/EBITDA, P/E and FCF metrics – which positively differentiate the energy sector even further.

Commodity prices should also stay elevated beyond the next few quarters. Again, the oil market has a structural supply problem caused by seven years of reduced capital expenditures. Meanwhile, oil demand through 2030 is effectively locked in. There are no credible policy- or market-based solutions that can change the global vehicular fleet, replace shipping and aviation fuels, and/or overhaul the petrochemical industry on a timeline or scale that will significantly affect oil demand the rest of this decade. I also remain skeptical that any political career could survive the draconian economic measures needed to materially alter that outcome.

So in spite of our recent gains, I believe we still have significant room to run in Tarpon. As our results this year so far corroborate, the energy sector is unique – both as an inflation hedge and a sector with significant long-term growth potential. Our companies are also, in my opinion, advantaged among their peers.

Q2. What is the worst-case scenario for oil and gas? What probability would you assign to that? What black swans do you think are lurking out there that are specific to oil and gas?

Let's step back and describe in layman's terms the different kinds of risk we have in Tarpon:

First, the big "stop-the-presses" kind of risk.

Second - the risk everyone seems worried about lately, but which is really just volatility, and is not an actual danger to our prospects longer-term.

Then, third, our highest-probability risk – even though it's still not likely.

Last, I'll briefly mention the most ever-present risk for us.

And let's limit the scope of these answers to just the energy sector. I have no particular insight into assessing risks related to wars, pandemics, Elon owning Twitter or any other horsemen of the apocalypse.

Also, I don't consider the latest crypto implosion to be a black swan, either.

That's just a good old-fashioned reckoning.

Don't buy magic beans on the internet from ding-dongs, y'all.

Real black swans – at least in energy - are typically geopolitical. Like we saw this spring, when Russia invaded Ukraine. In that vein, it's notable that the probability of a near-term return of Iranian barrels to the oil market is now the lowest in two years. In the meantime, as China oil demand continues to increase, the potential impact of those Iranian barrels on prices continues to decrease. It also seems clear that even if the war in Ukraine were over tomorrow, sanctions on Russia's energy sector would remain intact for as long as Putin remained in power.

Geopolitical black swans are notoriously hard to see coming, but the risks we do know about are untroublesome at the moment.

Here's what I believe to be the worst-case scenario for us:

The world immediately begins to allocate massive amounts of capital to fossil fuels.

Which would dramatically increase supply – and bring commodity prices down significantly, for a long time.

Capex is destiny. For us, in energy. High levels of capital investment in this sector is - by far - the biggest risk to this thesis. Fortunately, it's also the most unlikely to sneak up on us.

Over the last ten years, global energy consumption has grown by 2% per year, with oil growing by 1% and natural gas growing by 2.6%. In 2021, fossil fuels met 82% of global energy demand. Nonetheless, oil and natural gas producers have systematically underinvested in production since 2014 – leaving them unable to easily meet continually rising demand.

That hesitancy to invest is due to a number of things, including the demands and social pressures of the ESG ("Environmental-Social-Governance") movement in capital markets. The result is an unsustainably low level of capital expenditures in oil and gas production – which, according to Evercore ISI Research, peaked in 2014 at over $700 billion and fell to $350B - $450B each year from 2015-2021.

It's that chronic underinvestment that is now leaving the world short on production, and in spite of continued demand growth. As a number of analysts have persuasively argued - oil and gas capital expenditures will need to increase an additional $1.2 to $1.3 trillion by 2030 to support global economic growth.

Yet that ramp-up is nowhere in sight. To the contrary, and according to Energy Aspects, today's capex levels are approximately 30% below what is needed just to keep up with current demand.

At the start of 2022, consensus forecasts had the big three U.S. shale basins producing more than 10.0M barrels of liquids output per day by this September. Actual production now appears to be approximately 9.2M barrels a day – a 0.8M barrel per day disappointment. More strikingly, consensus estimates of U.S. shale output in 2025 appear to be consolidating around 15M barrels of oil per day – which is 10M bopd below the peak U.S. shale potential seen in 2019. Again, that is primarily due to widespread hesitancy about long-term investment in the sector.

Next year, crude production forecasts from the U.S. Energy Information Administration for 2023 continue to shift lower – again, from a baseline that is already failing to meet demand today.

Again, it's not just us noting the scale and potential consequences of this chronic capex shortfall. Click here to read a recent speech about the same from the CEO of Saudi Aramco, the largest publicly traded company in history.

In spite of the glaring need for more growth in fossil fuel production, refining and distribution, that capital investment remains slow to emerge. Should that investment begin to ramp, it would lead to more supply – and ultimately pressure the share prices of our companies. Currently, however, that risk is very low.

The next risk – the one I get asked about most often - is related to a recession.

As per those prior macro videos, the odds of shallow recession are currently higher than a deep downturn. The fact that oil and nat gas prices are as high as they are now – on the eve of a widely anticipated recession – speaks to the tightness of supply in both markets. And, perhaps, the market predicting a relatively light recession, too.

To be clear, recessionary fears if unabated would be unlikely to spare the share prices of our companies, regardless of fundamental strength in supply and demand balances…in the short-term.

But any decline in our group's share prices due to a recession would be temporary. Due specifically to this paradox:

A recession would exacerbate the existing supply problems in energy markets.

If a recession caused the prices of oil and natural gas to collapse, then investment in both commodities would collapse, too. Capex would decline further from today's already-too-low levels. So a recession would perpetuate the current shortages of oil and natural gas, and ultimately drive prices even higher.

While many investors equate a recession with the severe downturn of 2008-09, there is a case to be made that the recession we may see in 2023 will more closely resemble that of 1973-75, in which commodities prices emerged roughly 50% higher after the downturn.

In other words – a recession would only kick the capex can further down the road.

Given the degree of today's supply challenges, there is historical precedent for a sustained bid for oil and natural gas, even during a recession – as the market attempts to continue to incentivize the much-needed capital investment for the sector.

To be clear, this potential "de-coupling" of oil and gas demand from a broader economic downturn would not be without short-term volatility in our companies' shares. But long-term investing demands trade-offs, and pretending volatility is not one of them is disingenuous at best.

Further, one silver lining of this scenario could be that it would limit price spikes – the third and most probable risk for us.

The highest probability near-term risk we have is a prolonged super-spike in oil and/or natural gas prices. And by "super-spike" I mean WTI prices above $150 and U.S. Henry Hub nat gas prices over $15 – for an uncomfortably long period of time.

Uncomfortable to most folks, I mean. We would all meet up at the tiki bar.

I estimate the probability of a prolonged super-spike in oil or natural gas over the next six months to be approximately 40%. While oil market fundamentals at the moment are more observably bullish than those of natural gas – the latter is also more likely to be weaponized by Putin in Europe this winter. Those odds might be higher – if not for my opinion that OPEC would act decisively to temper a super-spike in the oil market. Saudi would also prefer a long period of elevated prices to a brief period of sky-high ones.

The worst outcome from a super-spike scenario would be turning an expectedly mild recession into a deeper one. While that same "kicking the capex can" paradox would exist, the differences in causality could be significant. Specifically, when compared to a Fed-induced slowdown, a deep recession triggered by unsustainably high energy prices might bring an end to the current bullish energy cycle. And that would warrant changes in Tarpon.

In theory. In the meantime, let's sit tight, keep our heads on a swivel, and stay tuned.

Finally, a quick note on the most ever-present background risk in the energy sector: public policy.

Energy policy in the West has been incoherent for decades. America in particular needs to decide whether lithium mining, nuclear fission or oil production is the lesser evil. Right now, we're saying no to all of them - which does not bode well for the future prices of any commodities.

At the moment, in the policy battle against high oil prices, the West is trapped in a box canyon.

And there is only one way out: capex.

Except not only is it failing to ramp, it's being further discouraged – by political rhetoric and widespread energy illiteracy.

Politicians in the West have a clear economic solution at hand: to provide greater incentives for oil and natural gas production.

Whether they have the political courage to do that, however, is another matter entirely.

I continue to assign a low probability to the risk of public policy materially impacting our thesis.

And in summary: I see no risks that are concerning enough to be actionable in Tarpon today. The de-risking we did back in 2020 continues to hold up well.

To Be Continued On The Boards…

I'll answer a number of other recent questions on the Investor Boards over the next week or two.

To reiterate the highlights of the above:

To incentivize capex spending, oil and natural gas need to reach inflation-adjusted prices that sustainably exceed current levels. Energy prices have been unsustainably low for an extended period of time, but that cannot last much longer. Clean technologies and electric vehicles will not gain market share fast enough to meaningfully dent oil demand this decade. Higher oil prices over an extended period of time appear inevitable. As a result of Russia invading Ukraine, the same can be said for natural gas prices, too.

Recession or not, both oil and natural gas will remain in a structural, multi-year upcycle that will be driven by demand. While there are risks to our thesis that continue to bear close watching, they should also be considered in the proper context:

The fundamentals of the oil and natural gas markets are the strongest they have been in decades.

Please join us for more recent Q&A on the Boards, and save-the-date for that Zoom on December 15th, too.

Thank you.

- Cale

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