

Letter to Investors: Tarpon Folio

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Dear Investors,

The Tarpon Folio increased 16.4% in the third quarter of 2023, compared to a decline in the benchmark S&P 500 Index of -3.3%.

In spite of a volatile start to the third quarter, which saw the third plunge in oil prices of greater than 10% this year, followed by the Hamas invasion of Israel, Tarpon continues to grind higher in October, as well.

Year to date, through market close last Friday, the Tarpon Folio is up 18.5% on an unaudited, after fee basis, compared to an 11.5% increase in the S&P 500 over the same period of time.

A quick note on recent events and our energy thesis:

The Hamas invasion of Israel makes global oil markets incrementally more complicated. Israel and Gaza on their own are not material to global oil supply or demand. Conflict in the Middle East, however, could be very relevant to supply.

The odds of an upside spike in oil prices have increased modestly of late. The recent increase in geopolitical risk premium on a barrel of oil could also be persistent. And while my bullish view on oil would be bolstered by escalation in the Middle East...for reasons beyond the portfolio, let's hope it doesn't come to that.

Year-to-Date Summary

Tarpon continues to be positioned well for higher interest rates as well as increased oil and natural gas prices. Despite year-long fears of a possible recession, demand data for both commodities continues to impress.

Our companies' balance sheets are the best in history, and they are generating record levels of free cash flow - yet they also trade at relatively low historical multiples. In spite of in some case returning 75% of their free cash flow back to us, they are also discounting oil prices closer to \$60 than the current \$85 a barrel.

Our companies continue to be materially undervalued, and their management teams continue to earn my trust – in terms of capital discipline, specifically.

In the tech-dominated S&P 500 Index, AI was the primary driver of returns earlier this year. Premature fears of a recessionary impact on oil demand, plus the hype around AI, dinged our relative performance versus the S&P 500 earlier this year. That problem now seems to be correcting itself.

U.S. natural gas prices improved significantly during the quarter, too, up 35% at Henry Hub. Since January, the number of rigs drilling for natural gas in the U.S. has fallen 26%, from 160 to 118. U.S. natural gas supply appears to have peaked in early September and we should see a modest annual decline from here, given those falling rigs counts and relentlessly rising LNG exports.

After declining \$10 a barrel by the end of the second quarter, WTI oil prices increased 20% in the third quarter. That increase can be attributed primarily to a large daily supply deficit that shows no signs of decreasing.

More on this in a bit.

One notable name change in Tarpon this summer: Baytex Energy (BTE) acquired Tarpon holding Ranger Oil (ROCC) in late June via a stock-and-cash deal priced at \$44.36.

The buyout was bittersweet. It formalized ROCC as another ten-bagger for us, via our original cost basis of \$3.99 per share in predecessor company Penn Virginia – but I would have preferred an all-stock deal, as Baytex snatched up Ranger at an attractive price. Nonetheless, we rolled all our eligible shares into Baytex – a company we'd previously owned several years ago, but which has since found an excellent new CEO, optimized its asset base, and dramatically strengthened its balance sheet.

Baytex is attractively valued, as well. At the current strip, shares trade at a free cash flow yield of 24% on expected 2024 numbers.

By way of contrast: the current free cash flow yield of Nvidia – adjusted for stock-based compensation - is 0.7%.

Read into that what you may.

Also of note:

We are realizing stunning yields on a number of Tarpon companies, as they begin returning significant free cash flow to shareholders. Here are the latest annual yields we are earning - declared "base" dividends (excluding buybacks and variable dividends) on the actual cost basis of the shares we own in Tarpon:

Permian Resources (PR): 71.4%
Matador Resources (MTDR): 65.6%
Kinetik Holdings (KNTK): 57.8%
Diamondback Energy (FANG): 18.0%
Range Resources (RRC): 10.0%

Those yields should increase further in 2024. Permian Resources, for instance, has already announced an increased base dividend starting in Q1, not reflected above. That list is also likely expand in 2024, too, as other Tarpon companies launch new shareholder return programs.

Components of Return

The biggest contributors to Tarpon's performance so far in 2023 have been shares of TETRA Technologies (TTI), up 90%, Permian Resources (PR), up 75%, and Range Resources (RRC), up 48%.

TETRA has historically consisted of two small but attractive businesses. With 30% share of the high value completions fluids market, TTI should benefit materially from growth in deepwater drilling through the end of this decade. The company is also a leader in the treatment and recycling of water produced by oil and gas drilling – a surprisingly large market, with 24 billion gallons of water a year that needs to be treated.

Recently, TETRA's ownership of 40,000 acres of mineral rights in the Arkansas Smackover Formation - which contains significant concentrations of lithium – has garnered more attention. The June announcement of a potential commercial arrangement with ExxonMobil to jointly develop that project has been a catalyst for shares this year. In spite of that year-to-date rise, TETRA trades at a 55% free cash flow yield on expected 2025 results.

Our shares in Permian Resources (PR) are also up 75% year to date. The market continues to reward the company's increased capital efficiency, driven by two young, sharp Co-CEOs. The recently announced acquisition of a nearby undervalued peer with strategically attractive

acreage will greatly increase the company's scale, is accretive to free cash flow, and will afford PR the opportunity to further increase shareholder returns without encumbering the balance sheet. PR trades at 3.7x EV/EBITDA on next year's expected numbers – and currently offers an implied dividend of between 7.6% and 9.6%, depending on how much free cash flow the company elects to put to a variable dividend versus share buyback - after paying out a new 6 cent per share quarterly base dividend beginning in Q1 of 2024.

Our shares in natural gas producer Range Resources (RRC) are also up 48% year to date. Range has thirty years of core inventory in the heart of the Marcellus shale, the largest and most prolific natural gas field in the United States. Decades of experience in this top-tier rock means Range can modestly grow its production with an exceptionally low capital intensity - almost 40% below peers. A full cycle return (IRR) north of 250% puts Range in the top decile of capital efficiency among all global energy producers.

Assuming \$75 oil, \$3.75 gas and \$600 million per year in capital spending, Range should generate \$4.0 billion of cumulative free cash flow from 2024 thru 2028 – just under 50% of the company's current market capitalization. In the meantime, we are earning a 10.0% annual yield on our cost basis in Range shares via the current dividend.

The most significant detractor to our performance in Tarpon year to date has been small cap Amplify Energy (AMPY), down 9.4%. Amplify has been a ten-bagger for us, after accumulating our position in the spring of 2020, and shares were up 183% in 2022. Management is disciplined, resilient, and rational - more interested in maximizing per-share value than growing the size of the company.

I am not overly concerned about AMPY's share price performance this year. Free cash flows will continue to slowly inflect higher, and that decline in share price is likely reflective of turnover in the investor base, as event-driven investors exit after a large settlement was awarded to the company - and long-time shareholder Avenue Capital liquidated an internal fund that held 2.4 million AMPY shares since 2018.

Amplify continues to make material progress re-starting production from its highest margin asset, the Beta field. A large margin of safety exists in net asset value, a significant inflection in free cash flow is on the way, and we should soon be hearing more about non-core asset sales to unlock value – as well as a new shareholder return policy.

I estimate AMPY shares are worth approximately \$13 based on a 0.75x multiple of estimated PD PV-10 at \$75 WTI oil and \$3.75 nat gas, exclusive of expected 2023 year-end net debt.

After adjusting for modest stock-based compensation, shares also currently trade at a free cash flow yield of 13.6% on expected 2024 numbers.

So we continue to stay patient with Amplify, too.

The Macro Picture

This summer, Saudi Arabia and Russia extended monthly oil supply reductions of 1 million bopd (barrels of oil per day) and 300,000 bopd through the end of 2023. Those cuts were originally announced as temporary, yet they continued to be extended. Those new extensions, in combination with steep prior earlier production cuts from the rest of OPEC+, are pushing the oil market into one of its biggest supply deficits in the last decade - with an approximate 2.3 million bopd shortage in the third quarter.

That shortage in daily supply is materially decreasing stored oil inventories around the world. Those inventories have declined nearly an estimated 60 million barrels in 2023 through the end of Q3 – of an artificially elevated base, due to prior releases from strategic petroleum reserves including here in the U.S. - and are now well below five-year averages. In a few more weeks, once refiners emerge from their annual fall maintenance seasons, further declines in global oil inventories are a near certainty - given the size of the daily supply deficit.

As a reminder: because the “paper” oil market – of futures traders, speculators and hedgers - is an estimated 30x larger than the already huge “physical” oil market - made of actual barrels of oil, bought by traders and sold to refiners - the price of crude usually trades off the level of global commercial inventories, and not the daily difference between supply and demand.

To be sure – the oil market is huge, vast, and complex, and can be influenced by hundreds of variables at any given time. Nonetheless, the most important variable in setting the price of oil is the level of commercial inventories around the globe. And the second most important variable is a derivative of the first – the change in that level of global oil inventories.

In the spring of 2022, shortly after Russia invaded Ukraine, in an effort to dampen skyrocketing oil prices, the U.S. Administration began to send barrels of oil from the country’s Strategic Petroleum Reserve (“SPR”) out into those commercial oil inventories around the world.

Commercial inventories do not care where their barrels come from. They’re all lumped together. There is no separate pool of ‘cavern-free, organically pumped’ barrels of oil. Though maybe that’s what the blockchain was supposed to be for?

Those SPR releases were remarkably successful at artificially stabilizing global oil inventories – and therefore oil prices - for about a year. In all, about 300 million barrels of crude and refined products were transferred out of strategic reserves from here and other western governments into the oil market. Which, in the end, did an excellent job of keeping a lid on oil prices.

However...that period is now over.

SPR releases are no longer propping up global oil inventories. As a result, the daily supply deficit has been eating through those inventories at a historically rapid pace.

Which is bullish for oil prices.

Without those SPR releases, based on a rough tool called comparative inventory analysis, we can estimate that oil prices over the last year would have instead been higher than \$100 per barrel.

And while effective in keeping gas prices down at the pump in the short-term, in yet another example of the law of unintended consequences, those SPR releases also further deterred the significant capital expenditures already needed from industry to further ramp oil production longer-term. Wood Mackenzie estimates that global development capex for 2023 will be approximately \$490 billion, a little more than half the average of \$800 billion (in 2023 terms) spent each year from 2010 to 2014.

Now that the SPR releases have concluded, it is also not clear there are any viable policy levers left for governments to use to attempt to cap oil prices heading into the next few years. Policymakers appear to be missing this critical point:

Investors, not company management teams, are really driving capital spending at E&Ps now.

And those investors are capex vigilantes – demanding shareholder returns, in the form of debt paydowns and dividends and buybacks, before tolerating any material production growth. Or else...share prices will suffer.

All of which makes this particular energy cycle different so far: the capital discipline is real. And spectacular.

Meanwhile, by the end of 2023, the world will likely be consuming the most oil in history – approximately 103 million barrels of oil. Every. Single. Day.

The One Main Thing

It's becoming preposterous to believe that the world's oil and natural gas fields are going to be shut down or put in run-off mode anytime in the next ten years. The more investors begin to grasp that reality, the more they will be willing to pay for those long-term assets - and the higher the multiple on those long-term cash flows, too.

In the meantime, I continue to use \$75 WTI and \$3.75 nat gas in our expected numbers for 2024 - though that's not a prediction as much as it is a desire to stay grounded in our valuations. There is upside risk to those numbers.

Practically speaking, a range for WTI of \$80 to \$100 oil through 2027 looks reasonably likely – that lower bound at the global marginal cost barrel, and the higher end reflective of the incentive needed to stimulate major producers - including Saudi and U.S. shale companies.

Regardless of oil prices, however, the goal remains:

Maximum sustainable free cash flow per share over the long-term.

And sure - it would be fantastic to buy shares early in a brand new AI software company with first mover advantage, massive network effects and a giant Total Addressable Market...IF all of that worked out for you.

But hear me out:

Slowly increasing demand and scared-straight supply in a depleting-asset based business can also make for a fantastic investment...especially if valuations reflect a significant chance of a scenario that is likely to be wrong.

Choose wisely.

Thank you for investing with IIM, and please let me know if you have any questions.

- Cale

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