VENATOR
CAPITAL MANAGEMENT LTD.

TAKING A VICTORY LAP: OUR LAST WORD ON OIL

Instrument (Inception)*	January 2015 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**0.7%**	**0.7%**	**15.4%**
Venator Partners Fund (July 2014)	**0.6%**	**0.6%**	**-**
Venator Investment Trust (September 2007)	**0.7%**	**0.7%**	**11.7%**
Venator Income Fund (August 2008)	**1.0%**	**1.0%**	**15.1%**
Venator Select Fund (September 2013)	**-8.4%**	**-8.4%**	**31.4%**
S&P/TSX Total Return (March 2006)	0.6%	0.6%	5.6%
Russell 2000 (March 2006)	-3.2%	-3.2%	6.8%
S&P Toronto Small Cap (March 2006)	0.5%	0.5%	1.1%
S&P 500 (March 2006)	-3.0%	-3.0%	7.3%
Merrill Lynch High Yield Index (August 2008)	0.7%	0.7%	10.0%

In June 2012 we wrote:

"Shale oil appears to be on track to mirror the experience of its natural gas cousin, having gone from a $120 cost per barrel pipe dream, to a $60-$90 cost per barrel reality. US domestic shale oil reserves are estimated at anywhere from 800 billion to 1.8 trillion barrels. With scale (like with what happened to the gas market), I could see this cost per barrel metric falling into the $30's, possibly in as soon as five years (using gas fracking cost declines as a reference). The bottom line is that US and global oil production is actually increasing, that US oil production is expected to keep increasing, and that it is not uncommon to find predictions of the US becoming a net exporter of oil within the next ten years (feel free to read that statement again). This is what logically happens when you combine declining demand (economic and conversion of trucks from diesel to gas) with increasing supply. Energy independence, that long standing American dream, may become a reality in ten years thanks to vast, previously uneconomic, shale reserves. The best part: there is nothing OPEC can do about this other than open the spigot and crush oil prices to below $50.00 in order to discourage shale investment."

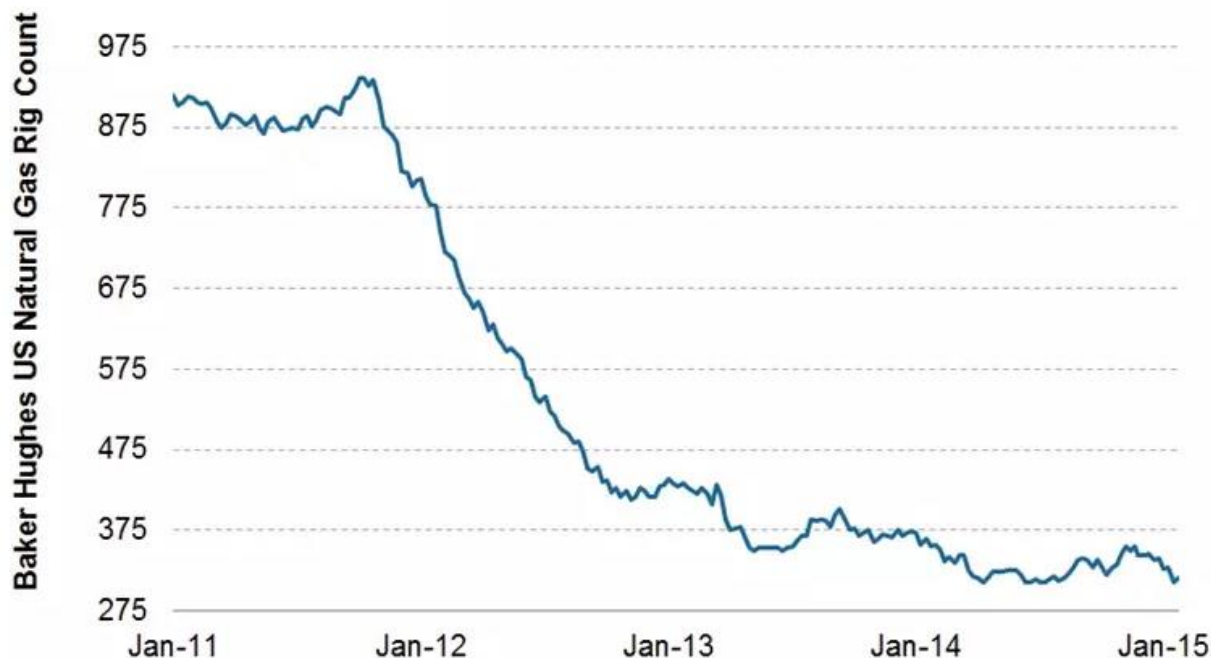
This was a rather extensive monthly letter outlining our very pessimistic view on oil, suggesting that shale oil could do to oil prices what shale gas did to gas prices (basically sent them down by over 70%), that shale oil would take the pricing power out of OPECs control for the first time in my lifetime, and that oil could conceivably dip into the $30.00s. It was a good call, and we have profited handsomely from it. However, as this view has gone from contrarian to consensus, I really don't think we need to be "out there" on this call anymore, and I am closing the book on what has been one of my favourite calls in my nearly 20-year career. That being said, we are still bearish on oil, we are still shorting the sector, and we have some very good trades on in the space, I just don't feel the need to be another voice in the noise of so-called experts (who by and large didn't see this coming) now falling all over themselves to see who can have the lowest target price and get themselves air time with the financial press.

That being said, I thought it would be a good idea to give you our parting (and still bearish) views on oil and energy stocks. Firstly, let's get the obvious out of the way: it's not different this time, but there are always differences. Oil is still cyclical. The low should be the marginal cost of current production and the high should be multiples above that number. Oil price cycles tend to last 3-4 years, but the last upswing lasted 10 years, the current gas cycle (a good reference given its shale experience) appears like it will last at least six years, excluding weather factors, and we believe that while still cyclical this oil cycle may also last over six years.

The first point in our thesis is OPEC is done as material influencers of prices and they know it, or at least the Saudis do. It's a key point because you need this assumption in order to allow the rest of our free market thesis to work. OPEC supply threats can cause short term volatility, but they are finished as a long term determinant of oil prices. Any rhetoric coming out of the Middle East that serves to cause a jump in oil prices should be shorted: short the rallies. This is because the Saudis have been brutally honest with us as to why they are not cutting their output to boost prices (please leave your amateur political science degrees at home people, there are no conspiracy theories here). They are rightfully worried about a loss in market share, more specifically a permanent loss in market share. This is because North America is on the verge of being self-sustaining in terms of oil supply. If OPEC were to cut 2 million barrels out of supply (currently 37 million) to send the price to $60.00, and North American producers were to ramp production to fill it, then that would be a permanent loss of market share, because once those expensive shale wells are drilled, they aren't that expensive to maintain. So in the end the price would likely end up right back where it started, but OPEC would be selling 2 million less barrels of it, in part because global oil demand will probably shrink over the next ten years (another of our past contrarian call based on fuel efficiencies and substitution that I don't plan on rehashing here).

So since our view is going to be a “free market” view, the next part of puzzle is figuring out the cyclical range, which in a supply prominent bear market, has to start at the bottom, or the marginal cost of maintaining production. Keep in mind this price is lower that the oft-guessed-at cost of starting a new project, because once a well is up and running it is likely going to keep running because quarterly cash flow (and dividend sustainability) are “now”, whereas the cost of drilling that well two years ago is sunk. When we penned our letter three years ago we talked about the all in cost of drilling a shale well having dropped from $120.00 per barrel down to $60.00. Today that number is quite possibly at $40.00 (no one knows for sure) and it's still going to go lower. We have met people who know better than us that claim that $40.00 is the lowest possible cost of break even on a shale oil well (not the same people who mistakenly were saying $6.00/mcf was the lowest attainable break even on shale gas; Birchcliff produces at a cost of $2.00 today), but even they haven't thought things through. If land gets cheaper to acquire, and day rates on drilling and well servicing equipment goes down, and wages fall (“if” might be the wrong words here because it's happening now; it's certainty), the marginal cost of launching a shale well is coming down into the $30.00s (especially as producers cherry pick their best properties for near future production); and that’s for a new well. Once that well has been drilled, the cost of sustaining production might come down below $20.00. So is low $20.00s the bottom for oil? Let's just say that it's not outside of the realm of possibilities, and a dip into the $30s is likely in this forecasters opinion.

Also, don’t let the rig count fool you. Lately, oil is dead-cat-bouncing on reports that the rig count is falling. The assumption is that this will curtail future supply and send oil prices back up. Let's take another look at the experience in the natural gas market to see what we can use to figure out if this will matter. A quick look (below) shows that the natural gas rig count has declined by about two-thirds from its all-time high, and yet this market remains oversupplied and production keeps increasing!!! There are a number of explanations for this, the main one being that companies are simply targeting their best and most likely prospects (drilling inside the boundaries rather than looking to expand their reserves through speculatively drilling in lower probability areas).



But that's just the commodity price itself, we haven't factored stock market stupidity into the equation, and we are seeing a lot of it lately. First things first, oil executives want higher stock prices, not higher profits or cash flow. They mistakenly believe that analysts and dividends cause stocks to stay higher, and this is going to work against them and the oil markets in general. Analysts, by and large, grade oil producers on production growth first and foremost. They value companies on cash flow per share (this is before capital expenditures) and, as we said before, when you look at the cost of operating a well excluding buying the land and drilling the well, it is very low indeed, and a management team graded on this metric is going to keep on drilling (we see this in the natural gas space all the time; favoured companies with cheap cash flow per share metrics that spin off no actual free cash flow!). So do not expect production to come down. Note that recent "cuts" are not cuts to production, they are cuts to growth; they all still plan to grow production just at a slower pace. The pressure to maintain dividends despite negative free cash flow is only going to worsen the situation as producers eat into their own balance sheets until they trip debt covenants (by the way, the cost of buying land and drilling wells three years ago is zero in the hands of the creditors, so expect a wave of defaults to keep production up even into the $20s as well).

Generally speaking, we avoid resource sell-side analysts because they are almost always bullish on their commodity of choice. That being said, many in this latest crop are battling gold analysts of yester-year for the crown of the most oblivious analysts I have seen in twenty years (remember valuing a company at 2x NAV, effectively saying that we think a $10 dollar bill in the future is worth $20 dollars today). The research we have

seen has analysts using roughly $70.00-$80.00 oil in their long term forecasts. OK, maybe they are just optimistic, even if we give them a pass on the faulty logic involved in calling for a supply decline when they expect producers to keep growing production because oil is going to average $70.00 going forward! But just when you are going to give them some benefit of the doubt, incredulity kicks in again with conservative sensitivity analysis showing that these stocks can still make sense at a “worst case scenario” of $60.00 oil. That particular report (out of one of the most prominent New York brokerages) came out on a day where oil was threatening $45.00. That's right, with oil at $45.00, the worst case this analyst could imagine going forward was $60.00! I don't mean to pick on one anonymous analyst, we have seen many similar reports.

This leads to ridiculous research reports reiterating “buy” recommendations on Exxon, a stock only 15% off of its all-time high even though everything they sell is off by 50%. I don't care how diversified and vertically integrated they are, Apple is pretty vertically integrated and sells worldwide too! Someone needs to tell these guys to walk down the hall to their Apple analyst and ask them what they would do to their target prices if Apple were forced to drop all their prices by 50% tomorrow (I say forced because the drop in prices of what Exxon sells isn't something they can control).

Now we do some pretty good due diligence here at Venator, but I don't consider knowing the current price of oil as particularly proprietary. If we find out that Exxon has dropped prices by 50%, and the analysts don't know it yet, does that qualify as inside information; after all, it doesn't appear to be common knowledge! (Note: counsel has advised us that knowing the price of oil does not constitute inside information on Exxon even if none of the analysts know it). And I don't mean to pick on Exxon specifically, similar situations exist with other majors (the market for junior producers seems to have figured it out, although again, I am not sure many of the analysts have).

THE VENATOR OIL PLAYBOOK:

There is opportunity in volatility. In such a large, wide and varied sector such as energy there will be opportunities in the various sub-sectors of this cyclical industry. The following represents some very brief synopses of how we view segments of the industry:

Oil Producers: The small and mid-caps, generally down about 50%+ in-line with the drop in the price of oil, are probably being fairly treated by the market. However, some of the larger caps are not. Companies such as Exxon (mentioned above) are barely off from their all-time highs. This affords us the benefit of shorting companies in slow motion, giving us time to reflect and react without an itchy trigger finger. They are not defensive and won’t get stronger in a sub-$50.00 oil market. The relative strength in large caps is somewhat akin to what we saw in the gold market. Newmont hung in there pretty well too for a while, but after three years eventually dropped 70% from its high (junior and intermediate golds took only eighteen months to trace the same fall).

Gas Producers: I have liked gas as a cyclical bottoming out play in the past. But unfortunately this drop in oil is a double edged sword. On the negative side, many gas stocks have some oil exposure which is going to hurt. Also the late start to cold winter is likely to keep the market oversupplied through the fall which will possibly result in sub-$2.00 gas in the summer, an event likely to induce some panic selling among those investors still left in the sector. Longer-term, the lower cost producers are going to benefit from lower pricing from drillers and service companies. Short-term bearish, long-term bullish; lets revisit this call late summer.

Drillers: This is where you want to be if trying to bottom fish the sector. Assuming you can discern between a high quality rig inventory and a low quality one there is some good money to be made here in every cycle. Rigs last a long time, are portable and can be auctioned in a worst case scenario. Most rig operators are currently trading around 0.5x book value, a valuation that has historically represented a bottom. With a little patience, there are doubles to be made here (unlike producers who will feel more pain as long as oil stays below $50.00). If you don't want to get too creative, just stick with Precision Drilling. It's liquid and is high quality. Also, you can grab some good bonds in the sector with fairly high short term yields backed by 3x-plus asset coverage; we have done this in our Income Fund.

Services: Stay away from this sector. While rig operators generally get bundled into the service category we are referring here to non-rig service companies. They have shorter lifespans, they have assets that depreciate quickly (i.e. trucks) and often have technology that obsolesce quickly as well. These are short selling candidates. No need to be a hero; stick to the rigs.

Infrastructure: This sector is tricky because not everyone has the same payment schemes. Some companies are paid a fixed fee, while some make percentages of sales, and others may make money based on a varying spread between shipping points or raw vs refined product. The layperson should again just stick to rigs. But these infrastructure assets have value, and this value does a good job backing the bonds, and these bonds have been falling to very attractive yields. We have been buyers of this sector in our Income Fund.

Special Situations: Finally, there are always special situations. Companies that can't be quite classified as energy-related but have a lot of energy customers, or companies with divisions operating in the energy space. These are case by case and we have a number of stocks we actively track, but nothing we care to disclose in a public forum.

As always, we reserve the right to change our mind.

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