

OGIB INTERIM BULLETIN #379 - JANUARY 28th, 2015

PORTFOLIO PURCHASE

TESORO AND VALERO REFINERY STOCKS

MARKET UPDATE

One of the benefits of being in my position is you sometimes get to talk to some amazing industry people; people who are on the ground and can give a bird's eye view of what's really happening.

I had one such call yesterday with a man who owns a few non-operated interests in the Bakken. I took copious notes over our hour long chat, but wanted to get you some highlights of his on-the-ground observations:

1. There will be no serious reduction in Bakken production at all in 2015.
2. People paying attention to falling rig counts will be making a big mistake in their investment decisions. Two thirds of the rig count will drop in the Bakken but there will be no production decrease this year.
3. He has seen no slowdown in his AFEs (Authorization for Expenditures)—this is for NEW wells, about to be drilled, in this price environment. Again, because most of the rigs are coming back to the core Dunn and Mountrail counties—he said wells with a 600K + EUR will still likely get drilled as it will give off a 15% IRR at \$50. I found that rather depressing as a long player in the oil producers.

And history has been very consistent on this—whenever there is a big price decline in oil or gas, the best crews operate the best rigs in the sweetest spots of the best plays and production doesn't go down near as much as you might think.

4. The realized price for Bakken oil is \$10 under WTI—all the marketers are trying to get people into 3 yr deals locking in that spread

5. He said the downspacing that everyone thought would happen now perhaps will not. And those locations likely won't show up in PUD (P2) inventories in reserve reports this year. But of course they will come back at higher prices. But in terms of debt lines, that support is gone.

Overall, his comments led me to be more bearish on oil than I was before. Drilling a \$10 million well for a 15% IRR—yuck.

And of course the EIA weekly stats bear all that out today—oil production and inventories up again, to 406.7 million barrels and 9.21 million bopd respectively.

So as always in recent past, stop losses will be tight on recent purchases. I said 2015 is a time for small bets and being nimble—that may prove out right here.

Now, last week I noticed a divergence in oil stock charts vs. the oil price—i.e. the equities were looking better than the commodity. I think the reason for that was the Market was looking at demand statistics—demand for oil and gasoline is up—depending on who is cooking the statistics—500,000 bopd to 1 M bopd over last year.

And especially if there is no winter in February—that would be bullish for more miles driven.

So if demand for gasoline is high and rising, and oil production in the US remains stubbornly high—that should be good for refinery stocks.

So I bought some—**500 shares of Tesoro (TSO-NYSE) at \$82.06 and 500 shares of Valero (VLO-NYSE) at \$51.76.**

Again—most investors overthink their investments. The main reason for that is they don't have the discipline to sell with a 10% loss. I'm pretty committed to that in this choppy market so if I come up with an idea that has some fundamental merit to it and the charts look OK, I'll start a small position and add to it as it moves up or turf it if it moves down.

And I think these refinery trades have both. I'll show you the charts below. But there are two things driving refinery stocks right now. One is the simple equation I just mentioned—higher gasoline demand and low oil

prices should translate into better crack spreads.

The second is that the refineries are starting to do more and more MLPs—and frankly, this just makes sense in our ZIRP environment (zero interest rate policy). Honestly, the refinery business makes no sense from the investor point of view. High capex, low valuations. Before the Big Run of 2012-2013 (from which I profited handsomely) refineries were dead money. Thin margins, flat charts, high capex, low valuation—dumb investments for guys like me.

As the Shale Revolution progressed, and logistics became a big part of The Game—that would be the mid-stream sector; organizing and building big and small pipelines—mid-stream pipeline companies did very well. (My worst mistake as a newsletter writer was not having a separate letter just on the pipelines and midstream—the best stock charts in the business).

The Market embraced the fee-based stocks with glee, giving them much much larger valuations than refineries. And finally we started to see the refineries move more into this area to capture this higher multiple. Refiners and Private Equity groups did some vending out of some assets into variable rate refiners like **NTI and CVRR and ALJ**—but now they are really getting into more mid-stream, fee based infrastructure.

And the Market is rewarding this. Reading research reports in the last week, the #1 valuation criteria for many sell side firms is how many assets these refineries can build or buy and push into MLPs or MLP style public vehicles where the multiples are double or more the traditional refinery multiple of 4-6x cash flow.

So that is an extra driver for refinery stocks right now.

Tesoro's chart is beautiful. It focuses on the west coast, where driving miles have increased the most in the USA:



Valero is mostly a Gulf Coast refiner. The Gulf Coast should benefit from a huge surplus of barrels around the Atlantic basin as it has the most oil storage available right now—and Cushing Oklahoma is second place, and the only way to get to Cushing really is via the Gulf Coast. So if oil is going to have a big price drop anywhere (from here at \$45/b that is), it should be here, which should create higher spreads for VLO.

The WTI-Brent spread has widened recently, and if WTI has a glut and collapse, that spread will widen.

To me, this argument on paper makes a lot of sense. So I'm getting long-- in small bets. But this energy market is choppy, and with lots of crosscurrents, and nobody knows what the Law of Unintended Consequences will bring to investors.

NATGAS

There are few things certain in the energy that's certain...but natgas going lower is one of them. I'm hearing my contacts on the trading desk are now expecting natgas in Canada to go NO BID for a couple weekends this summer. I don't know about that, but I do expect natgas to be \$1/mcf for a good chunk of the summer (unless the Marcellus suddenly peaks).

I am not interested in buying any Montney stocks (Canadian liquid rich juniors)—despite a recent research report by one of Canada's major brokerage firms coming out with price targets on some of the largest players there at TWICE what they're currently trading at—based on 13-22x EBITDA. Thirteen to twenty two.

The report—and I'm not going to name the firm—made my eyes go big. With gas going to \$1/mcf IMHO in Canada, and quite possibly lower for a couple days this summer...how can that be? Sadly I still see several CEOs using price decks of \$3/mcf gas ++ in presentations.

This report suggests 50-80 month payouts on wells at \$50 WTI and \$3/mcf gas. If that's true, these companies should not be drilling for oil and gas up in the Alberta wilderness—they should be planting marijuana.

Turn the roughnecks into tree planters I say. It's now legal, and it pays out a lot faster than oil or gas. *I just couldn't wrap my head around that report at all--but that's what makes a market.* If there is no winter in the next three weeks, all these Montney stocks will fall off a cliff.

Of course I'm being facetious about the marijuana—but you get the point. It's companies like Chinook—who is presenting at the Subscriber Summit one month from today—and Pine Cliff and other acquirers who will win in 2015. Chinook has net cash. That's what you want—lots of cash, no debt, and strong hedges.

LASTLY--I have done up full reports on **Whitecap and DHT**, the tanker company. Webmaster DJ should have them in the Members Centre later today. Don't take that as me saying go buy them right now--they are just both good companies in their sectors and when the time is right they are the ones to buy.

LINK TO SUBSCRIBER SUMMIT--<http://toronto-subscribersummit2015-tickets.eventbrite.com/?aff=ogibsubscribers>

-Keith