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A TALE OF 2 OIL STOCK GROUPS-- LEADERS AND LOSERS

REFINERY STOCKS

A SURPRISING NATGAS CHART

I only focus on the 6-7 leading juniors and intermediates in the US and Canada--and I've been watching them continue to move up with just a bit of envy.

I did buy **Raging River (RRX) and Whitecap (WCP)**, and a bit of **Secure Energy (SES-TSX)**, the leading services play in Canada, but the charts say I didn't buy enough. (The leading juniors have actually been the best stock performers vs. the intermediates and large caps.)

I've said before—as I watch the oil tape, I think it wants to trade higher. And now that consensus has firmly won out I think.

Right now I'm thinking my original theory of 2015—that US production would stay a little bit stronger for a little bit longer—is starting to become a distinct and smaller minority.

My sense is the Street is becoming increasingly confident that US oil production is peaking right now, and a definitive—even if shallow--production declines will start to happen 2-3 months sooner (mid-late Q2) than the Street thought it would in February (which was mid-late Q3).

But I'm still feeling shy about deploying capital into the producers.

The two factors that surprised the Street in Q1 was the pace of rig drops (consensus was we would rarely see over 50 a week and we saw a month of 90 rigs drop) and that oil demand was inelastic. Last fall there was lots of statistically backed up stories saying demand did not increase as prices drop. Even by late January the demand stats were pretty clear—BIG jump

in US demand, much faster than the Street expected.

During this downturn, M&A prices barely budged—every deal I saw get done was completed at prevailing metrics—basically no discount to prices pre-September 2014, and nothing close to the lower “strip” pricing.

And it’s a bit surprising to me that it’s the leading juniors that are the stocks agreeing with that. So far, they have had the most optimism—on both the sides of the border.

In Canada, **Whitecap (WCP-TSX)** and **Raging River (RRX-TSX)** are as high or higher now than this time last year when oil was almost twice the price! They have outperformed the larger Canadian intermediates—**think Crescent Point (CPG-NYSE/TSX)** or **Baytex (BTE-NYSE/TSX)**, which are down 30-50% still YoY. Intermediates almost always have the best beta to commodity prices in any market—metals, energy or agriculture.

In the US it’s a bit more balanced, where the oil weighted junior companies like **Matador Resources (MTDR-NYSE)** and **Diamondback (FANG-NASD)** are very near their prices of a year ago, as is the more senior leaders like **Pioneer (PXD-NYSE)**, **EOG Resources (EOG-NYSE)** or **Devon Energy (DVN-NYSE)**.

It’s hard to believe if you bought those American stocks a year ago today and held them through all this fear and volatility you would only be down 10% AT MOST.

But those are the leaders. They always come back first. The companies who were much more reliant on equity infusions to stay alive during the bull market—or are just too small in low margin environment—stay flatlined. In Canada that’s companies like **Long Run (LRE-TSX)** and in the US the baby-Bakkens like **Emerald Oil (EOX-NYSE)** and **American Eagle (AMZG-NASD)**.

Pretty much all of the financings done this year are in the money. It’s interesting that the stocks I’m down on in my portfolio I bought in 2014; the ones I’ve bought in small doses in 2015 being cautious—are up.

It really has only been the leaders who have been able to finance in 2015 thus far. That makes for a bifurcated or divided market into those that have medium-to-interesting stock charts and those that are flatlining.

Another interesting point is that the natural gas leaders have also been moving up. So far in 2015, my biggest WRONG call has been to ignore the leaders in Canada's Montney play that straddles the BC-Alberta border. This liquid rich play is a similar play to the Eagle Ford in Texas.

Most of these companies are at least 50% levered to natural gas, and my uber-bearishness on natgas so far this year kept me away from that area.

But again, the leading management teams there have been rewarded, like **Advantage (AAV-TSX), NuVista (NVA-TSX) and Kelt (KEL-TSX)**. Those stock charts have seen the 50 dma cross over the 100 dma and AAV has crossed well over its 200 dma—even as natgas prices falter now. (Most of the Canadian stock charts followed the liquids count, meaning the more condensate and liquids the company has in relation to natgas, the higher the stock chart. But AAV is very gassy.)

So the leading Montney stocks are following the broad trend of higher oil price expectations lifting all boats. This is happening even as natgas production from the Western Canadian Sedimentary Basin—WCSB—is up 600 million to 800 million cubic feet of gas per day this year; one of the first times the WCSB production has been up in several years.

Here's an interesting chart on natgas from the EIA this week that shows natgas production in the Eagle Ford dropping the same amount as the Marcellus and Utica is increasing:

Region	Oil production thousand barrels/day			Gas production million cubic feet/day		
	April 2015	May 2015	change	April 2015	May 2015	change
Bakken	1,320	1,297	(23)	1,549	1,528	(21)
Eagle Ford	1,723	1,690	(33)	7,532	7,487	(45)
Haynesville	58	58	-	7,118	7,162	44
Marcellus	57	57	-	16,706	16,716	10
Niobrara	417	403	(14)	4,680	4,630	(50)
Permian	1,981	1,992	11	6,437	6,441	4
Utica	62	64	2	1,972	2,007	35
Total	5,618	5,561	(57)	45,994	45,971	(23)

You could argue that's a somewhat bullish chart. Again, much like oil where fundamentals for producers haven't changed--everybody is still losing money right now--natgas producers are too but sentiment can be quick to change, and sentiment moves stock prices.

At the same time, refinery stocks are faltering. They took a big hit Monday as Goldman Sachs went negative on them. GS gets way more credit than they're due given their track record making calls in the energy sector, but it is what it is.

The reality is that crack spreads for refineries are still very good, and at current oil prices none of the producers whose stocks have jumped 50-100% in two months are making anything but the most meager of profits.

But that's not relevant, because that's the present, and the Market prices in fundamentals 6-9 months ahead in the future.

So what all this is telling me is that the Street's consensus is for higher oil prices, but not high enough that the turkeys can fly once again. That fits into my \$65 oil thesis—where the best producers and guys with size can make production profitable—but not the little guy or the inefficient guy.

If that theory gains credence through weekly Wednesday EIA numbers, it will be interesting to see how excited the Street gets and how much they

start to move up the leading stocks—with all of them already pricing in \$75-plus oil—or if the Tier 2 stocks start to move.

The Market is also moving up on EIA guesses that production WILL fall off, however history hasn't always been kind to their guesses. But like all of us, they do the best they can. But like GS, I'm surprised the Market doesn't take what they say with a larger grain of salt.

So much negativity was priced into energy stocks, that just not going to \$20/barrel is creating a rally. One other factor is that there is just so much dumb and short term money sloshing around looking to capture the bottom for oil that volatility is crazy.

My contacts on the institutional desks tell me that most day to day action is retail, though institutions are getting a little bit more involved—but they are gobbling up whatever they can get on the financings of the leading companies when they come to market. That still leaves me a bit suspect of this market, and I don't feel the need to stick my neck out on any Big Call.

One more factor for the bulls is the demand side of energy—and you'll see a story on this in the blog today. Oil demand in the US is up 700K-800K bopd, depending on the week, year-over-year. Increased demand is also starting to show in Asia—to the point where a 1.5 M bopd increase in demand this year is quite possible—and that's just the amount the world seems to be oversupplied.

Looking even farther down the road, I wonder just how much support the Saudis need to see from the US in cutting production before they join in—reigning in production. They have made it clear they're willing to be part of a team in curtailing production—they just don't want to be the patsy in the cartel.

I've said before there could be some short term investor euphoria if WTI does go from its current \$52/barrel to \$65. At that price, the sweet spots of plays, the core acreages, can become very lucrative again with reduced service costs.

Highly levered (lots of debt) and small producers may find that price doesn't give much true cash flow though. They will try to finance in this window to buy more time, but they will remain zombie stocks. Conventional plays will

work, and some scale—being a large operator—will work--if you can get your payback on wells to under two years.

I don't see \$65 oil improving the Canadian dollar, so Canadian producers should enjoy some great pricing—if WTI does go to \$65, that puts Canadian production very close to \$80/barrel. Most producers up here make great cash flow at that price.

Also important to note that Canadian differentials for both heavy and light oil are very tight now, and are expected to stay tight—meaning the price difference for Canadian oil is now low; it's very close to WTI (on a historical basis).

WHAT AM I DOING—I am just NOT feeling brave about putting all my money to work yet. I will continue to research new ideas—and revisit some old ones—that give me extra leverage for almost no extra risk. I'm looking for companies that offer me huge optionality (upside) if FACTOR "A" happens—along with a \$15/b increase in crude prices--and almost no downside if it doesn't happen.

I would add that I have always called oil to be \$10/barrel lower than it ends up being. My wife says I have called 11 of the last 3 recessions.

REFINERIES

Obviously, higher input costs via higher oil prices is bearish for refineries. The Street is split on refineries, suggesting that almost one million barrels a day of refining capacity coming out of turnaround, or maintenance season will increase supply and cap crack spreads. Exports of refined products continue to be very strong out of the US, running 4.2-4.4 million bopd.

But I think this trade idea now bears watching very closely (pardon the pun).

ETHANOL

Ethanol plants are refineries. The increased demand for gasoline this year is bullish for them. But west coast margins remain very low; Midwest margins are looking OK. And like oil refineries, I'm leaning towards thinking

the Midwest is where the best margins will be this year.

I spoke with a seasoned corn trader last week to get a better sense of why, IMHO, corn has been trading better than I expected over this winter season. As in \$3.80 a bushel vs. \$3-\$3.20 which was my expectations, with maybe even a spike down to \$2.75. I get together with a group of guys—including this gentleman and his son--each year in Calgary and visit (oil and gas) management teams for a few days.

The conclusion of our chat was he is expecting corn to be \$3.20 a bushel for months and months and months—which should help keep ethanol margins alive.

US corn has had two bumper crops in a row, and Mr. Corn expects the 2015 crop to be greater than what the Street is now anticipating. Corn has a relationship with soy in terms of their mix in animal feed. Soybean planting is up dramatically at 15%, while the EIA says corn plantings are down 2.7%; Mr. Corn says this cannot happen and he doesn't trust EIA data.

Farmers were slow sellers of corn earlier this year due to what they thought were low prices. By the first week of July, they will have a strong sense of how the 2015 crop will go and (Mr. Corn says....) if the summer is normal (not too hot or too cold) they will realize another great crop is enroute and will begin selling the last of their 2014 crop—which should cascade prices down to \$3.20 or so. He expects a very low corn price from mid-July through September (co-inciding with peak summer driving season and high gasoline demand....)

He suggests extreme weather only impacts corn every 1.4 years out of 10. And so far South American corn production is strong--Southern China can now import corn from South America cheaper than they can get it from Northern China--and the war in Ukraine is not impacting corn commercialization there.

World demand for corn is still positively sloped but has flattened. Bird flu in poultry growing areas like Ontario and Minnesota are impacting demand a bit, and in China—Mr. Corn says—bird flu has been endless, with the hog population down 7%.

SECURE ENERGY--SES-TSX

I met with Secure Energy CEO Rene Amirault and CFO Allen Gransch yesterday while they were in Vancouver. They re-iterated their core Processing Recovery and Disposal business would be about flat this year, with growth compensating for slightly reduced pricing.

Drilling Services will see a 50% reduction in volume and some pricing discounts, but only in the 5% range.

In their OnSite division, 70% of revenue is production based, not drilling based, though that 30% drilling will see a 50% drop as well.

They are looking at a lot of M&A now—a continuation of trying to convince producers to outsource their PRD work to Secure, buying other independents or tuck-in acquisitions of small nearby facilities.

Their argument to producers—who account for half the PRD market still—is that Secure is more efficient, and can bring in other customers to further lower their op costs back to the producer selling them their facility.

They have been working on a water recycling technology for over a year now, and are now in beta stage, testing the commercialization of it. What are the costs involved and how much pricing can they create for it in the market. There is a possibility they can recycle drilling fluids and at some point in the process remove a good chunk of oil from that—which they would get to keep in most instances. So that has the potential to be a small uplift for them.

Secure has started building Full Service Rail terminals (FSRs) to complement their FSTs—Full Service Terminals that either have pipeline access or where the oil gets trucked to pipe. But transporting oil via rail is twice the price of pipelines, and only economic when the “diffs”—price differentials between hubs—is big.

RBN Energy’s blog has a good story on Canadian rail today--
<https://rbnenergy.com/a-look-at-the-crude-by-rail-track-record-eia-monthly-cbr-movements-ex-canada>

Suggesting that rail growth in Canada will be slow. So the FSRs may not

end up having the 4 year payback that the FSTs do.

CONCLUSIONS:

1. So far in 2015 I bought the right stocks, just not enough of them
2. Increasing oil demand and faster than expected rig drops have changed the Street's psychology on energy to more bullish in the last 2-3 weeks--but I don't think it's strong enough to buy Tier 2 names yet.
3. My caution has cost me opportunity, but not capital losses amidst all this volatility.
4. My Big Question now is--if the energy market is setting itself up for a huge lift from \$53-\$65 WTI, which stocks move as the best ones are already pricing in higher oil prices than that.
5. Natgas production may fall more than I would have originally thought by the drop in oil prices--enough to move stocks though?
6. My bullish thoughts on refinery stocks are tempering.

LASTLY--housekeeping. I'm sending you all an online feedback survey--PLEASE fill it out. 15 questions that will help me make this a better service. It's anonymous. Takes 5 minutes.

-Keith