Ninepoint Energy Fund Market View

July 27, 2020

Investment Team

Eric Nuttall, CIM
Partner, Senior Portfolio Manager

We stand at the cusp of a new bull market for oil, painfully deferred thrice by a White House induced Saudi production surge in 2018, a US/China trade war in 2019, and in 2020 by a global pandemic that led to the largest (temporary) demand shock in history. The silver lining for oil bulls is that these same events that forced an agonizing walk through investment purgatory cemented the realities that will lead to oil surging well above current pricing in the coming years: exhaustion of Tier 1 US shale inventory and continued disenfranchisement of energy equities leading to ongoing fiscal discipline and a complete re-evaluation of the US shale business model going forward, continued insufficient investment in long-lead mega projects resulting in stagnating global offshore production and eventual decline, and increased fiscal urgencies of OPEC nations that resulted in the highest degree of cooperation (and compliance) in OPEC's history. Within the next 2 years it seems likely that given US shale output inelasticity to a rising oil price and ongoing global demand growth that OPEC spare capacity will be exhausted leading to a price spike high enough to both incentivize new investment in long-lead projects and temporarily rationalize demand so as to balance the market. Given that the average lead time of such projects is 4-6 years the longevity of the next oil bull market should allow for significant upside in energy stocks. Just how high can the price of oil climb and by extension what upside do we see in energy stocks? Read on.

The dominant theme in the energy market today is the degree of COVID-19 induced demand destruction and the uncertain timing of the (inevitable) full demand recovery. It is common for some to refer to a "new normal"...a world in which we are all so terrified we will no longer fly nor go on vacation and in which we will all work from home...resulting in permanent demand destruction. This belief system is keeping money on the sidelines (or in other sectors that are trading at nosebleed level valuations) resulting in ongoing apathy towards the space. What is profoundly frustrating is that real-time data does not support the current level of bearishness and it appears that much of the initial doomsaying proved to be overly negative. As bad as the initial shock was to demand all trends are significantly improving from the lows: oil demand in China is now higher than pre-COVID19 levels, Indian demand is expected to be back to normal in Q3, European demand is now only down 13%-15%, and US product demand such as gasoline is only down 12% from year ago levels. This all is happening with much of the global economy still under some level of lockdown and is a reminder of how integral oil is in our daily lives. At the worst Goldman Sachs estimates that global demand was down 20MM Bbl/d in April and now Energy Aspects believes that demand has recovered back to "only" down 6MM Bbl/d in July. Yet, how are we to believe that oil demand is rebounding so quickly when we read negative headlines such as these on a daily basis?

Forecasters See More Oil Demand Destruction

by Bloomberg | Julian Lee | Thursday, July 16, 2020

Oil price slide continues on lingering crude demand concerns

WorldOil · Yesterday

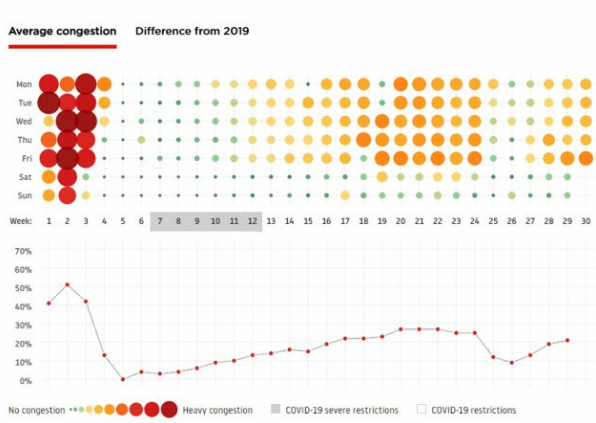
The Long Road To Oil Demand Recovery

By Tsvetana Paraskova - Jun 28, 2020, 4:00 PM CDT

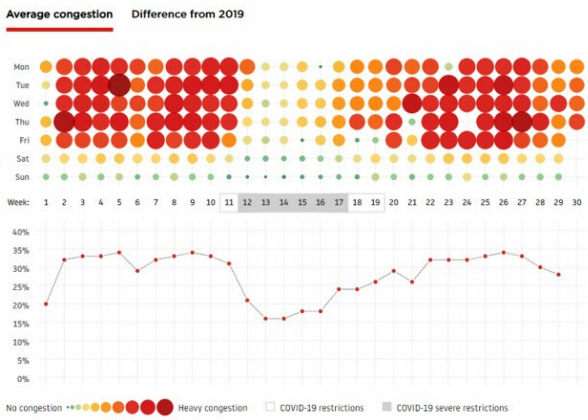
How are we to assess (and verify) that oil demand is truly coming back given the legendary opaqueness of oil market data? With the COVID-19 pandemic has come new ways to track energy consumption in near real-time via sites like Google community mobility reports, Tomtom traffic indices, TSA checkpoint numbers, Flightradar24 which tracks most commercial flights in the world, and Apple mobility trends. They all show the same trends...with varying degrees depending on geographic and mode of transportation, people are quickly returning to their (highly oil intensive) old ways. The "new normal" looks very much like the "old normal" from an oil consumption perspective.

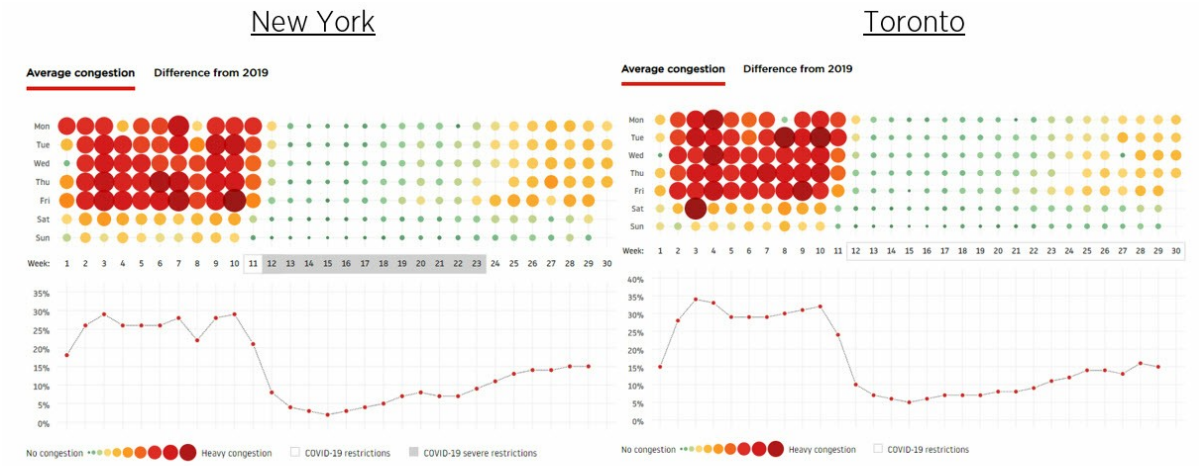
For example, using Tomtom data we can evaluate the 24MM Bbl/d gasoline market and 28MM Bbl/d gasoil/distillate market and see that the traffic congestion level in a city like Berlin is already back to pre-COVID levels while other cities such as Beijing, New York, and Toronto are showing clear improvement in recent weeks:

Beijing



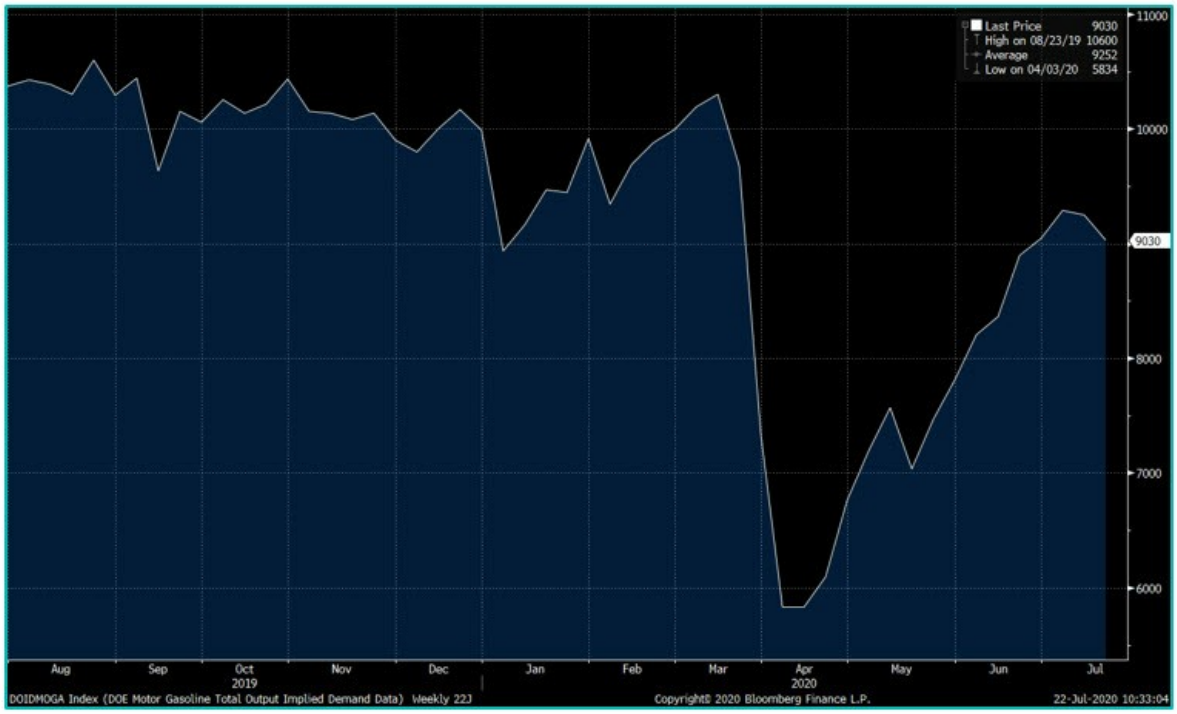
Berlin



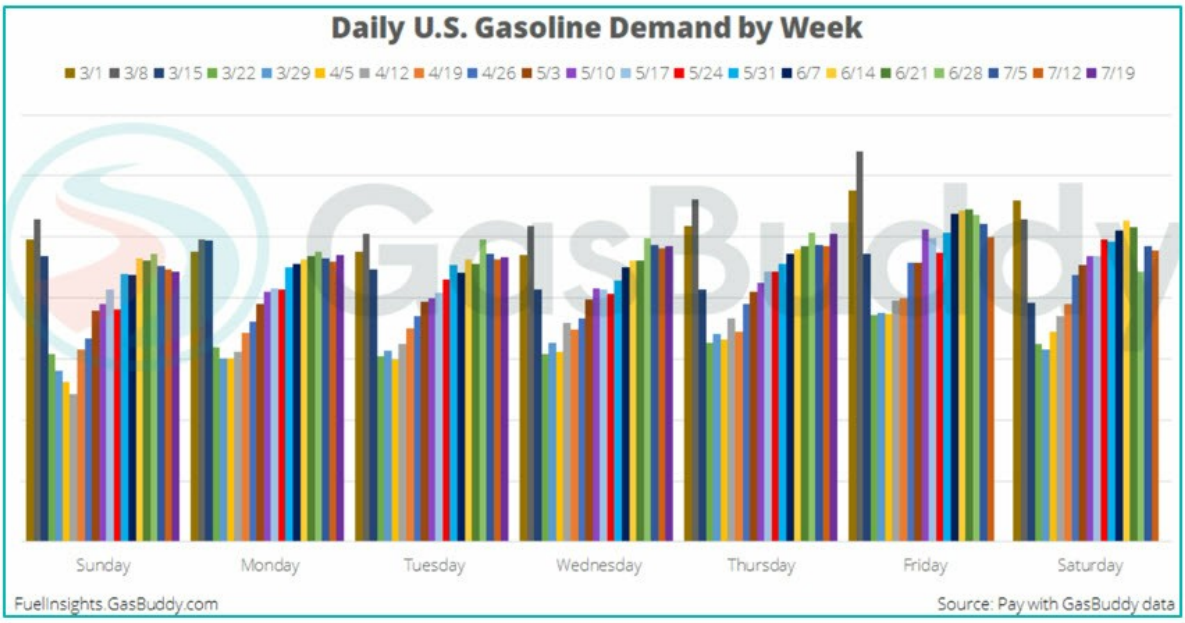


Source: Tomtom Traffic Index as at July 24, 2020 https://www.tomtom.com/en_gb/traffic-index/

Further, weekly DOE data shows a strong recovery in the US gasoline market with demand back to 9MM Bbl/d (up from the low of 5.8MM Bbl/d in April and down 1.2MM Bbl/d (12%) from a year ago) and GasBuddy data shows that gasoline demand as of July 23 (post Texas/Arizona/California covid spike) hit the highest level for a Thursday in 3 weeks:

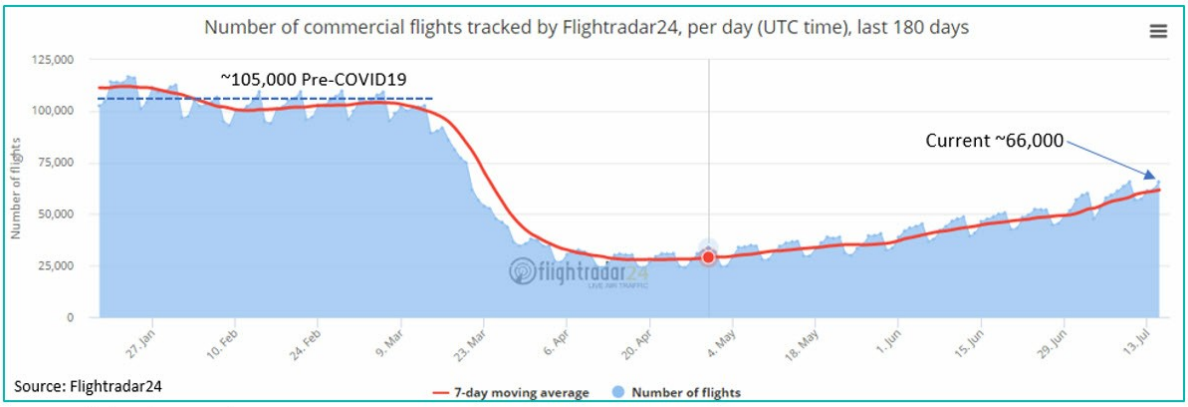


Source: Bloomberg, July 22, 2020



Source: Gasbuddy, July 24, 2020

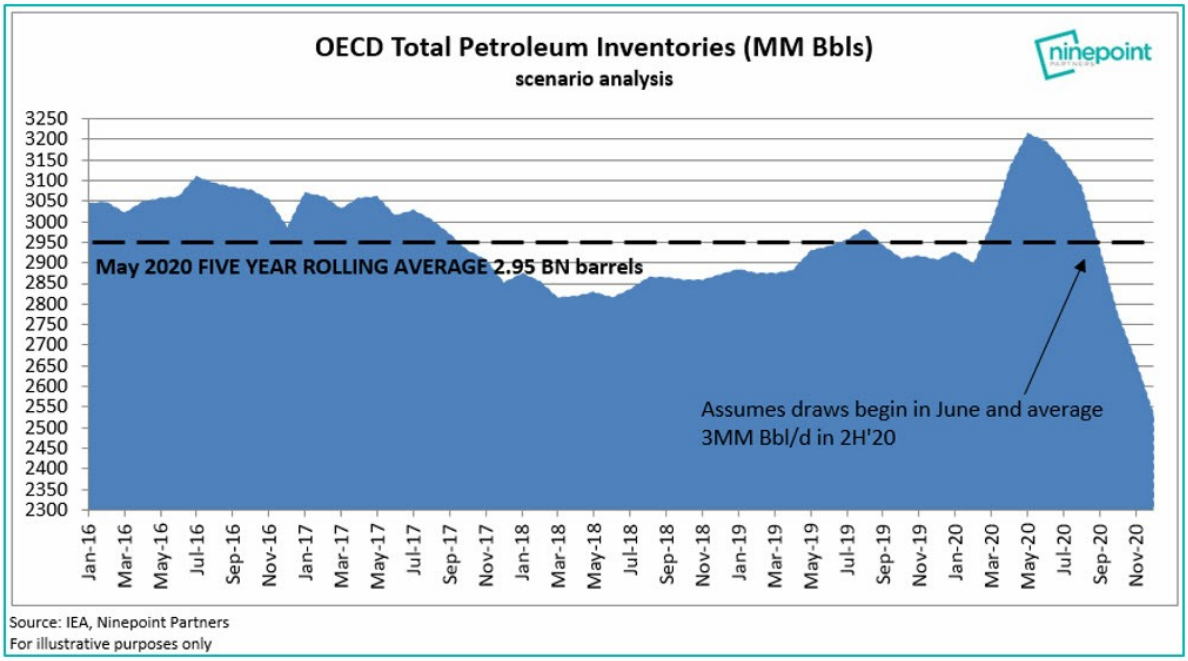
We can evaluate the recovery of the 8MM Bbl/d jet fuel market (the clear laggard) by using Flightradar24 data which tracks most commercial flights around the world. Their data shows that commercial traffic lowed in mid-April at 24,000 daily flights and has recovered to ~66,000 (still down 37% from pre-COVID levels). It is likely to be the last oil product market to recover and the CEO of America Airlines recently said that US domestic traffic will likely remain down 50% until a COVID-19 vaccine is widely available:

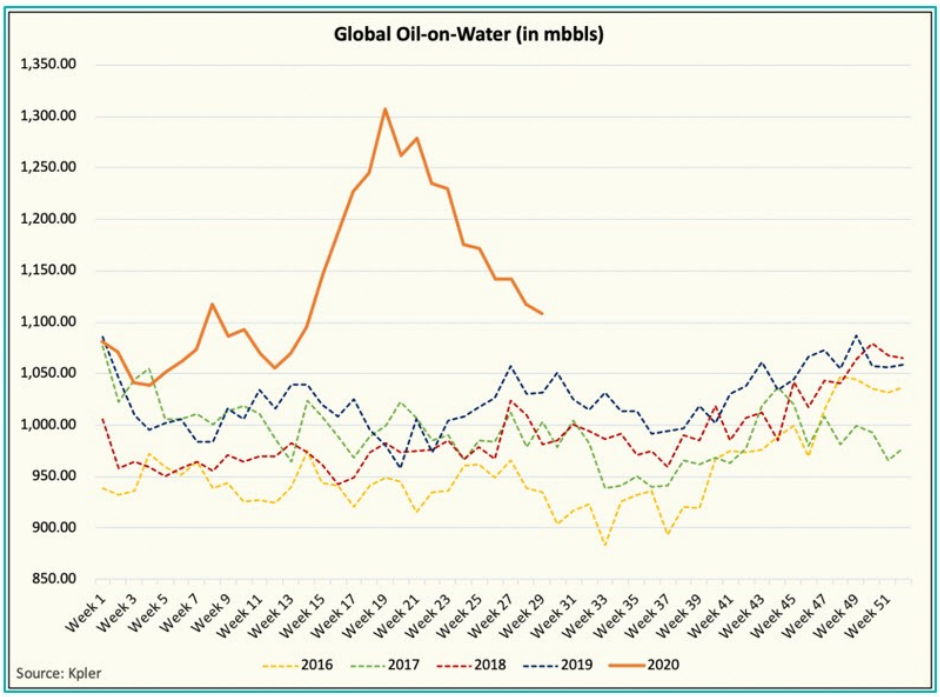


Source: Flightradar24, July 15 202

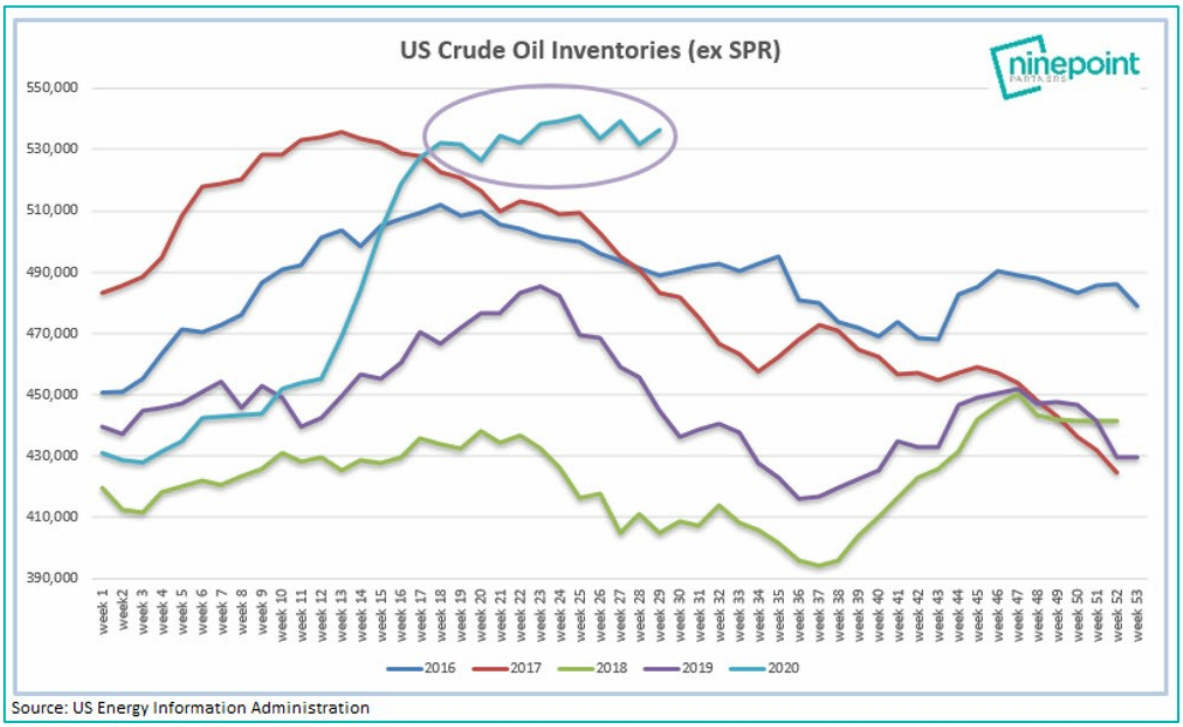
In summary, while the initial demand shock was historic in size it was temporary and has already recovered to about 94% of normal. It would seem plausible that as economies around the world continue to slowly emerge from lockdown (with the occasional bump in the road like California and Texas) that demand should approach pre-COVID19 levels sometime in early 2021 (with a vaccine widely available in mid-2021).

While 99% of airtime revolves around demand destruction equally important are the voluntary and involuntary supply curtailments happening around the world. The highly successful OPEC+ April deal that led to as much as 10MM Bbl/d being removed from the market combined with other voluntary shut-ins (Canada ~800,000Bbl/d, US ~1,400,000 Bbl/d) as well as involuntary production loss (Venezuela, increase in global declines, etc.) have greatly helped to counter demand loss resulting in non-cataclysmic inventory builds over the past few months (there was a time that global "tank tops" were feared). Given ongoing compliance by OPEC (even chronic cheaters like Iraq are cooperating) and the lack of supply response from US shale (more on this later) we believe that inventories (adjusted for SPR builds in China and India that need to be removed from global balances) could approach normal levels by the end of the year (this is not even close to consensus). While US inventories will be the last region to normalize we can see trends improving in other areas like total OECD inventories (built much less than feared in April and May) and global oil on water (steeply declining):





Source: HFI



The oil multi-year bull market of 2021-2024+

We've described why the supply/demand fundamentals for oil should in the coming quarters reach pre-COIVD19 levels (we were at ~$60/bbl back then). Looking to 2021 there are 4 primary converging factors that we believe will allow oil to enter a multi-year bull market. If you were to call us out on this and say "haven't we heard this one from you before?" you would be right. Some of the key elements (US shale deceleration) were already in place while others like global offshore declines have taken longer to play out than originally expected (satellite field tiebacks and perhaps sacrificing depletion rates for short-term cashflow maximization explain why) but the biggest setback to our call (other than the biggest demand drop in history this year) was the unanalyzable US/China trade war of 2019 that seized up global trade and led to an apparent drop in oil demand (the first time since the Financial Crisis). With all that said and with the benefit of hindsight, we were too early

in our original call. However, what do we see evolving today that allows us to make the same call now? There are 4 key elements to the thesis:

1) US shale hyper growth is over – going forward companies will set lower growth targets (~5%) and expressly maximize free cash flow to allow for return of capital in order to compete with other sectors given what is now an abhorrent record of shareholder capital destruction. This means that US shale production will be largely inelastic to a rising oil price and this is a profoundly important development since without US shale non-OPEC production would have been flat for the past 5 years (!)

2) Global offshore production (about 1 in 4 barrels produced today) is entering a period of stagnation/decline due to too many years of insufficient investment. Industry has now fully harvested the last of the mega projects that were sanctioned in a $100 oil price environment and new projects coming online should be insufficient to fully offset base decline rates.

3) OPEC spare capacity, adjusted for currently constrained production that will come online over the next 6 months as production continues to normalize, sits at around 2MM Bbl/d (at best) and resides in a country with meaningfully higher oil price desires hence their unwillingness to bring on production anywhere near current price levels.

4) Oil demand will continue to grow for at least the next decade despite continued electric car adoption and expansion of (supposed) green energy capacity due to population growth rates and an aggregate increase in net living standards (which has a very high correlation to energy consumption).

We can say with confidence that the years of 1MM+ Bbl/d growth from US shale are over. While the evolution of overspending cashflow (financed by share issuances and bank loans) to spending within one's means to underspending cashflow (to allow for shareholder returns) was well underway, the bludgeoning of 2020 has further cemented the reality that US energy stocks are clearly out of favour and they must further adapt else remain radioactive to generalist investors. Capital has been completely shut off, shale co's face a still too high decline rate which challenges the ability to generate free cash flow, and index weights have shrunk so far that an investor could spend as much time analyzing Microsoft as they would covering a sector that has become both incredibly volatile and insanely complex. Add onto that ESG driven divestments like this due to growing wokeness/energy ignorance and the need to change becomes even more clear:

FUND NEWS

Warburg Pincus Dials Back Investing in Oil and Gas

The firm won't make investments tied to fossil fuels from its next global buyout fund

By Luis Garcia

Updated July 22, 2020 7:00 am ET

Warburg Pincus is telling investors it won't make any deals linked to fossil fuels from its next flagship fund, joining other private-equity firms that are reducing their investment presence in the oil-and-gas sector.

"Warburg Pincus will begin a transition away from investing in companies that are dependent on hydrocarbon pricing in the core global fund," said a person familiar with the firm's plans.

Source: Wall Street Journal

US shale companies must continue to evolve from strictly growth entities to value creators, and they will accomplish this by slowing down their growth rates (from 30%-50% to 5%) which lowers corporate decline rates and extends inventory life allowing them to maximize free cash flow and allow for buybacks (given depressed valuations) and more consistent dividends. Executive compensation plans have changed to reward such behaviour and even if a CEO wanted to defy the wishes of his own shareholders, environmental activists,

and even a certain Presidential candidate the ability to resume the ways of old are further constrained by:

1) Impaired balance sheets due to the 2020 price collapse and expired hedge books

2) Partial exhaustion of Tier 1 inventory with well results demonstrating flattening/falling lateral length adjusted productivity measures

3) A service sector that has been absolutely decimated and is being forced to conduct mass layoffs, scrap equipment, and shrink to survive:

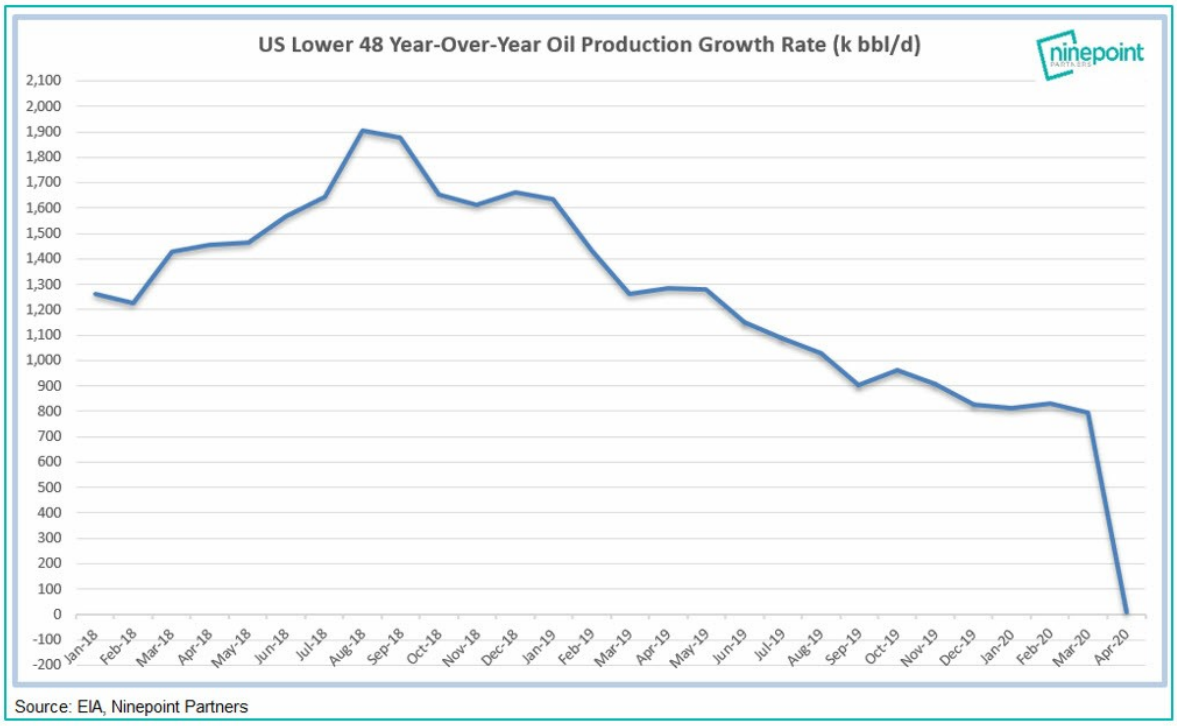
Oil firm BJ Services files for Chapter 11 bankruptcy

Halliburton lays off 1,000 employees at Houston HQ

Layoffs, pay cuts loom as Schlumberger plans to cut up to 30 percent from budget

Oilfield Co. Calfrac Files For Ch. 15 After Canadian Insolvency

The end of US shale hypergrowth is a watershed event for the sector. The Permian has officially ceded its title of "global swing producer" back to OPEC and even some Permian insiders like Parsley's CEO Matt Gallagher recently said a few weeks ago "I don't think I'll see 13 million (bbl/day) again in my lifetime" (US production highed at 12.8MM Bbl/d in November 2019). This point bears repeating: without US shale growth non-OPEC supply would have been essentially flat over the past 5 years while demand has grown by approximately 6MM Bbl/d. What of the next 5 years???



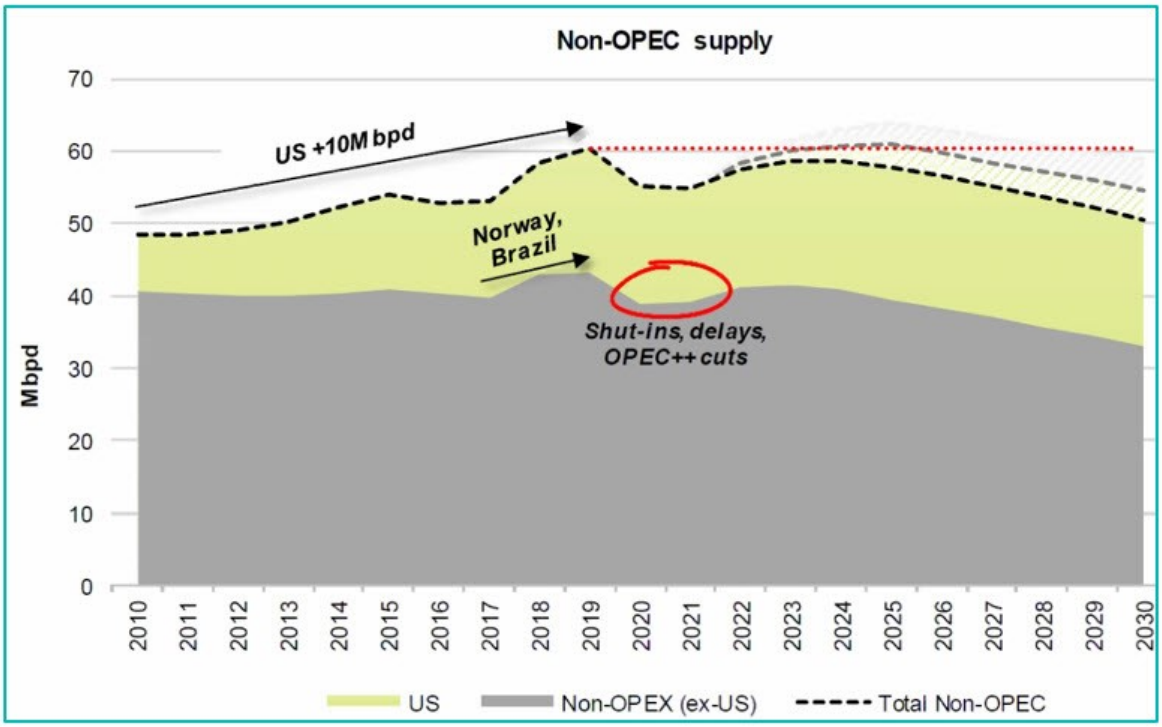
The second major factor to our bullish thesis is the long awaited impact of chronic underinvestment in global offshore projects. Since the oil price crash of 2014 investment in both development projects and exploration has been dramatically slashed as companies have had to realign spending with cashflow. The easiest thing to scrap was investment in projects that have cash outlays today that will take 4-6 years to come onstream and then a further 3-4 years to reach project payout (hence industry's move into "shorter cycle" shale). Combine that with the recent influence of carbon divestment, ESG scoring, an anti-hydrocarbon movement in general, and then a demand shock and you get the following result:

The IEA warns global energy investment will fall by $400 billion in 2020, the biggest drop in the sector's history

If current **oil** investment stays at 2020 levels then this would reduce the previously-expected level of supply in 2025 by almost 9 million barrels a day, the IEA said.

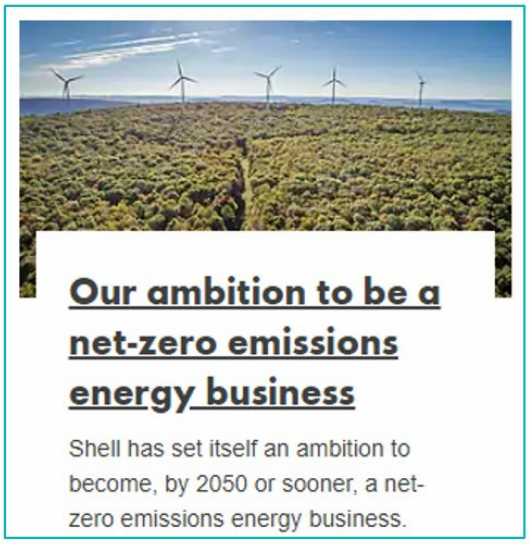
Source: Reuters, May 7, 2020

Subsequent to the last 2 major offshore developments coming online in 2019 (Johan Sverdrup in Norway and Liza in Guyana) there lies a dearth of major oil projects and when one assumes a natural offshore decline rate of 5%+ (Gulf of Mexico production fell by ~10% on an annualized basis when activity paused during the BP Macondo spill in 2010) it seems increasingly likely that global offshore production will no longer be able to grow until a new cycle of investment begins (and again...cycle time is 4-6+ years). Combine this with the lack of US shale hyper growth and you can quickly see that the future supply of oil will be increasingly challenged. Bernstein, whom we greatly admire, estimate that non-OPEC production will struggle to grow for the next 5+ years as a result of what we have described:

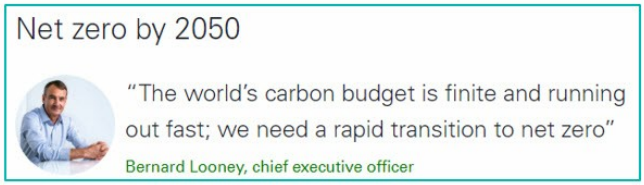


Source: Bernstein, May 2020

We cringe at terms like "super cycle" and "peak oil" given recent history, but even the chronically pessimistic IEA is warning of a supply crunch (global supply to fall by 9MM Bbl/d by 2025!) in the years ahead should investment levels not increase. We ask...how is that even possible? How can a CEO of a supermajor today, who is bombarded with shareholder concerns about emissions and the necessity to reach net zero emissions by 2050, who just went through the worst oil price crash in history, who needs to continue to pay a dividend lest they further disenfranchise shareholders, and whom now needs to prioritize increased spending on "green energy" projects like wind and solar so as to stay relevant with mainstream investors, possibly commit capital to a project with likely political (and price) risk where cash outflows today do not harvest cash inflows for another 4-6 years and reach project payout roughly a decade from project sanctioning when some corners of the energy community worry about peak demand by 2030???



Source: Royal Dutch Shell



Source: British Petroleum

Nothing short of a sustained price spike and the promise of egregious returns will incentivize a CEO (and investors) to once again sanction offshore projects. Consequently, it is both the current ESG mania and cry of the ecowarriors that is hurtling the world towards an energy crisis.

"But Eric" you ask…"what of OPEC?" Doesn't Saudi Arabia have productive capacity of 12.5MM Bbl/d?" "What of Iran if Joe Biden wins?" In a world where global offshore is flat lining/falling, US shale is likely to grow by no more than 0.5MM Bbl/d a year, and demand is likely to return to normalized growth of ~1MM Bbl/d per year, there is only 1 country within OPEC that matters and that is Saudi Arabia. Most market observers would agree that Saudi likely has productive capacity of 10.5-10.8MM Bbl/d when you remove the short-term ability to draw down internal inventories. In the context of a 100MM Bb/d oil market and the likelihood that most of the April OPEC production curtailment will have returned to the market by year-end it leaves the world with a radically thin safety cushion. Given domestic priorities and meaningfully higher budgetary requirements it is difficult to see how OPEC in aggregate meaningfully increases their productive capacity quickly enough before the supply crisis begins in the next few years.

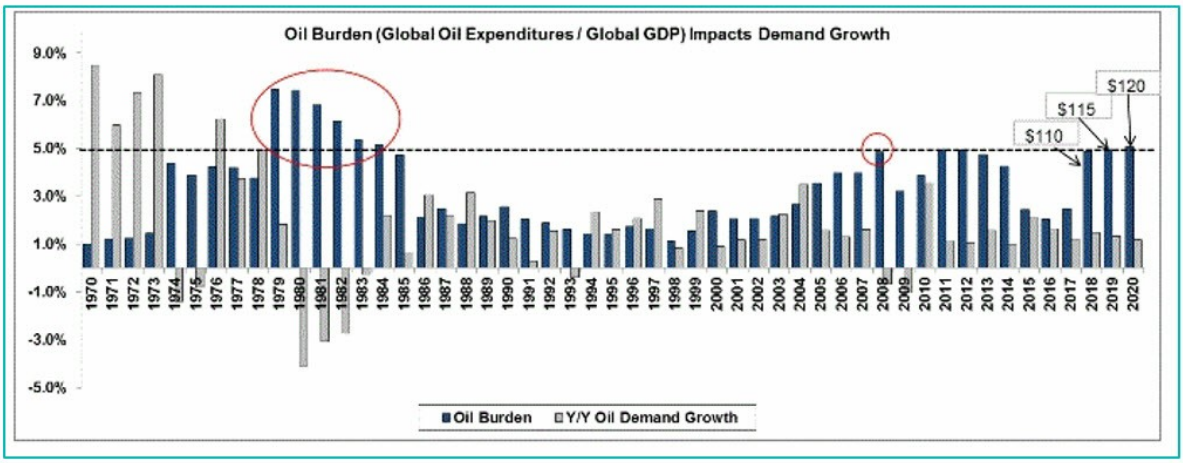
So how high can the price of oil go? Given the improvements in underlying fundamentals and the likelihood that supply/demand fundamentals will approach pre-COVID19 levels in the next few quarters it seems reasonable to think that oil can rally into the $50's by year-end and to $60/bbl in 2021. Pre-COVID19 oil was already at $60+/bbl as demand had recovered from the US/China trade war, US shale growth had already started to decelerate, and industry capex was set to only modestly increase. Going forward once demand reaches prior 100MM Bbl/d levels (early 2021?) from a supply perspective as a result of the 2020 catastrophe:

1) The US shale model will have changed forever leading to production inelasticity given the need to generate excess free cash flow + balance sheets that need to both repair the damage inflicted in 2020 plus realign to the new definition of balance sheet strength (<1X debt:cash flow)

2) Industry capex has fallen by the greatest extent in history and the damage inflicted on the service sector is profound. Decline/depletion rates should increase given continued underinvestment

3) Saudi Arabia sits on the only accessible spare capacity (excluding Iran) and likely desires a Brent price in the $70's before accessing spare capacity

With oil demand likely to grow by ~10MM Bbl/d over the next decade, the lack of meaningful growth (if any) from non-OPEC, and the lack of adequate spare capacity within OPEC it seems like the inevitable outcome is a price spike to a level that rationalizes demand. In a historical context, demand rationalization usually happens when net expenditure on oil surpasses 5% of GDP which would correspond to an oil price of ~$120/bbl.



Source: Howard Weil, May 18, 2018

While $120 is not exactly our official oil price target and we are using $50-$60/bbl when evaluating investment opportunities this backdrop remains in our mind when looking at energy stocks reflecting a long-term oil price in the $40's.

Positioning

We are clearly bullish on the future price of oil and as a result have the Ninepoint Energy Fund exposed to companies that will most benefit from a higher oil price while at the same time not taking on undue levels of risk (ie. unmanageable debt levels). We were diligent in ensuring that all of our holdings could weather the pricing storm of Q2 given adequate liquidity and strong hedge books and as a result were able to immunize the balance sheet damage resulting from the very weak oil pricing in Q2. Geographically, we are finding the best opportunities in Canada given prudent debt levels, lower relative decline rates, improving pipeline takeaway capacity, and greater investor relevance given higher index weightings. We currently have 10 Fund holdings and these are how they screen at $50 and $60 WTI in 2021:

Security	Weighting	Market Cap	2021 FCF Yield @ $50	2021 FCF Yield @ $60	EV/CF @ $50WTI	EV/CF @ $60WI	EV/PDP	$50/bbl target upside	Weighted Return	$60/bbl target upside	Weighted Return	% ownership of company	Days to liquidate Position	% away from 52 week high
Fund Holding #1	10.8%	$391	19.1%	43.3%	3.2	2.2	0.7	110.6%	11.9%	231.9%	25.0%	2.8%	1.6	63.2%
Fund Holding #2	10.3%	$1,253	16.1%	39.6%	3.7	2.8	1.2	97.5%	10.1%	214.9%	22.2%	0.8%	0.8	60.8%
Fund Holding #3	10.4%	$1,192	43.2%	78.7%	6.3	3.8	0.7	77.7%	8.1%	128.4%	13.4%	0.9%	0.3	51.2%
Fund Holding #4	10.3%	$1,233	24.8%	59.0%	3.6	2.2	0.5	115.8%	11.9%	355.3%		0.9%	0.4	63.1%
Fund Holding #5	9.5%	$196	36.2%	65.6%	2.3	1.7	0.7	151.4%	14.4%	269.2%	25.6%	4.9%	6.3	63.9%
Fund Holding #6	9.3%	$381	42.7%	107.0%	3.8	2.2	1.0	205.4%	19.2%	598.4%	55.9%	2.5%	1.0	71.2%
Fund Holding #7	9.3%	$448	21.3%	26.4%	5.3	4.4	1.0	61.4%	5.7%	102.2%	9.5%	2.1%	1.9	54.3%
Fund Holding #8	9.5%	$168	17.9%	76.1%	3.2	2.2	0.8	113.1%	10.7%	346.2%	32.9%	5.8%	2.3	77.8%
Fund Holding #9	9.2%	$959	25.9%	46.3%	4.6	3.2	0.7	69.5%	6.4%	192.2%	17.7%	1.0%	0.4	58.9%
Fund Holding #10	1.9%	$359	2.1%	8.9%	4.1	3.1	n/a	43.7%	0.8%	84.8%	1.6%	0.5%	0.4	61.8%
Total/Average	90.6%	$658	27.5%	60.2%	4.0	2.8	0.8	104.6%	99.3%	252.4%	203.8%	2.2%	1.5	62.6%

For illustrative purposes only

Using what we consider to be conservative trading multiples (4x-6X depending on the stock) our average holding would have 104%/252% upside to our $50/$60 oil price targets as they are trading at only 4.0x/2.8X EV/CF at $50/$60 in 2021 (compared to historical multiples of 7x-8x). More importantly from a free cash flow perspective, at $50/$60 our average holding could buy back 27%/60% of their shares outstanding while keeping

production flat. This ability will ultimately act as the curative for lingering apathy towards the sector. From a portfolio perspective the implied upside in a $50/$60 oil price environment would be 99%/252%. Given our average Fund holding is still down 63% from its 52 week high and would have to nearly triple to get back to pre-COVID19 levels this implied upside seems reasonable (if not conservative).

Summary

We have endured the worst energy sector bear market in history. Other than 2016 and 2019 sector returns have been highly challenged for too long. Last year felt like a final reprieve from investor purgatory given decent returns (+19%) and a great setup heading into 2020 and then COVID-19 hit leading to energy stocks collapsing by as much as 90% at the lows. Investors would be forgiven for wanting to give up on the sector yet the promise of much, much better days are not that far away. As bad as this year has been from a stock performance perspective it has cemented in the realities that are leading towards a supply crunch in the near future. While it is almost fashionable to be negative on oil and the future of our industry this level of pessimism has led to incredibly depressed valuations and hence incredible opportunities for those willing to emotionally battle through the day-to-day noise and volatility. Where else can you buy into businesses so out of favour, trading at 60% free cash flow yields at an oil price that reflects pre-COVID19 conditions with the belief that those times will return in the not too distant future?

Eric Nuttall
Senior Portfolio Manager
Ninepoint Partners

NINEPOINT ENERGY FUND - COMPOUNDED RETURNS[1]
AS OF JUNE 30, 2020 (SERIES F NPP008)

	1M	YTD	3M	6M	1YR	3YR	5YR	10YR	15YR	INCEPTION
Fund	16.6%	-50.7%	95.0%	-50.7%	-40.0%	-27.5%	-23.3%	-10.5%	-7.0%	-3.4%
Index	-1.2%	-46.1%	28.4%	-46.1%	-42.4%	-21.0%	-15.3%	-9.2%	-5.1%	-2.1%

[1] All returns and fund details are a) based on Series F units; b) net of fees; c) annualized if period is greater than one year; d) as at June 30, 2020; e) 2004 annual returns are from 04/15/04 to 12/31/04. The index is 100% S&P/TSX Capped Energy TRI and is computed by Ninepoint Partners LP based on publicly available index information.

The Fund is generally exposed to the following risks. See the prospectus of the Fund for a description of these risks: concentration risk; credit risk; currency risk; cybersecurity risk; derivatives risk; exchange traded funds risk; foreign investment risk; inflation risk; interest rate risk; liquidity risk; market risk; regulatory risk; securities lending, repurchase and reverse repurchase transactions risk; series risk; short selling risk; small capitalization natural resource company risk; specific issuer risk; tax risk.

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