

PALOS

Palos Weekly Commentary

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Palos Funds

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Canapux: Potential Innovation for Canadian Oil Exports

2018 was a very challenging year for the Canadian oil market. Pipeline shortages led to an oil glut which caused WTI-WCS differentials to widen to never-before-seen levels. This lack of takeaway capacity created a strong demand for exports of crude-by-rail (CBR). According to the National Energy Board, crude by rail volumes hit a new record as they increased over 138% YoY in October (latest reported month). Both Canadian National Railway (TSX: CNR) and Canadian Pacific Railway (TSX: CP) have been increasing their exposure to crude and have been successful at increasing their capacity without cannibalizing grain, which was a common concern. They have been experiencing similar growth over the period, with the former gaining a slight volume advantage.

Potential spills and their environmental impacts have been an ongoing international cause for concern. The Fraser Institute reports that on average, rail tends to spill less total oil than pipelines, but incidents occur at a higher rate. In response to this concern, CNR has developed CanaPux, a new and safer way to transport crude. CanaPux transforms crude into a solid form by blending and encapsulating bitumen with different polymers. What is fascinating about CanaPux is that the product won't ignite, dissolve, create dust and can float on water. The potential impact of a spill would be dramatically reduced and be much easier to clean up.

These pucks could be exported using the existing coal supply chain and could allow Canadian producers to safely export crude to Asia. The great advantage of this is it would enable producers to access the world price and not be as affected by WCS-WTI differentials. According to CN, it would cost about 23USD to ship a barrel of bitumen as CanaPux to Asia from Alberta, including packaging, rail and vessel charges. This is 1USD less than the cost to transport a barrel by train to the US Gulf Coast. In addition, it would seem that more crude could actually be transported in pellet form. An open top rail car can potentially carry the equivalent of 615 barrels of crude in pellet form, while a tank car holds only 390 barrels.

This innovative product is still very much in its early days and needs to be tested before it can be implemented on a large scale. CNR has mentioned that if its pilot succeeds, it plans to team up with an unnamed Asian partner to build a plant that could convert 50,000 barrels per day. They have also communicated with Canadian producers that would be interested in testing the technology.

Palos Funds cont.

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Even if the takeaway capacity and supply become balanced by the end of 2019 thanks to the replacement of the Enbridge line 3, if the Trans Mountain expansion or Keystone XL pipelines fail to materialize and the US continues to buy 99% of Canadian crude exports, there will be more capacity shortages and the oil market will be in trouble once more.

We believe that this technology has a lot of potential and that Canadian producers can benefit from it. However, even if CanaPux falls short, the Canadian oil industry is in dire need of some innovation that grants access to foreign markets. Given the current landscape, the industry would benefit greatly from geographic diversification and reduced dependency on US imports.

The funds have been opportunistically increasing their exposure to CNR as we believe that they will continue to innovate, will benefit from its multiyear CBR contracts, and that it is well positioned for growth overall.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) ¹	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	\$7.92	0.29%
Palos Equity Income Fund - RRSP	PAL101	\$5.36	0.24%
Palos Merchant Fund L.P. (Mar 31, 2018) ²	PAL500	\$1.83	7.25%
Palos WP Growth Fund - RRSP	PAL210	\$7.10	0.41%
S&P TSX Composite (Total Return with dividends reinvested)			0.17%
S&P 500 (Total Return with dividends reinvested)			0.13%
S&P TSX Venture (Total Return with dividends reinvested)			2.48%
Chart 2: Market Data ¹			Value
US Government 10-Year			2.62%
Canadian Government 10-Year			1.90%
Crude Oil Spot			US \$46.54
Gold Spot			US \$1,284.10
US Gov't 10-Year/Moody BAA Corp. Spread			246 bps
USD/CAD Exchange Rate Spot			US \$0.7362

¹ Period ending Jan 2, 2019. Data extracted from Bloomberg

² Fund is priced annually

Palos Funds cont.

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