

PALOS

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Weekly Commentary

Issue No. 17 | APRIL 13, 2020

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By Charles Marleau, CIM

Why I'm Sticking with Tourmaline Oil Corp

I have been focused on reducing our energy exposure during the first quarter of 2020 and the fund is currently underweight the energy sector relative to the TSX Composite Index. My sense is that the energy sector is facing a long period of recovery as we recognize that extreme politics is having a negative impact on global oil prices. At the same time, there are some diamonds in the rough. We've decided to maintain our position in Tourmaline Oil Corp (TSX: TOU). The reason is simply in the numbers.

I believe TOU is among the best oil & gas companies in Canada and in a strong position to not only weather the storm, but to possibly thrive from the carnage. While I recognize that energy companies are presently out of favour, I find the Tourmaline story to be a compelling one. Since the beginning of the year, TOU is down roughly 30%. Over that same period, the energy sector as a whole is lower by approximately 60%. What catches our attention is the relative outperformance of TOU versus its peers. This affirms our view that TOU is the most compelling energy name, and on a fundamental basis we believe its the cheapest intermediate on the TSX. The company also has one of the stronger balance sheets; debt to cash flow (D/CF) is under 1x. We believe that TOU is well suited to sustain growth inside of its cash flow.

Behind the scenes, we're seeing a spike in AECO Canadian natural gas futures into 2021. Why is this important? The simple explanation is that, as oil producing companies hunker down and slash capital expenditures, production will significantly decline. Since natural gas is a by-product of oil drilling, lower oil production means much lower gas production. Hence, why we are seeing 2021 AECO strip pricing up 25% since the middle of March.

The company's name is **Tourmaline Oil Corporation**, and this is somewhat misleading. Truth be told, TOU is the largest gas producer in Canada and the fifth largest Canadian midstream processor. The proverbial cherry on top; TOU has 2.6 Billion BOE 2P reserves (barrels of oil equivalent), 12.3 Tcf (trillion cubic feet) of gas and 552.8 MMbbls (million barrels) of oil. On reserves alone, we believe the stock should trade around \$10 per share on net asset valuation. This calculation doesn't even factor in the value of the company's infrastructure assets. Valuation is compelling as TOU is trading at 2.9x EV/DACF, the lowest valuation for any intermediate. If we assume that it should trade more inline with its peers at 4.2x, the stock should be around \$16; about 60% higher than we are today, and with much lower risk!

By Charles Marleau, CIM

To conclude, here are a few highlights with regards to environmental sustainability, which has become a growing focus of many pension funds, sovereign wealth funds and university endowments. TOU has the lowest emissions and carbon intensity of any Canadian senior producer and has reduced its emission by 46% between 2013 and 2018. The company also has one of the largest insider holdings. Hence why we are sticking with TOU as we see this company as clear winner in the months and years ahead.

Disclaimer: Palos Funds are shareholders of TOU.

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns) ¹	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL100	\$6.26	-23.92%
Palos Equity Income Fund - RRSP	PAL101	\$4.53	-20.27%
Palos Merchant Fund L.P. (Dec 31, 2019) ²	PAL500	\$1.71	20.15%
Palos WP Growth Fund - RRSP	PAL210	\$5.31	-30.62%
Palos-Mitchell Alpha Fund (Fund Initiated on Jan 29, 2019) ³	PAL300	\$6.65	-35.91%
S&P TSX Composite (Total Return with dividends reinvested)			-16.13%
S&P 500 (Total Return with dividends reinvested)			-13.16%
S&P TSX Venture (Total Return with dividends reinvested)			-26.86%
Chart 2: Market Data ¹			Value
US Government 10-Year			0.72%
Canadian Government 10-Year			0.76%
Crude Oil Spot			US \$22.76
Gold Spot			US \$1,736.20
US Gov't10-Year/Moody BAA Corp. Spread			375 bps
USD/CAD Exchange Rate Spot			US \$0.7156

¹ Period ending April 9, 2020. Data extracted from Bloomberg

² Fund is priced annually

³ Fund is priced weekly on Tuesdays

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