OGIB BULLETIN #122 FEBRUARY 10, 2013

MARKET COMMENTS
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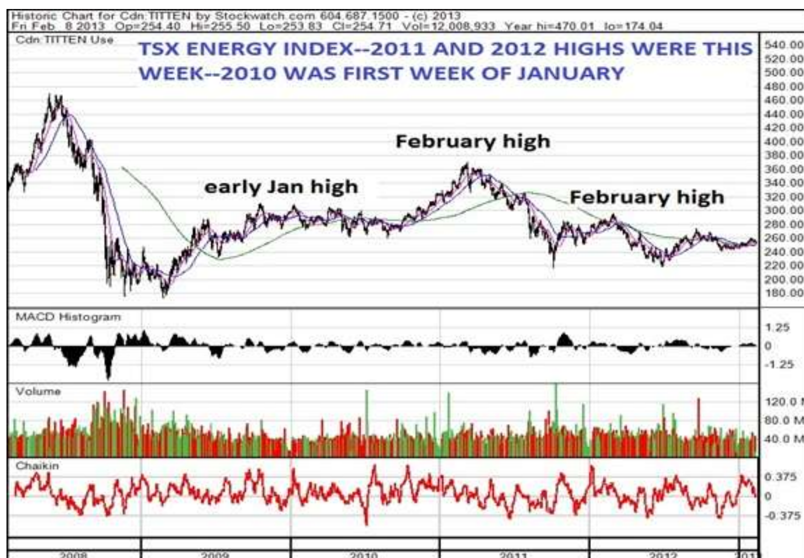
NORTHERN TIER, DONNYCREEK
AND OTHERS

MARKET COMMENTS

There is a definite seasonality to the oil and gas stocks in Canada. Generally speaking, the top is right now. In both 2011 and 2012, the TSX Energy Index peaked out the first week of February. In 2010 it was the first week of January.

Each of the last two years, the March-June timeframe gave investors serious downturns—the juniors as a group dropped by roughly 50%. It's tough (for me anyway) to hold stocks in those kinds of corrections.



What this really means for me is that—I'm much more likely to sell any junior that I don't LOVE, in the near term. Or at least reduce it. And if it's got a good chart, I'll keep it. But make no mistake, even my favourites are vulnerable. And if the chart starts to break down, I'm happy to sit on the sidelines.

I read a stat once that stuck with me—80% of all stocks trade with the market; they go up and down with the tide. And while the tide might be coming into equities now, they don't appear to be moving into junior oil stocks.

That's why you're seeing me move into stocks that process commodities—refineries and ethanol makers—to make money in this sector in 2013.

Also, oil is in what I call the "no-win" price range for junior producers. These juniors do the best when oil is at the BOTTOM of its trading range—usually around WTI $75-$80/barrel. Then traders know a rising tide will lift all boats, and the junior stocks get love—and bids.

But now, Brent oil is $119/bbl and WTI is almost $96. Since 2008, history is clear: oil juniors have an INVERSE relationship with oil prices when Brent gets above $120/bbl.

That's because the market starts to price in lower growth, if not outright recession, and one of the first the market does then is sell the riskiest assets; i.e. junior stocks of all kind.

So at $120 Brent, it's hard for investors in junior stocks to win—if oil goes up, these stocks go down as the market prices in recession. If oil goes down, these stocks go down, as the market prices in lower cash flow.

This year, there is a lot of chatter about how global capex is expanding In 2013 and the central bankers are managing the economy now blah blah blah…and so there's a chance this time it could be different. Maybe. But history is pretty clear.
So govern your own portfolio accordingly.

DONNYCREEK—DCK-TSXv; DONYF-PINK

I want to spend a couple MORE minutes on Donnycreek, because the amount of emails I got this week tells me it's a highly owned stock in the OGIB community here.

I'm lucky that I have several subscribers in Calgary who are very plugged in there. One of them called me telling me he was hearing the condensate price in Canada was about to collapse. Despite researching this intensively for my blog series, I have so much respect for this person I re-called all my contacts in the oil and gas marketing business to get their thoughts.

Condensate is now trading $11/bbl above WTI, which is down from the high last month. But everything I was told leads me to believe the condensate market in Canada should remain strong for the rest of this year at least; though people did say they had heard the same chatter in the glass covered, connecting corridors over the streets of Calgary called "Plus 15".

So it could be that which Donnycreek's drop in share price, or somebody thinking they know something about well #3, or the $1.60 stock coming free trading a week Monday…I don't know.

But the fundamentals of the condensate market remain quite strong IMHO.

Seeing the stock go down near the time of the financing stock coming free trading is not unusual at all in the small cap space.

The market plays all kinds of tricks that retail investors don't appreciate.

This game can happen somewhat in reverse. An example of that recently is DeeThree's latest financing. The stock actually spiked in advance of a financing. Usually when the Street knows a pubco is going to raise money, they sell the stock down.

But if it's a hot deal, and in demand, brokerage firms will actually BUY the stock up once they know a financing is coming, to "paint the tape"; show management that they have been big buyers of their stock and should get a bigger chunk of the financing.

Management often rewards the largest net buyers of their stock with the biggest piece of financing, which comes with a bigger commission (on average, say 6% vs. 2% trading commissions (or less). They don't mind buying the stock if they know the stock is going higher once the financing closes.

For DeeThree, the financing closes Feb 19 I believe so all this market action is quite bullish for the stock. But it's probably rangebound this week.

NORTHERN TIER ENERGY NTI-NYSE

All the refinery stocks in the US had a great day Friday, and I think the big catalyst was Northern Tier. As I mentioned a couple days ago, the company announced they would increase throughput 10% this year. The market loved that news moving the stock up to a new all time closing high of $29/share.

What I think is more important however, is watching the Street really come around to this idea that light oil prices are going to drop—potentially a lot—later this year as the industry clogs up all the light oil refineries with domestic product. And that should equal some yield compression (even more).

On Friday, Bank of America Merrill Lynch upped their target price on NTI to $34/share, giving the stock an 11% (pre tax at that!) yield on their targeted distributions for 2013 of $3.77 a share. It was intriguing numbers for me, as I think NTI has a very good chance of distributing over $6/share in 2013. That would make a $54.50 share price.

I'm into pie-in-the-sky hypotheticals here, BUT….if the Street believes that the light oil price will now have a structural discount for a few years until either
a) refinery capacity increases or
b) enough presidential exemptions allow large amounts of light crude to leave the US

then an 11% pre-tax yield is possible I guess. But if The Street sees it as just a hyper-

peak in a regular refining cycle, I would suggest 11% is very aggressive. I can only hope ;-).

BofA Merrill Lynch put together this graphic to show the potential distribution increases from the increase throughput, and its effect on valuation:

Table 3: NTI Capacity Expansion: Adds ~$40mm to cash flow

Impact on cashflow	Notes
8,000	barrels per day
$20.0	Gross Margin
$4.5	Opex/bbl
90%	Utilization
2,628,000	annual bbls @ 90% utilization
52,560,000	Implied annual margin
(11,826,000)	Implied annual opex
40,734,000	**Est Annual Cash Flow**
$0.44	**Per unit**
$4	**Implied value at 11% assumed yield**

Source: BofA Merrill Lynch Global Research

They said it costs $16-$18/bbl to get Bakken oil to the east coast, and that is the size of the structural price differential in NTI's favour now. That is more than the $10-$14/bbl I see/hear everywhere else. In any event, it does make NTI my favourite refining stock. It should have the largest structural price advantage the longest, until a) or b) above happens.

In January I spoke of a Morgan Stanley report saying refineries should get some multiple expansion this year even if crack spreads don't meet 2012 levels overall. I think we're starting to see that happen as the Street "gets" the domestic light oil story now.

Both these links speak to this issue:
http://fuelfix.com/blog/2013/02/08/domestic-crude-puts-u-s-refineries-in-a-sweet-spot/ (Houston Chronicle)

http://www.bnn.ca/Shows/weekly-with-andrew-mccreath.aspx(BNN is the Canadian equivalent of CNBC)

MISUNDERSTOOD STOCKS CAN GIVE BIG PROFITS

I was speaking with one of my mentors/subscribers this week and he said something that resonated with me—The Big Wins come from stocks that are misunderstood by the market.

Generally, I'm not technical enough or have enough confidence to stand out from the crowd a lot (though I guess I was one of the first retail letters on the refinery trade), but I do get lucky sometimes.

An example of this from the OGIB portfolio would be DeeThree. At the end of 2011 the Alberta Bakken was a bust, only one marginally economic well had been drilled and the

stock had gone from $5 to $1.75 in the last 10 months. But I didn't sell it because even without the Alberta Bakken, it was going to have 50% growth PER SHARE in the Belly River with no geological risk. It was a proven play. But the market didn't care about that; it just hated the Alberta Bakken (like me and Argentina right now). And of course then we all got lucky with the Alberta Bakken being VERY economic and DeeThree making Belly River even better.

So when I look at my current portfolio and ask…which company is the most mis-understood? Well, **Lynden Energy (LVL-TSXv)** would have to be close to the top of this list. Because there is no sell side research on The Street, it's not a well known story. Should the Cline Shale play work out—and it looks like it is at this early stage—their 33,000 net acres could be worth $2,000-$5,000 per acre undrilled, because it likely also has several other productive formations.

That's 60 cents a share minimum, and $1.50 maximum. And of course if they get some production flowing from Mitchell Ranch, that can get to $10,000-$15,000. (If they can find one of those new Canadian trusts that use US assets, they can get $40,000 ;-)).

In one sense it's only mis-understood because there is so little in the public domain; there's not a lot of transparency around the play.

My understanding is they don't intend to drill the quality (deeper; Ellenburger, Mississippian) formations at Mitchell Ranch—they want to see others spend the money and get a bid for the land. I think that's smart, but it requires a lot of patience. And I'm not so good at that.

RIDGELINE ENERGY SERVICES RLE-TSXV; RGDEF-PINK

Ridgeline is buying another water processing facility, this one in Missouri, that is somewhat similar to their Santa Fe Springs (SFS) facility in east Los Angeles…but not quite.

The good news is that a couple banks own the asset and want to sell it, so vendor financing is possible. This would reduce dilution on the purchase.

So, the Street is asking RLE—when will you be self sustaining? This is a tough question, but a much worse one is…who are you again?

The Street knows Ridgeline, and the company has performed (way better than the stock in the last year). SFS has gone from a run rate of $3 million to $17 million in a few short months—and it's still increasing. RLE has already seen improvements in Missouri since they took over management in early December.

And by the way, the industry called in Ridgeline, not vice versa. They're being offered underperforming assets.

Dennis Danzik knows business as well as technology, and he and CEO Tony Ker have, operationally, done a great job in the last year. Oil and gas business has been slower in coming than expected. One reason for that is that O&G is their lowest margin business, and their other verticals for their water treatment technologies are booming, with better margins.

I don't think the stock is going to turn around real fast—but I do think it will turn around. I'm looking at (I mean, in my crystal ball) two years from now, seeing a company with just under $100 million revenues, split 60/40 from Missouri and SFS with some oil and gas customers thrown in, EBITDA of $30-$40 million and a gross margin that is steadily increasing.

A 6x multiple=$240 million market cap on 160 million shares out then and I get $1.50 share price. So that's The Prize as I see it now (in a perfect world).

Almost no new management is needed for this Missouri acquisition. They front end loaded some high quality talent for SFS in 2012, and they have the bandwidth to handle Missouri right now.

I still see a large Private Equity partner as a great way to fund growth here, but no word on that yet.

I expect to begin increasing my position here as the story unfolds.

GREEN PLAINS GPRE-NASD

This stock really is so simple—it's a bet that corn prices (input costs) will drop faster than gasoline prices (output). Note I said gasoline, which is based on Brent pricing, and NOT oil prices, which is based on WTI light oil

But there is a legal angle here—ethanol is mandated to be in US gasolines. And, of course, politicians lie all the time, but this link does have the Secretary of Agriculture repeating the Obama Administration's support for ethanol:
http://fuelfix.com/blog/2013/02/08/obama-wont-abandon-ethanol-official-says/

The recent jump in the stock was the market rewarding management for doing a great job managing the company through a very tough year. With the market forecasting not as severe a drought as last year in the US midwest, higher corn yields from more drought resistant corn (=lower prices) and better global corn production, the market may be willing to start giving GPRE some speculative premium.

In a sense, this is the opposite to the natural gas trade. A torrid hot summer like 2012 is great for air conditioning natural gas demand, but bad for corn crops.
My stop loss on this trade is $7.50

TRIANGLE PETROLEUM – TPLM-NASD

A week or two ago I said Triangle would be a longer term story—and then another Bakken producer hit a 5000 bopd well and everybody in the Bakken got a big lift—and psychology changed on TPLM.

They'll be announcing an operational update this Thursday, Feb 14, and hopefully investors get some love ;-). This is the first quarter in which their two vertically integrated subsidiaries will report--both RockPile, the fracking company, and the midstream company Calibre.

With Bakken discounts now only $3/bbl below WTI, and staying very steady (there has been serious volatility in these spreads over the last year), any strong growth in production could get rewarded. This news release should also give the market an idea of how much new debt the company could obtain from new reserves.

I hope they will also share how much hedging they're doing, because if the thesis of lower oil prices are coming this fall due to limited refining capacity, these producers should be hedging to their absolute maximum.

While they may not talk about it in the release, on the call the next day they could talk about what drill results they see happening in Montana near their Prospect Station.

I want to talk about this big 5000 bopd hole. Remember that Triangle will never get that kind of rate. When you produce a well, you can, to use a golf analogy, Drive for Show or Put for Dough. Driving for Show means a big IP rate that impresses everyone in a press release. But sometimes that big flow rate can cause formation damage underground; the industry calls it pulling on the well too hard, and you don't get the maximum production over time out of the well. Putting for Dough is going for a lower IP rate, but one which minimizes the decline rate. Triangle Puts for Dough.

MISCELLANEOUS

Here's an email from a subscriber I wanted to share:
Keith –
Just passing along the following (picked up from Stockwatch) with a question.
The Globe and Mail reported in its Saturday edition more than two dozen large companies are paying dividends, with most yields topping 3 per cent. The Globe's David Milstead wrote that some are creeping into the double digits, but the reality is that some wells are dry, and wells, no matter how productive, are diminishing resources. Over time, as pumping continues, less and less comes out of the ground. Rare is the company that has shown long-term growth in production per share. Dirk Lever at AltaCorp Capital Inc. in Calgary looked at 11 Canadian exploration and production (E&P) companies and concluded that "according to our estimates, **nobody is living within cash flow -- nobody."** Only Bonterra, Peyto and ARC Resources had positive compound annual growth over the 2005-12 period.

Question: Is this observation more true of large cap companies paying divs, as opposed to, say, the small caps like DCK, DTX, MEI, INA, etc? Altho even most of these have been putting out dilutive share placements recently, do they have a better chance of swiftly arriving to the point where expanding their number of wells drilled can be financed from cash flow?

Brad

ANSWER--Excellent question. The market overall is moving from a growth wanted model to a grow-within-your-means model. Sustainability is becoming MUCH more important, as the market realizes these tight/shale oil plays don't recycle cash fast enough to grow without constant equity infusions—and investors are just not seeing long term PER SHARE growth, and therefore not enough STOCK PRICE GROWTH.

It will be interesting to see which management teams heed the call of the investor, or if they heed the call of their investment banker. I've said for a long time—there is no free cash flow in the junior space which is giving us the crazy volatility, which is driving retail away. But they can't seem to help themselves.

If DeeThree can't get bought out, with two great assets at the beginning of their productive lives, few good companies will get bought out and they'll all have to either grow slower, or continue to dilute as cash flow multiples compress—that's not good for investors.

That's one of the main reasons I like Argent Energy Trust (AET.UN-TSX)—because they are spending just under 100% of their cash flow with their DRIP—dividend re-investment plan, and have the ability to grow organically better than most. I would still like to see a lower sustainability ratio, but their latest asset was bought so accretively I think they can grow into that.

DONALD DONY TECHNICAL COMMENTS

Here is where I say the stocks in the OGIB portfolio I like best, in order. I find it difficult now as I'm cautious on all the junior producers. DeeThree, Coastal and likely Callon Petroleum have the best developing fundamentals, followed by Manitok.

Strategic is next, though the Street is nervous about production delays up north at Steen River, and that could stall the stock for awhile if true. And several emails from subscribers recently make me want to remind everyone—Mr. Dony is as human as the rest of us. He calls 'em likes he sees 'em, but these are junior stocks.

NORTHERN TIER ENERGY—NTI-NYSE: The primary trend is up. Buying momentum is overbought. Buying volume is neutral. The outlook over the next 30 days if for a continuation of the primary trend. The break through resistance at $27 is very bullish. Support is now at $27. Recommendation: Expect NTI to pullback to $28-$27 zone short

term. Try to buy on any dips. NTI is nearing the first target of $29. After that level, $31.75 is the next target. Continue to hold.

DEETHREE—DTX-TSX; DTHRF-PINK: The primary trend is still up but slowing quickly. Buying momentum is neutral. Buying volume has recently turned negative. Support is at $6.50 and resistance is at $7.50. The outlook for the next 30 days is for additional consolidation around $6.50. There is some negative divergence appearing which supports the view of consolidation.
Recommendation: Add to positions at $6.50. Place the stop at $5.50.
DTX should resume its primary trend in March. The target is $9.00.

DONNYCREEK—DCK-TSXV; DONYF-PINK: The primary trend is up. Buying momentum is negative and almost overbought. Buying volume is neutral. Support is at $2.25 and resistance at $3.00. Outlook is for further consolidation over the next 30 days. Recommendation: Any pullbacks are expected to be minor. Expect some price weakness on February. Add to positions at the $2.10-$2.25 range.   The first target is $3.40. Continue to hold.

MANITOK—MEI-TSXV; MKRYF-PINK: The primary trend is up. Buying momentum has fallen to neutral. Buying volume is negative. Support is at $3.00 and resistance is at $3.40. The outlook over the next 30 days is for consolidation around the support level. Recommendation: Try to buy down to the support zone over the next few weeks. A mild pullback/consolidation is only expected. Nearing the first target of $3.50. Once this target is made, the second target is $4.35. Continue to hold.

STRATEGIC OIL AND GAS—SOG-TSXV; SOGFF-PINK: Primary trend is up. Buying momentum is turning negative. Buying volume is positive. The outlook for the next 30 days is positive but rollover should be expected. Support is at $1.20 and resistance is at $1.40. SOG is showing some negative divergence which suggest a slight consolidation over the next few weeks.
Recommendation: SOG has reached the first target of $1.37. The new target is $1.80. Continue to hold. No major correction is expected but price weakness should be anticipated. Watch the $1.20 level. A break below this level points to $1.00.

LYNDEN ENERGY—LVL-TSXV; LVLEF-PINK: The primary trend is up. Buying momentum is neutral. Buying volume is also neutral. Support is at $0.85 and resistance at $1.03. The outlook over the next 30 days is for additional consolidation.
Recommendation: Some mild consolidation should be expected over the next few weeks down to $0.85-$0.90. This pullback represents a buying opportunity. Try to add to positions at this zone. The target is $1.12-$1.15.   Continue to hold.

RAGING RIVER RRX-TSX; RRENF-PINK: The primary trend is up. Buying momentum is neutral. Buying volume has turned negative. The outlook is neutral over the next 30

days. Expect some pullback/consolidation down to support. Support is at $3.10 and resistance is at $3.40. There are no signs of trouble.
Recommendation: Some pullback/consolidation is likely over the next few weeks. Nothing major. Add to current positions at $3.00-$3.10. $3.80 is the first target. Continue to hold. Watch the $3.00 level.

GREEN PLAINS—GPRE-NASD: The primary trend is up. Buying momentum is overbought and buying volume is positive. Support is at $8.50 and resistance is at $10. The outlook for the next 30 days is for a brief stall around support and then a continuation of the primary trend. Recommendation: Add to positions around the support level. The break above $8.50 is a very bullish development. $12.50-$13.00 is the next target. Continue to hold. Looks great.