OGIB INTERIM BULLETIN #195 - JANUARY 30, 2013
PORTFOLIO PURCHASE:
TAG OIL (TAO-TSXv)

UPDATE--REFINERY STOCKS

This morning I bought 15,000 shares of **TAG Oil (TAO-TSX; TAOIF-OTCQX) at $4.75**. On the surface, TAG has a lot of what I want in a junior producer right now, except for a high oil weighting (they're mostly gas now, though gas has 2-3x the netback in New Zealand vs. North America).
They have:

1. Growing production
2. Lots of cash
3. Tight share structure for leverage; and no warrants
4. Exposure to Brent pricing

The stock looks like it's about to break out. Since Apache (APA-NYSE) pulled out of their east coast shale play, the stock has traded 20-25% of its float in a very short period of time—so significant shareholder turnover has happened. Volume has been WAY above normal for this stock.

So the market sees value—and there is value here at these prices. Even at 2/3rds gas, their oil netback is so high that it works out overall to have a very similar netback to the better North American plays.

I see my main risk as timing. Management may not drill the east coast shales for a long time now—they've put it off for a long time. For some reason God doesn't seem to want the Whangai (pronounced FUN-GUY) shales drilled.

All indications are that their oil and gas processing facilities will be ready on time for March 31, but a delay would not surprise me.

I wouldn't call this trade a flyer, but I wouldn't call it a core pick either. But I do like the stock action right now.

REFINERY STOCKS—ON FIRE!

Refinery stocks were on fire in the US yesterday, as Valero (VLO-NYSE) announced revenue, cash flow and earnings that smashed through analyst's expectations. HollyFrontier, Alon, Northern Tier and other stocks were up in sympathy. This morning, Marathon Petroleum beat the Street and its shares are up

4.5%. Valero has just turned negative as I write, but on much larger volume than normal, as the next round of investors "get" the refinery story.

But I still don't think they get what's going to happen this fall when light oil prices in North America drop, giving VLO and other Gulf Coast refiners a turbocharge boost in profitability.

I'm not going to do any big analysis on VLO. It's my stock for the call on cheaper light oil in the second half of 2013.

Simple trade idea.

For me it will be interesting to see how the market treats the stock in the coming week. Some pullback is likely after a 12% rise in one day—and a 50% move in the last three months. It wouldn't surprise me to see a two month consolidation—but maybe not. The media was full of bullish talk on refineries and VLO today, so I think we are getting the next round of investors coming into the refinery trade. The mania just got bigger.

I would suggest if the stock has put in a high here, the market is more concerned that crack spreads have peaked here for awhile. I don't see that myself as likely, just with the media chatter and some quotes from the transcript of the earnings call, some of which I have reproduced below.

However, the Street is talking about how cheap the stock is on a multiple basis here at 5x cash flow. Well, refineries trade in a range of 4-6x cash flow. BUT—the last time VLO reported $1.80/share net income, like they did yesterday, back in early 2007, the stock was $80. So I do think this puppy has a way to run yet.

Now, from the conference call transcript, a couple quotes stood out for me. Here's one from management:

"The second strategic area is for modifications to our refineries that increase the flexibility to export products to premium markets and to process more of discounted crude oils, particularly domestic light crude."

They are moving towards increasing their light oil capacity because that's where they see the biggest discount move happening now. I jumped on the bandwagon of lower light oil prices in H2 13 a few months ago, and this validates that idea; once the Big River of domestic light oil supply pushes all light oil imports out of the Gulf Coast Refinery Complex (GCRC), domestic light oil prices fall.

This should not only turbocharge Q3 and Q4 earnings for refineries, but I think give them a higher multiple as these light oil discount prices become a structural part of the North American energy complex.

I think it will be 10 years before Cline Shale, Bakken, Eagle Ford and Eaglebine peak

out in production and reverse this structural event. And what else will the industry find in the meantime?

"And we mentioned I think in the notes that we were a 100% domestic light sweet crude, where we are running sweet crudes in the Gulf, so we back off all of our foreign dollars." "The discount LLS against Brent will move to several dollars at least tariffs, but it could move more. And those will be attractive to run that, but it's read, it's just so available where the heavy barrels have to be imported. So now you start to look around and as I said it depends on what have to a Keystone. But as you begin to look around, the Mexican volumes are moving in different directions, you have the Venezuelan volumes moving different directions, you do have increases in Columbia. So we just manage the supply function here and think the light crude is going to be readily available."

What they're saying here is that they see a several dollar discount of LLS to Brent (which lately have been trading at par to each other, give or take $3), and it could be more. (I think it will be a lot more but nobody knows.)

And they're happy to have the security of domestic supply, because Venezuela, Mexico and Colombia don't have consistent supply volumes into the GCRC.
Other comments included

1. Export market for refined product is still very strong, especially diesel
2. One analyst suggested it was highly likely that 200,000-400,000 bopd of Alberta oil could be railed to the GCRC within 18 months. Management said it would be more than now but couldn't say how much
3. Another analyst suggested that even if a lot of the domestic light oil was shipped/barged around to east coast refineries, *the growth in US light oil supply would even fill that up in just one quarter*. Wow. To me, that's a powerful statistic. Well, it's a bold guess really.

Lastly, on refineries, everyone please remember that both the infrastructure and production situation is changing so rapidly down in the US right now, that nobody really knows what the situation will look like 6-9 months from now, and certainly not 24 months from now.

For example, I wonder if the LLS drop of $10-$15 a barrel I expect will translate up into increased lower light oil prices in the Bakken and into Canada, or, with huge new storage capacity in the Gulf coming on (some 19 million barrels worth being built), that the LLS discount will be regionalized.

Where that question has some bearing is the WTI price. Personally, I see a ***BIG*** WTI-Brent spread after this light oil price drop—as high as it has ever been, in the $20 range, happening in mid-late Q3 and staying permanent. But I've been wrong before ***;-)***

This spread will actually, but slowly, narrow over the coming 5 months before that happens, but in H2 2013 I see it ballooning out again—once the Street understands that

this is a refinery issue, not a pipeline issue.

The Seaway pipeline expansion hasn't done much for WTI-Brent spread. I think it could be a buy-on- mystery-sell-on-history trade

OTHER NEWS on OGIB STOCKS

DONNYCREEK—I'm writing a 3-part series on condensate for the blog next week. I did a lot of research, and it is very bullish thesis for condensate in Canada. The next two years should see Donnycreek and Contact (50% and 25% respectively at Kakwa in the Montney) receive EXCELLENT prices; and receive oil company style netbacks. Condensate is the only energy bull market in upstream Canada. I want to understand what the facilities bottlenecks are that they referenced in a press release this morning—that's likely slowing volumes down. I expect them to build their own processing facilities at some point.

I am still very keen on the stock, but subscribers note that the $1.60 financing (in which I participated) comes free trading mid-February.

WAVEFRONT—I skimmed the quarterly release—flat revenue from last quarter and continued $1 million a quarter losses. The stock is in tough until that cash flow bleeding stops.

BORDER PETROLEUM—no news, and I expect no news for two months, but the stock is telling us the drilling isn't going so well. As I told paid subscribers several weeks ago, I am slowly exiting my position there. As long as PRY's chart looks that bad, BOR will too.

CALLON PETROLEUM—no news but the stock is breaking out today (to the upside).

DEETHREE—I had a retail stockbroker in the $30 million financing syndicate call me to say he's only getting 10% of what he asked for—it's the first time in 2 years that's happened to him on a Canadian energy stock—very bullish.

NOTE!!! As bullish as I am on several producers (like SOG, MEI, DTX) I plan to sell my cost out of these stocks mid-spring 2013 in anticipation of the drop in lower oil prices second half 2013. I suspect the dividend paying oil stocks in Canada to take big hits when this new differential appears. I am avoiding**all** yield stocks among Canadian junior/intermediate producers.