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OIL (Part III): It Is Different This Time (But Not Really)

Instrument (Inception)*	July 2016 Return	Year-to-Date Return	Compound Growth
Venator Founders Fund (March 2006)	**5.0%**	**0.6%**	**13.0%**
Venator Partners Fund (July 2014)	**4.9%**	**0.4%**	**1.9%**
Venator Investment Trust (September 2007)	**4.9%**	**0.4%**	**9.4%**
Venator Income Fund (August 2008)	**1.5%**	**11.2%**	**12.6%**
Venator Select Fund (September 2013)	**2.9%**	**6.7%**	**19.7%**
S&P/TSX Total Return (March 2006)	3.9%	14.1%	5.2%
Russell 2000 (March 2006)	6.0%	8.3%	6.5%
S&P Toronto Small Cap (March 2006)	5.5%	35.0%	2.5%
S&P 500 (March 2006)	3.7%	7.7%	7.5%
Merrill Lynch High Yield Index (August 2008)	2.5%	12.1%	8.8%

For those readers who haven't been with us for very long, we, at Venator, have been bearish on the prospects for crude oil over the last four years. To quickly recap, in June 2012 we penned a bearish piece entitled "The End of Expensive Oil" in which we made the following claims/predictions:

- Shale oil appears to be on track to mirror the experience of natural gas;
- We could see this cost per barrel metric falling into the $30's;
- North American Energy independence may become a reality within ten years; and
- There is nothing OPEC can do about this other than open the spigot and crush oil prices to below $50.

We had a follow-up piece in January 2015: "Taking a Victory Lap: Our Last Word on Oil" in which we added a few more irons to the fire:

- It's not different this time, but there are always differences;
- Oil is still cyclical, but this cycle may last over six years;
- OPEC is done as material influencers of prices and they know it - short the rallies;
- The marginal cost of launching a shale well is coming down into the $30's, and the cost of sustaining production might come down below $20; and
- Don't let the rig count fool you, a modern Tier 1 rig is worth over 3x a Tier 2 rig.

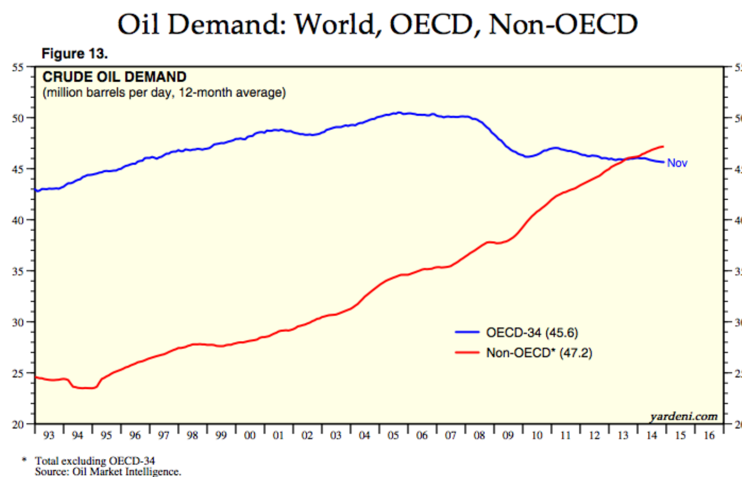
Pretty much all of our assumptions turned out to be correct with the notable exception that, with this letter, the January 2015 piece is no longer our "last word on oil"!

With oil recently revisiting $50, we re-initiated our short position in the commodity with an eye to oil hitting fresh lows over the next 12-18 months. To clarify our long standing bearish thesis, we believe that the supply and demand characteristics for oil are in unprecedented territory not seen in the last 100+ years of the oil economy. Some of this has to do with technological advances in production, which has effectively moved to "just-in-time" locally sourced and globally mobile production, but more of it has to do with technological developments on the demand side, as

the now well understood emergence of electric vehicles is set to perpetually chip away at demand on the margin; and oil prices are all about the margin.

SUPPLY AND DEMAND DYNAMICS EXPERIENCING UNPRECEDENTED CHANGE

When you consider the last 100 years of supply and demand for oil, the story is rather simple: both supply and demand increased dramatically. While there were occasional bouts of pricing volatility, supply/production always seemed plentiful enough to fill the more steadily rising demand for oil. But while supply is continuing to increase, largely through technological extraction advances (the same reason supply always increases), we are witnessing a rolling over of the historical trend of increasing demand.



For the next twenty years we believe that the world will see plentiful *available* supply and DECREASING demand (we have never seen this before) – THAT'S DIFFERENT. An oil market with plenty of intermediate-term, readily available supply (caveat: there will always be short-term cyclical disruptions) coupled with long-term declining demand is a market in which you are perpetually selling short-term rallies into a lower-lows/lower-highs price chart.

We keep reading how oil companies have cut production plans and how long it will take to bring production back on. To dispel the myth, you recently could have hedged forward production at $50 in an hour, and commissioned a high-end Tier 1 rig in a prolific field in the next hour, and be flowing at a cost of about $40 per barrel or less for shale oil in under four months. In other words, supply responses can be far faster than anyone realizes, putting a theoretical cap on oil prices somewhere in the low $50's. When you have debt that needs to be serviced, you will be looking to produce all the variable cash flow positive oil you can (remember that lease costs are sunk, in some cases drilling costs are sunk, and interest needs to be paid regardless, so you need to take these costs out of your break-even calculations, along with IR-type goals like 20% ROE per well). Not to mention that shale oil wells are becoming more prolific as decline rates have dropped markedly in some basins.

OPEC is aware that they are on borrowed time, and they will continue to sell as much as they can given that their costs are under $20 per barrel, while the US will continue to turn on the taps at variable costs under $50. Despite all the spring talk of production freezes and/or cutbacks, it is instructive that *OPEC is currently producing at record levels*. At this point, they are probably not worth listening to anymore.

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ELON MUSK *IS* CHANGING THE WORLD

This next point is something a lot of people are noticing, so it is not a view unique to Venator, but it's worth mentioning nonetheless. Since the launch of Tesla's Model S in June 2012, it has captured 25% of the luxury high end vehicle market. What's more, the Model S continues to outgrow its competitors in 2016.

U.S. Sales of Large Luxury Vehicles

MODEL	2015 Sales	2014 Sales	% Change
Tesla Model S	25,202	16,689	**51.01%**
Audi A7	7,721	8,133	**-5.07%**
Audi A8	4,990	5,904	**-15.48%**
BMW 6-Series	8,146	8,647	**-5.79%**
BMW 7-Series	9,292	9,744	**-4.64%**
Jaguar XJ	3,611	4,329	**-16.59%**
Lexus LS	7,165	8,559	**-16.29%**
Mercedes-Benz CLS-Class	6,152	6,981	**-11.88%**
Mercedes-Benz S-Class	21,934	25,276	**-13.22%**
Porsche Panamera	4,985	5,740	**-13.15%**
TOTAL	**99,198**	**100,002**	**-0.80%**
Source: Company Reports			

With the pending launch of its compact Model 3, Tesla is set to capture 30%+ of the middle market. Pre-orders exceeding 400K equates to nearly two-thirds of the US market for its target of BMW 3-Series and equivalent $40,000+ vehicles (as a point of reference the 2015 US unit sales for just the BMW3/4 series, Mercedes-Benz C-Class and Audi A4/5 were 268,000 combined). While the Model X appears to be priced too high to capture market share in all but the highest end of the SUV segment, Tesla is rumoured to be launching a sub-compact SUV by 2019. Furthermore, we wouldn't downplay the "cool factor" that could cause those not willing to pay over $40K for a car currently to "reach" for a Tesla Model 3, eating into the Accord/Camry market (while we realize that this is a big chunk of change, a $650 per month expense on a five year lease may be worth the cool factor attached to the Model 3 to a generation in which unemployed, stay-at-home millennials carry around $800 iPhones and pay an additional $1000 per year plus in app subscriptions to own it).

Tesla hopes to sell 1 million vehicles per year by 2020. Regardless of how realistic that goal may be, it is worth noting, for perspective, that EV unit sales will probably be only 120K this year and hybrid sales are about 400K per year (vs 15 million light-duty vehicles sold per year). Using those numbers as a base, there is no question that the Model 3 is set to at least triple total EV sales by 2018/19 on its own. The point is that, while Tesla is targeting 5% of the overall car market (unless they can economically come even further down market), they are capturing that share for the highest gas guzzlers, leaving only more fuel efficient smaller vehicles using gasoline. More importantly, their success is forcing more electric/hybrid adoption everywhere so you could be looking at 10% of all car sales being EV/Hybrids by 2020 (especially if Apple is still "cool" when they enter this market).

In terms of demand for oil, transportation is still well over 50% of overall demand, while the other major uses of oil such as distillates aren't exactly safe from renewable energy competition either. If 10% of gasoline demand goes away over the next ten years due to the emergence of electric vehicles, this would be really bad for oil prices. Oil prices are determined at the margin, and the marginal picture looks bad for many years to come.

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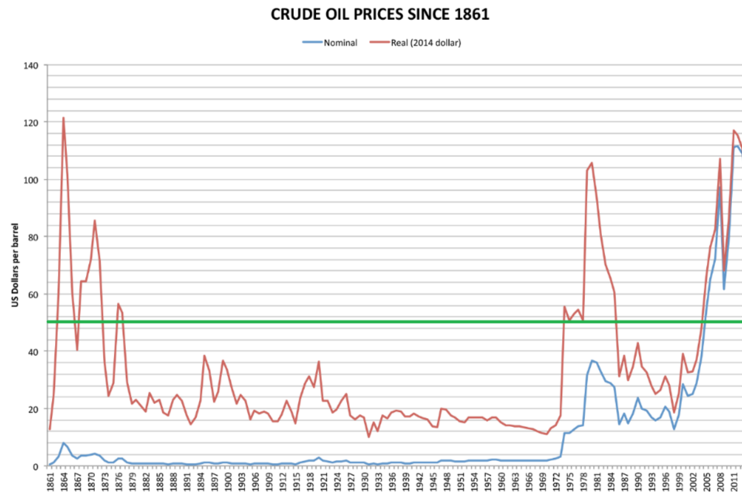
IT'S NOT REALLY DIFFERENT THIS TIME: YOU JUST HAVE TO THINK BIGGER

For those with short memories who incorrectly think that the recent "bottom" of $25 oil is abnormally low, we offer the chart below. A quick scan will confirm that prices over $50 are the anomaly, occurring only artificially in the 1970s, and as a result of the China-led emerging markets and commodity-wide "bubble" of the 2000s. Twice in 100 years, 20 years apart – that's the outlier. It's amusing that industry veterans talk about reverting to a mid-cycle mean of $65 as though that's a normal price in a historical context. Historically, that number is somewhere in the low $30s.



To be clear, oil is still, and will likely always be, cyclical. We can just disagree on that cyclical range, which we see as $20-$50. Cyclical tops and bottoms tend to be defined by costs of production and shortages/surpluses. It's just too quick and easy to bring on production nowadays and, with demand possibly in a long, slow secular decline, the perceived shock-shortage factors that were in place for so many decades seem to have gone away.

Finally, at this point in the technology cycle of energy, there is the non-zero probability that we are witnessing the end of oil as a meaningful supply of energy over the next 50 years. This isn't as big a deal as it would seem: forests used to supply power; candles used to supply light; horses used to supply transportation; film used to supply pictures; and wires used to connect us to other people remotely. While there is no doubt that the world will always need increasing amounts of energy, we may not need oil to get it.

As always, we reserve the right to change our mind!

Brandon Osten, CFA

CEO, Venator Capital Management Ltd.

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