EDGEPOINT®

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EdgePoint Go West Portfolio, Series W

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COMMENTARY - Train wreck
By Geoff MacDonald, portfolio manager

"Why must I wander like a cloud following the crowd"
- Michael W. Smith's song, Go West Young Man

The world is connected, meaning one thing leads to another. The connections that set off one chain of events connect to another, which then connects to another, and so on. You can look at these connections in many ways. They could be a set of building blocks based on innovation and an investment, and then a follow-on innovation and investment. Or they could be a set of falling dominoes resulting in a train wreck without a change of course. Connections can be good or bad.

Over our careers, we've observed a tendency for investors to look at the immediate effects of policies, news, investments, etc., while avoiding the longer-term consequences. Alternatively, there are times when longer-term policies aren't viewed with an ounce of thought about the near term, but instead primarily viewed with the end goal in mind without considering the many consequences on the path towards it. Either way, we do our best to avoid the trap of overlooking secondary consequences. Second-level thinking consists of the good connections people often miss, while train wrecks are the bad ones investors ignore.

The road to hell is often paved with good intentions

Importing invasive species to get rid of other pests is a classic example of how one good well-intended action can set off a series of other events and connections that may not have been seen at the time. The investment world is full of similar examples. Today, we'll painfully highlight some of them.

After re-reading this commentary's draft, I was worried my good intentions could also land me on the road to hell. This might sound like an opinion piece, but that's not the intention. We're focused on when supply growth will come to finally end this cycle, and also end the EdgePoint Go West Portfolio as an attractive investment. We've decided to take the reader down some long, dark paths to ask if such darkness would even reverse our course. There are significant investment implications to whatever the answers are to those questions.

Attracting capital to the oil & gas sector has been challenging for many reasons. Top of the list is owing to how poorly the management teams in this sector allocated capital in the past. Cycle after cycle, the vast majority simply seemed to spend like drunken sailors. The management teams must look at themselves, their misaligned historic incentives and their awful pro-cyclical investments before they wander towards blaming government policy. Pure free-market capitalism would dictate that they don't deserve the capital they've had in the past and it finally looks like the capital providers are leery to invest too much with these companies. The few remaining investors who hung on through this awful ride deserve credit – which will eventually turn to blame – for demanding the purse strings stay tight.

But it's not fair only to blame management's past decisions on the resulting lack of capital and, thus, lack of production growth. There's also a long history of unintended train wrecks caused by, generally, well-intended government policy that often sets off actions and connections down the road that may be very different from where the free markets would have taken us. We've been watching these secondary consequences impacting the sentiment in this sector during the past few years. Combined, ESG "box ticking" and exclusionary investing have put a cloud around oil & gas investing. In general, we do our best not to weigh in on the political arena – our job is to navigate these winding roads and understand the various connections and chain reactions.

It seems the substitution of fossil fuels at all costs is seen by many as something that will bring light at the end of the tunnel. Ironically, it's increasing the chance that the light at the end of the tunnel isn't daylight, but a freight train coming right at us.

Since we don't set policy, our job is to watch, observe and try to make sense from the messes or opportunities when, or if, they arise. We're just squirreling away within the boundaries of our day job, trying to understand it all.

Our more-than-token ESG piece

When we think of ESG, we think about how a company is making the world a better place. That's ESG at EdgePoint. The companies that are going to do the best for the world are those that are making improvements to the state of the world. Those are also the companies with the most room for improvement.

We've told some incredible stories in the past about how your Go West holdings are decarbonizing their operations. We engage with these companies each year to ensure they continue this path – it's just good business.

Making the world a better place can't possibly ignore suffering today. But there's an ESG box-ticking path that seems to ignore both the immediate term and those with the most to improve (who can contribute most to making the world a better place). Many of these companies are in the fossil fuel industry and we believe our approach to ESG is far superior because we're still around to help them get better.

Fossil fuel awareness with a heart

We're certain that forcing a faster energy transition by making fossil fuels unaffordable isn't going to work. It will punish those for trying to survive today because we can't survive today without them.

We agree on a need for a transition away from fossil fuels, but today they fuel life. If oil & gas are dead, so are we as a civilization.

Decarbonizing too slowly means death and destruction at some unknown time many years into the future. Decarbonizing immediately means death and destruction within months.

Though this commentary will focus on some troublesome connections and chain reactions set off by a distaste for fossil fuels and a lack of investment, we're optimistic that we'll eventually find the balance to ensure little death or destruction today, or far less into the future. We're not ones to bet against human ingenuity.

While we're still alive and able to procure heat, shelter and food thanks to those fossil fuels, we're unfortunately watching some freight trains coming at all of us. If the trains keep coming without changes in direction, there will be incredible insight into the future price of those very fossil fuels. That will greatly influence the duration of this Portfolio (i.e., how long we will continue to view Go West as a good investment).

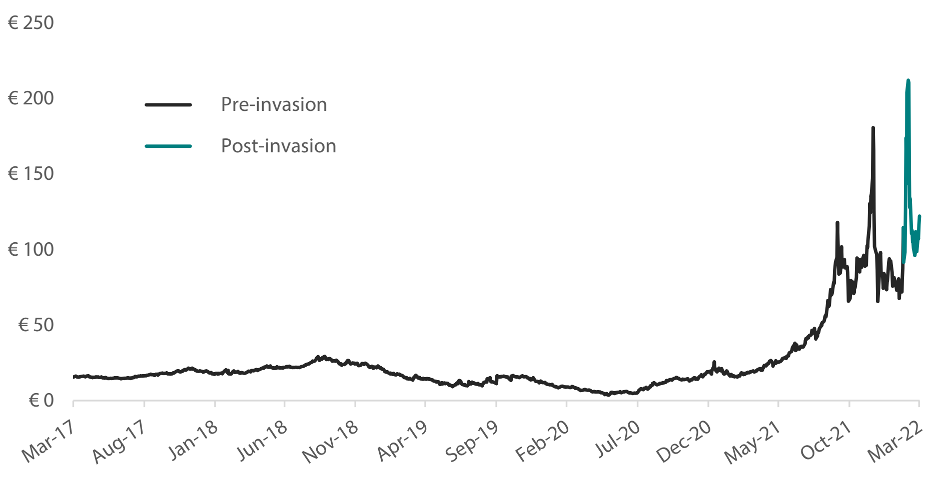
Inconvenient connections

You're already aware of the increased odds of an ensuing food crisis for those with fewer means to pay for the rising food prices – or even procure food in a world of shortages. The odds were very high even before Russia invaded Ukraine.

Europe's train wreck energy policy ensured it, driving increases in their regional natural gas prices to five-fold and then more than 10-fold this year, when compared to those experienced in the previous five years.

European natural gas prices started their rise in January of 2021. This isn't solely a post-Russia/Ukraine phenomenon, although the conflict certainly exacerbated the situation.

Dutch Title Transfer Facility (TTF) gas 1-month forward price
Mar. 31, 2017 to Mar. 31, 2022



Source: Bloomberg LP. The Russian invasion of Ukraine began on February 24, 2022. Dutch TTF gas is the benchmark for European natural gas prices.

Natural gas is approximately 80% of the cost, as the key input, for nitrogen fertilizer. So, it's no surprise that the explosion in natural gas prices in Europe has dramatically impacted the cost structure of European fertilizer producers. Norway's Yara reduced production from plants in Italy and France.[i] Hungary's Nitrogénművek actually halted its production.[ii] Austria's Borealis Fertilizer started cutting its production in September last year and in March stated they are considering stopping output for "economic reasons."[iii] Russia is a major supplier of fertilizer. China has been paying attention and stopped exporting its fertilizer last summer.[iv] In short:

- Virtually every major crop in the world depends on an annual application of nitrogen fertilizer, and
- Nitrogen fertilizer depends on natural gas (or coal in some markets), and
- Natural gas is a fossil fuel, so
- Virtually every major crop depends on fossil fuels, so
- Without fossil fuels, billions will starve.

This list isn't meant as an insult to your intelligence. We know you understand this. In part, we're writing about this to build a case for investment consequences in a world more connected than most policymakers, investors and ESG box tickers understand. We're mostly writing this commentary to show that many of these people with influence hate fossil fuels so much that they seem to be choosing a bit of starvation in favour of even a mild embrace. It's the most extreme example possible to give you conviction that supply growth of fossil fuels has factors at work that limit their supply. That could be bullish for our Go West Portfolio, as dark as that might appear on the surface.

Whipping boy

Though billions would starve without fossil fuels today, these fuels don't get much love and, based on our observations, seem destined to get even less love. If we have a food crisis over the next year, will anyone say that the hunger is due to a feared hunger at some unknown time, possibly decades away? Of course not – it will be blamed on a war. There's an insight to that question and answer, with many investment implications for Go West.

This is not to mention that fossil fuels also power all the mechanized equipment on all the farms in the world.

It's hard to talk about this, but there's a real chance that farmers will deploy less fertilizer given the skyrocketing price. This will negatively impact yield. Given the large shutdowns in Europe, who knows what exports will come from Russia, while China's hoarding of their fertilizer will cause its own shortage somewhere. It's more than probable that farmers won't get their hands on all the fertilizer they might need, and that could spell disaster for global food supply.

If fossil fuels continue to be the scapegoat of policymakers, exclusionary policies, the Davos crowd and ESG box tickers, we need to understand the consequences – and the consequences of those consequences.

As we said earlier, forcing a fast transition away from fossil fuels by making them unaffordable isn't going to work. Go West investors would likely make good money, but it will just punish all of us trying to survive, and some more than others. We'd love to transition faster, and the companies in Go West can help make that happen.

This is corny

Of course, we hope there's no food crisis. But our job isn't to hope. Our job is to wonder about things like if even a famine somewhere in the world could change views on fossil fuels. If it doesn't, there will be more learnings for likely supply growth for such fossil fuels, something Go West is trying to solve. Here's another list we know you are very familiar with:

- Today in the U.S., approximately 10% of finished motor gasoline is composed of ethanol.[v]
- Ethanol is made from corn.
- 40% of the U.S. corn crop is refined into ethanol.
- It takes 26 pounds of corn to make just one gallon of fuel for our tank.
- Corn is food.
- If one wants to debate whether the 40% of corn that goes into our fuel tanks isn't really human-food grade, one won't debate that virtually all that acreage could be used to produce human food.

On top of this, there's a new fuel that's taking the world by storm called Renewable Diesel (RD), which uses food as a 100% replacement for diesel rather than being blended to form a small part of diesel fuel. We have investments in our other EdgePoint Portfolios that have benefited from the large growth in RD production. Policymakers offer huge subsidies for RD, allowing the refineries to outbid those who used to buy the food *for* food.

I guess someone, somewhere, who makes decisions could suggest we temporarily stop putting food into our gas tanks until we get a fuller picture on the food production globally. Maybe drill a few more oil & gas wells?

After all, the U.S. became the world's largest producer of oil & gas. They have the means and the resources to turn on the taps. The companies have the capital. U.S. shale was over 80% of worldwide oil production growth in the last decade! Pretty easy fix, but the fix comes with incremental carbon dioxide pollution. Forget about policymakers, the ESG box tickers won't allow it, so it's a moot point. Nor have the shareholders forgiven oil & gas management for the decades of awful capital allocation.

In the past with such a rise in oil prices, we'd have always seen a supply response. Prices go up, oil companies make more money. Oil companies are incented to drill for more oil and more capital flocks to the sector amid rising profits. Supply grows to meet the demand, supply then usually grows to exceed the demand and prices drop. We will never say "it's different this time," but things are certainly distinct.

There's a connection missing in this connected world. Where's the normal supply response?

Beyond corny

Perhaps it's getting painful to show one more example of how a train wreck can develop in a connected world caused by policies that vilify the very thing that keeps us alive. We're sure you saw what was just announced on April 12: the Biden administration will allow more ethanol in U.S. gasoline this summer![vi] Rather than the 10% ethanol limit in the summer months, the U.S. will allow up to 15%. Ethanol creates more air pollution (smog) so it's historically limited in the summer, but smog will be incentivized this year. So will be the planting of more corn for ethanol, in place of soy and wheat for humans…to actually eat.

If you ever wondered how vilified fossil fuels really are, this example speaks volumes. Will a real potential crisis in front of us take precedence over a crisis that may be decades down the road?

There will be fascinating implications to that question that are both good and bad for our investments in Go West. The jury is still out, but the writing is starting to show on the wall.

Unicorn farts

It's pretty clear the pain that the U.S. administration experiences when asking their domestic companies to drill more. It's hard to do that when members of your own party are screaming for a windfall tax, amongst other more serious threats. It's a political thing you well understand. They won't yet ask their friendly neighbour to the north to drill more. There's the cancelled Keystone Pipeline that isn't far from completion, but that's another political thing. Instead, the U.S. will ask Venezuela to drill more.[vii] Perhaps the U.S. can get a nuclear deal signed soon with Iran that gives cover to reduce sanctions. Perhaps the oil from totalitarian regimes who oppress their people is cleaner and emits unicorn farts instead of carbon?

Without a normal supply response, we get consequences. This only works if equally efficient sources of energy production are built to replace the fossil fuels that society is no longer supporting. Again, think of the investment implications of this scenario.

Supply response vs. demand destruction

In our past eight commentaries, we've written about these many headwinds to global oil & gas production. All of these headwinds are extremely bullish for Go West. There's another potential freight train coming in the form of a food crisis. So far, it's being ignored. Watch the reactions from the policymakers. If they blame Russia and announce meaningless short-term measures like releasing oil from the Strategic Petroleum Reserves[viii] and increasing ethanol content in gasoline, you could expect oil & gas prices to stay much higher for much longer than we could have possibly imagined when we first launched Go West. The offsetting risk to these high prices is demand destruction.

What's that light at the end of the tunnel?

Meanwhile, back in Canada there's a light at the end of the tunnel. We're still squinting to see if it's daylight or another unintended consequence that sets off another chain of dominoes.

On April 6, Canada approved the $12 billion Bay du Nord project off the shore of Newfoundland.[ix] The Canadian Environment Minister laid out 137 conditions that must be met first, including being net-zero emissions by 2050. We don't yet know if these 137 conditions ensure the project is unlikely to ever be built – we're leaning to believe this isn't all smoke and mirrors.

This will be our path for Canada and the path for the investments in Go West. We will not see large projects approved without net-zero commitments. The net-zero commitments set off a chain of events that have material investment implications. Casting aside the higher prices for energy that successful net-zero commitments would impose on its consumers, there are a couple of divergent paths. Our hope for our Go West investments (and for a lower-carbon world) would be that global buyers of energy care about net-zero 2050 targets.

For example, in the recent budget, the Federal government is offering an Investment Tax Credit for Carbon Capture, Utilization & Storage.[x] The Federal government will effectively pay 50% of the cost for carbon capture. This policy allows for significant capital support to the industry. This would make our oil & gas, for all intents and purposes, greener than a leprechaun. There's very significant insight into this path that isn't being factored into current stock prices.

We believe Canada's future liquid natural gas (LNG) projects will not be approved without being net zero, but also without commitments from the buying countries demonstrating that their purchase of our LNG moves them towards their net-zero 2050 targets as well. Other than the ensuing higher energy prices that come with this, it's easy to argue that this would be great for the health of our planet's environment. If most countries follow the western world's lead and truly commit to 2050 targets, Canada would be the home of the world's most environmentally friendly natural gas & oil. This policy support could lead to a premium for our oil & gas. Perhaps even premium stock multiples as a result! Countries will line up for our clean fossil fuels while our government happily supports their development. That's a bright sunrise coming up at the end of the tunnel.

Our country would benefit in so many ways. Our investments in Go West would have an opportunity to thrive beyond what's currently imaginable. We talked about this vision a few commentaries back, trying to imagine a different world than the gut-wrenching trough we were experiencing at the time.

Or is it a freight train?

If enough countries don't care and would prefer to buy cheaper oil & gas from the countless producing nations that will not impose higher costs on themselves or commitments from the purchasers, then much of our future oil & gas wealth that's trapped in rocks today could remain stranded for generations. Alternatively, the world will be divided between those with expensive energy and those with cheap energy. The secondary consequences of this path are instructive for our holdings far beyond just the Go West Portfolio.

Today is already tomorrow

There are many uncertainties in the global energy markets. The chain reactions set off by Europe's failed energy policies, oil & gas companies' abuse of shareholder funds in the last cycle, exclusionary investing and ESG box ticking continue. But they won't all continue forever. How strong will these forces be in the face of a crisis? The answer will largely dictate the future return of this Portfolio. It's not yet clear. The examples used in this commentary were extreme, to drive the point home that only the extreme might change the course of some dominoes.

Today is already the tomorrow that most proponents or observers of these dubious policies and practices chose to ignore. The resulting pressures against oil & gas supply looked unbreakable when we launched Go West two years ago. Those pressures led to very undervalued shares, which was the impetus for launching the Fund. Short-term investors or proponents of those pressures were ignoring the undervaluation. They were also ignoring the longer-term consequences of those pressures that, without a doubt, had to lead to shortages and/or higher commodity prices.

High prices lead to low prices

We've now got those higher prices. We're starting to see shortages. The Go West investments have gone up, but not to valuations we'd normally expect given the commodity price increases. We honestly would have guessed that we would've closed the Fund by now and given all profits back.

Growth in supply, that few seem to want, would end the cycle. Demand destruction caused by these high prices could also end the cycle. Usually, greed takes over at these higher prices and production growth is incented. At some point it will come again, but it's not clear if it will come because of old-school capitalism, or if we need another crisis to really change the course.

Employees at EdgePoint continue to own 48% of this Portfolio[xi] because the prospects are still surprisingly bright, and stocks are not remotely discounting anything near current prices. But you still won't hear us say it's different this time, even if this commentary might lead you to believe it is.

[i] Source: “Norway’s Yara cuts European fertiliser output as gas prices surge”, Reuters.com, March 9, 2022. https://www.reuters.com/article/ukraine-crisis-yara-intl-gas-idAFL5N2VC1F8.
[ii] Source: “Nitrogénművek temporary halts its ammonia production”, GenezisPartner.com, March 9, 2022. https://www.genezispartner.com/news/other/nitrogenmuvek-temporary-halts-its-ammonia-production/?lang=en.
[iii] Source: Karen Laird, “Borealis to exit fertiliser business”, February 3, 2022. https://www.sustainableplastics.com/news/borealis-exit-fertiliser-business.
[iv] Source: “China’s Curbs on Fertilizer Exports to Worsen Global Price Shock”, Bloomberg.com, October 21, 2021. https://www.bloomberg.com/news/articles/2021-10-19/china-s-curbs-on-fertilizer-exports-to-worsen-global-price-shock.
[v] U.S. Energy Information Administration, Frequently asked questions – How much ethanol is in gasoline, and how does it affect fuel economy?. https://www.eia.gov/tools/faqs/faq.php?id=27&t=10.
[vi] Source: Steve Holland, Alexandra Alper and Jarrett Renshaw, “Biden taps ethanol to help lower fuel prices as consumer inflation surges”, Reuters.com, April 12, 2022. https://www.reuters.com/world/us/biden-allow-higher-ethanol-fuel-sales-summer-check-gas-prices-2022-04-12/.
[vii] Source: Marianna Parraga and Matt Spetalnick, “U.S. ties easing of Venezuela sanctions to direct oil supply”, Retuers.com, March 9, 2022. https://www.reuters.com/world/us/exclusive-washington-pins-easing-venezuela-sanctions-direct-oil-supply-us-2022-03-09/.
[viii] Source: Thomas Franck, “U.S. to release 1 million barrels of oil per day from reserves to help cut gas prices”, CNBC.com, March 31, 2022. https://www.cnbc.com/2022/03/31/us-to-release-1-million-barrels-of-oil-per-day-from-reserves-to-help-cut-gas-prices.html.
[ix] Source: Nia Williams and Ismail Shakil, “Canada approves $12 bln Bay du Nord offshore oil project”, Reuters.com, April 7, 2022. https://www.reuters.com/business/energy/canada-approve-bay-du-nord-oil-project-wednesday-ctv-2022-04-06/.
[x] Source: Government of Canada – Department of Finance, Investment Tax Credit for Carbon Capture, Utilization, and Storage, December 3, 2021. https://www.canada.ca/en/department-finance/programs/consultations/2021/investment-tax-credit-carbon-capture-utilization-storage.html.
[xi] As at March 31, 2022.

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