SUPPLEMENT: CROSSCURRENTS

Our last few Supplements have included a lot of past and present statistical data pertaining to the global crude oil market. For the entire commodities market, the last year has been a turbulent time and particularly so for crude oil. The Canadian energy market is not far off what we postulated in our 2014 Annual Report. What has been totally unexpected is the political regime change in Alberta, and this is not being dismissed by the stock market.

The global crude oil price was strong leading into Q3 2014, and industry conditions and activity levels were very robust for producers, oilfield service providers, downstream processors, refiners, mid-streamers, etc. If anything, industry conditions were so robust that inflation of capital costs and operating costs throughout the industry got out of hand and producers' profitability suffered. Nevertheless, capital was available to the energy industry in abundant quantity, and it was voraciously spent such that capital investment programs often dwarfed corporate cash flows. Seemingly no unconventional oil project (shale oil, tight oil, oil sands) in North America was too marginal to attract a massive amount of capital. The long-held status quo belief was that growth of global crude oil supply was challenged while growth of global crude oil demand was strong, and this relationship between supply and demand was expected to remain the norm.

Starting in mid-Q3 2014 and accelerating into Q4, the market began to notice that global demand for crude oil was not panning out as expected while crude oil supply continued to ratchet higher. This supply/demand imbalance was most clearly seen in North America where growth in U.S. shale oil and Canadian heavy oil and bitumen production levels caused storage levels to reach unusually high levels. Imported light oil volumes were almost completely displaced by domestic production. As a result, WTI oil prices traded at wider than normal discounts to Brent oil along the forward curve. Although the global crude oil market imbalance was estimated to be only 1.5 to 2.0 mmbbl/d, a small margin relative to global consumption in the range of 94 mmbbl/d, this was more than enough to take crude oil prices down 30% from the June high of US$107/bbl to the US$75/bbl level by November.

We hope that the Supplement included in Palisade Capital's 2014 Annual Report aptly described what happened next, which caught the market completely off guard. In a nutshell, the OPEC cartel's November decision to not act as a cartel and manage price by way of a production cut by "swing producers" (read Saudi Arabia and certain other, smaller, Gulf producers) was really the initiation of a market share battle of Saudi Arabian design. Effectively a decision was made by Saudi Arabia to maintain and ultimately increase its current crude oil production levels in an effort to not just defend but grow its global market share. Higher cost production around the world, such as deep water production, unconventional shale oil and oil sands, became severely challenged to compete with the world's lowest cost producer in a plunging price environment.

Saudi Arabia's actions post-OPEC meeting drove the WTI price to a six-year low near US$44/bbl in late January 2015 (and re-tested in March 2015). As discussed in the Q3 2014 Supplement, the fiscal cost to Saudi Arabia of maintaining this strategy is remarkably high, and the cost to other OPEC members could end up destroying their sovereign worth. In Palisade Capital's investing world the cost was also high with the TSX Energy Index experiencing a 44% retreat measured from its June 2014 high to its December low. We were not prepared for the OPEC decision and for Saudi Arabia's subsequent behavior. However, we did carry higher than usual cash balances leading into the start of Q3/Q4, which provided some defense.

We stated that we felt the proper strategy in the latter months of 2014 and Q1 2015 was to persevere and use stock market weakness as an opportunity to slowly and diligently put cash to work in some of our favored energy stocks. As reported, our belief was that crude oil would probably follow the historical pattern of a "V-shaped" recovery and that the energy sector and most share prices would slowly climb back. Our ongoing view is that current commodity price weakness discourages future investment, and that the longer that crude oil prices and industry activity levels remain low and major development projects (such as oil sands) are deferred, the higher crude prices might rise longer term.

We did not profess any knowledge of how long all this would take, but we believed that "buying the low" rather than "selling the low" was the right thing to do. Market timing is a mug's game but in hindsight we got the majority of our trades directionally correct and put approximately half our cash balances to work by Q2 2015, while maintaining a reasonably conservative overall portfolio construct. Since reaching the December 2014 low, the volatility of energy stocks has been high, with daily moves of +/- 2% in the energy index not uncommon. Overall trend has been up.

Our conviction for the Canadian energy sector was driven by our belief that (1) the laws of supply and demand would eventually prevail in the global crude oil market, and (2) smart management teams would react intelligently to the industry downturn, find a way to remain viable for the long haul, and perhaps even take advantage of the downturn by making wise investments at more attractive prices than had been seen in years. We are believers in the long term importance of the Canadian energy business to the global economic/energy ecosystem.

The global energy industry has responded in stunning fashion to the sell-off in crude prices, and Canadian energy companies have been among the swiftest to respond with the deepest cuts. Perhaps this reflects how over-heated the energy industry had become, and perhaps it also reflects the Canadian industry's more challenged economics and market fundamentals (such as transportation bottlenecks and highly limited access to global markets). For certain, the global and domestic industry's swift reaction to the sell-off in crude was also driven by the considerable inflation of project and per well capital costs and ongoing production/operating costs which had been encouraged by the prolonged period of $100 oil prices.

How exactly has the energy industry responded to the sell-off in crude oil prices? Here are some recent observations:

- According to Baker Hughes, a global oilfield services provider, the North American drilling rig count has now dropped by over 50% YOY and the U.S. oil rig count, having fallen for 23 consecutive weeks, is now 57% below its level of a year ago;
- The Financial Times reported recently that major crude oil producers have slowed, postponed or axed over US$100 billion of capital spending on 26 major projects worldwide, and that this could be just the start of a big wave of delays;
- ARC Financial Corp., an industry investment and analytical firm, estimates that the Canadian exploration and production industry is expected to spend $39 billion this year, down from approximately $75 billion in 2013 and 2014 and around $67 billion in 2012;
- The Financial Post recently reported that a quarter of the jobs directly and indirectly tied to the Canadian oil & gas industry could be wiped out this year; as many as 185,000 jobs or 25% of the 720,000 workers in Canada linked to the oil patch could be affected.

Large layoffs have been announced throughout the energy industry with some of the biggest hits being taken in the oilfield services industry. Not only are Canadian oilfield activity levels expected to be down in the range of 50% this year, but the exploration and production sector has managed to affect cost reductions of 15% to 30% with most service providers and suppliers. This has put a lot of pressure on the service companies, but it allows their E&P customers to carry on with economically justifiable spending programs, albeit with smaller budgets.

We have previously commented that an oil price range of US$75 to US$80/bbl was likely required, on average, to support drilling the type of unconventional reserves that delivered the bulk of the recent growth in North American oil production. With significant efficiencies now starting to be realized at the corporate level, and with capital investment costs and ongoing operating and production costs down materially and expected to remain down for some time, perhaps the required price to drill the average unconventional oil play in North America has fallen to US$60 to US$70/bbl. The industry's most efficient operators, with the best plays that have above average economics, are adjusting to the downturn and they will retain their viability and their long term investment merit. There is a risk that in the very best plays certain strong operators might reverse course and increase their near-term drilling budgets based on a US$60 to US$65/bbl spot price and their ability to sell production forward at higher prices.

Crude oil prices have recently been trading in a band either side of US$60/bbl (WTI), up close to 40% from the January and March lows. This has the semblance of a budding "V-shaped" recovery, but volatility is high and it is a bit soon to call the end of the oil bear market – we could revisit lower oil price levels depending on how both the supply and the demand parts of the equation pan out. However right now, both sides of the supply/demand equation are showing some green shoots and the trend may evolve into more stable prices and a higher trading band by year end. Recent positive supply/demand indicators combined with the lower break even cost of drilling unconventional oil are reasons for optimism. Stronger than expected NYMEX natural gas prices in April and May are also cause for optimism.

Share values in the Canadian energy sector have been very volatile, but overall have performed reasonably well since the bottom in December 2014. Currently, the TSX Energy Index is up by over 18% since the low, and this is despite the recent political regime change in Alberta. Leading into the Alberta election, we felt pretty good that our strategy of "buying the low" was proving out. As mentioned, approximately half our cash balances had been put to work and it seemed that the stock market had seen its low. A more significant recovery of the energy sector was largely seen as a function of time – waiting out the resolution of the global supply/demand imbalance in the crude oil market.

The preceding paragraph was written in the past tense for a reason. We believe that the recent Alberta provincial election result has thrown a bit of a wrench into the gears. We now have a regime change before us with an election platform that could have a destabilizing effect on certain subsectors of the energy industry. There are many unknowns but a lot of Alberta businesses and investors can still recall the era of the Federal NEP in the early 1980's which, from an investment perspective, basically shut Alberta down for a good part of the 80's. It boggles the mind, but at the least the potential exists for a self-inflicted, Provincially-driven replay. And who can forget the chaos in the stock market following Premier Stelmach's ill-conceived new royalty regime that was announced in October 2007? The silver lining is that the change to the political landscape in Alberta comes at a time when the industry is already on its heels, so the government, if they do their homework, will be hard pressed to take draconian measures.

A vibrant environment for making capital investment decisions, whether they be corporate decisions to sanction new energy development projects, or investment fund stock selection decisions, requires a known playing field with visible stability. Absent a stable and known outlook, the risk level increases and it becomes much more difficult to make capital allocation decisions. We fear that this could be the outlook for Alberta for at least the next several months as the new government completes its review of royalty policies, environmental matters, energy industry regulation, taxation and other fiscal issues. Businesses of all shapes and sizes need to see stability in order to invest with confidence and Alberta currently has an unstable near-term outlook.

Having said all of that, our hope is that the new government does nothing rash or sudden. We believe this will be the case. Their promised "royalty review" with industry involvement/input will take several months to unfold. Communication with industry and earnest dialogue is part of the hope and just maybe, with the energy industry already back on its heels, a mutually agreeable end result can be reached. In the meantime, capital providers will probably be inclined to remain cautious and sit on their wallets.

Capital is mobile and at Palisade Capital, we felt that the newly introduced political uncertainty in Alberta required some risk mitigation in respect to our portfolios. We have evaluated our portfolios for their direct and indirect exposure to Alberta and, although our investments are diversified across different jurisdictions, we have taken some steps to lighten our exposure to Alberta at this time.

A week following the election, on May 12, the Globe and Mail Report on Business ran a headline *"NDP win lessens Alberta oil and gas appeal".* In the week following the election Canada's benchmark energy index dropped by about 6%, about double the losses of the equivalent U.S. energy index. The market is obviously jittery over the newly introduced uncertainty.

Some of the more common questions that energy investors now have include the following:

- Can our energy industry withstand ANY form of increased taxation, royalty, regulation or cost, while the industry is in such a weakened state?
- Will the energy industry's cost of capital rise to account for the new risks, or will access to capital markets be shut off altogether depending on the new energy policy outcome?
- Will a new greenhouse gas emissions policy, which most Canadians agree is a good thing, be of a magnitude that renders future oil sands expansions uneconomic?
- Will any attempt to increase regulations governing hydraulic fracturing kill or badly wing another golden goose?
- Does the new government's opposition to certain proposed export pipelines bring doubt to the energy industry's future ability to grow?
- What will happen to the drilling royalty credits regulations set to expire in November 2016? The presence of these drilling credits explain much of the ongoing drilling activity of many junior and intermediate exploration and production companies, and the economic viability of many of their Deep Basin, Peace River Arch and Montney plays.
- Will something as innocuous sounding (to most people) as "raising the minimum wage" actually have a dramatic impact on corporate profitability at this time of already razor thin margins throughout the energy business?

We don't have the answers to these questions but we are somewhat concerned. At our recent AGM the question was asked "what are some of your biggest concerns at the moment?" One of our first responses was political change. Of course we had no idea what was coming. We continue to believe that in the long run, the direction of oil and gas prices will have a greater impact on stock valuations in the energy sector, and we are optimistic in that respect. However, our program of putting cash balances to work in the market is on hold at least temporarily and we are adjusting our investment holdings with a view to reducing risk while Alberta sorts out its new policy direction. So forgive us for sounding somewhat bi-polar. We have reasons for being optimistic based on green shoots we see on the crude oil supply/demand front, but we also have concerns primarily due to provincial government policy risks. These conflicting factors will be guiding us in our portfolio decision making for the balance of the year.