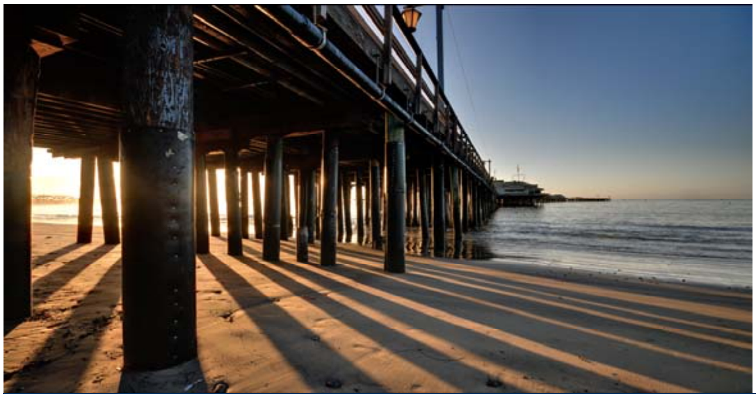

PERITUS

ASSET MANAGEMENT, LLC

Active Credit

Independent Credit Research – Leveraged Finance – April 2015

IRRATIONAL OIL MARKETS

“Markets can remain irrational longer than you can remain solvent.”
John Maynard Keynes

I would think if Mr. Keynes was alive today, he would certainly apply his famous quote to today’s oil markets. After collapsing almost 50% during the last half of 2014, oil continued to fall into the mid $40s during the first quarter of 2015. Many pundits are calling for further declines into the $30s and some have even called for pricing in $20s over the next few months. Justification for such pricing is based on growing storage and continued production growth in the US along with an Iranian nuclear deal. Oil collapsing by 60% because of a temporary 2% over supply certainly seems irrational to us.

Our take is that supply-demand fundamentals will re-assert themselves aggressively by the fourth quarter of this year. This does not mean that prices will react immediately. It is likely that broken market psychology will take at least another quarter or two to react.

Supply

What we continue to hear is that while North American rigs have fallen by an average of 50% from their recent peak, US shale production will continue to grow. Adding further “pressure” is that plenty of wells have been drilled but have not been fracked or tied in yet. So the supply gremlin appears unwilling to die. While all of this is true, what nobody is discussing is the time frame. What we know is that shale wells have great production in their first year, after that it fades rapidly. So if your decline is 70% in the first year (according to production decline rates we have reviewed), you are on the endless drilling treadmill just to replace your existing production. But as rigs get idled, how would that math work? As reported below[1], we are currently seeing a rapid decline in rig counts and expect this to continue.

> ***Rig Count***
> ***US rig count down for 15th consecutive week; US oil rig count at the lowest level in 4 years; Canadian oil rig count down 86% y-o-y***
> - *The Baker Hughes North American rig count declined by 136 rigs to 1,209 rigs during the week of 3/20/15.*

[1] Templeton, Evan, and Jeff Coles, “Energy Market Monitor,” Jefferies LLC, Leveraged Finance and Special Situations Group, March 23, 2015, p. 2. Emphasis added.

- *The U.S. rig count declined by 56 rigs, or -5% to 1,069 rigs during the week. The offshore component declined by 11 rigs to 37 rigs. The oil rig count declined by 41 rigs, or -5%, to 825 rigs from 866 rigs. The oil rig count is 44% below year-ago levels. The gas rig count declined by 15 rigs, or -6%, to 242 rigs. Notable basin rig count variances include: Permian (-19 rigs or -6%), Eagle Ford (-8 rigs or -5%), Williston (-5 rigs or -5%), Mississippian (+2 rigs or 5%) and Marcellus (+6 or 10%).*
- *The Canadian rig count declined by 80 rigs, or -36%, to 140 rigs from 220 rigs in the prior week. The oil rig count declined by 55 rigs, or -65%, to 30 rigs from 85 rigs. The gas rig count declined by 25 rigs, or -19%, to 110 rigs from 135 rigs. The Canadian rig count is down 64% compared to the same period a year-ago when the rig count stood at 389 rigs and it is 62% lower-than the five-year average.*

We continue to hear about efficiencies, cost reductions and longer laterals. All great stuff. But the rocks don't change and neither do decline curves. So what we would focus on is likely exit production rates heading into 2016. Between the rapid decline rates on existing wells and collapse in new drilling as indicated by the declining rig counts, this production rate will be down significantly.

As it relates to storage numbers, we think SocGen has it right. The tightness in storage is dramatically over-stated, as noted below[2]:

> ***In deciphering the remaining U.S. crude oil storage capacity, it is important to make an apples-to-apples comparison*** *between tank farm inventory levels and tank farm capacity. The monthly EIA inventory data combines crude oil stored in tank farms and in pipelines; however, the EIA's estimate of tank farm capacity does not include the capacity of pipelines. Thus an estimated 87 million barrels of oil sitting in pipelines could easily be perceived to be in tank farm storage, when in reality it is not. (Of note, 57 MMbbbl of crude tank farm storage capacity was added from Sept 2011 to Sept 2014).*

No question storage availability will differ by geography, but those folks telling us that storage will be filled and the oil will have nowhere to go are histrionic or may simply be talking the market down because they are short. Storage capacity remains and we don't expect to see a massive dumping of oil, further pressuring pricing. Also much of the current storage build is due to seasonality, as refineries perform their turnarounds and demand is at a trough. But as we get through the spring season, we expect a seasonal uptick in demand and thus any pressure on storage easing.

One final point on supply. While the focus continues to be on US production, Venezuela, Libya, and Nigeria are on the verge of utter collapse and their oil revenues falling by 50% in a short time frame will not help. Throw in Iraq, ISIS and Mr. Putin and global supply is likely to suffer some severe disruptions in the coming year or two.

[2] Koch, Russell and Joshua Sheppard, "Oil & Gas, Pipe-adjusted EIA Crude Storage Shows Room in the Tanks," Societe Generale, March 20, 2015, p. 1.

Demand

As we've stated in many of our prior writings, demand for oil continues to rise. And this is against the backdrop of a punk global economy. In its latest monthly report, the International Energy Agency ("IEA") now sees demand **growing by about 1 million barrels** per day in 2015.[3] This is up about 250,000 bpd from their original forecast for 2015. If the IEA forecast is correct, this puts average daily **global demand at 93.5 million bpd,[4] in what looks to be an all-time high.** Lower prices generally don't destroy demand but improve it. Demand has somehow currently become an irrelevant factor in the pricing mechanism but it cannot be ignored forever.

Strategy

It appears that absent a global event (not out of the question), prices are unlikely to move significantly higher in 2015 regardless of fundamentals. Saudi production data is at record highs and they will continue to pump and talk prices down to step on the throat of the US shale game. Interestingly, I think they have some surprising allies in the form of the majors. As we have stated before, the major US integrated oil companies have very little exposure to the shale basins. The CEOs of both Exxon and BP have recently come out with statements saying that oil is likely to stay low for a very long time. Since they have to lay out billions of dollars to bring on long lived projects (mainly deepwater), they are not exactly friends with the cowboys drilling the short lived projects without regard to the bigger picture.

The broken psychology that I previously referred to is the prevailing view that as soon as prices begin to rise, the tight oil producers can just turn on a tap, flooding the market once again, which will produce a natural cap on prices. While tight (shale) oil can certainly be brought on much faster than traditional long lived projects, it still requires two things which are no longer around: cheap long term capital and high prices. This is what allowed the market to develop and we expect that its unwinding will likely destroy much of it.

Since energy remains by far the largest industry inside the high yield market[5], all investors in the asset class must have a plan to deal with the environment in which we find ourselves. The energy industry has many similarities to the Telco market back in 2002-2003. After Worldcom had blown up, virtually everything remotely associated with Telco was destroyed. Then as now, separating the traps from the trades was crucial. Many investors piled into supposedly cheap "CLEC" (competitive local exchange carrier) paper, only to watch their bonds vaporize. The real trade was ancillary to the CLECs and included rural wireless providers and cell tower companies. We believed that active management of specific security exposures was essential in that environment, and see the same needed today on the energy side as investors navigate through this landscape.

In this light, and at the risk of repeating ourselves, as we survey the investment opportunities, we favor bonds and loans of low levered, long lived Canadian production companies. We believe

[3] Based on IEA data from *World Oil Demand* © OECD/IEA, IEA Publishing; modified by Peritus Asset Management. Licence: https://www.iea.org/t&c/termsandconditions/.
[4] Based on IEA data from *World Oil Demand* © OECD/IEA, IEA Publishing; modified by Peritus Asset Management. Licence: https://www.iea.org/t&c/termsandconditions/.
[5] For instance, Energy is 17% of the JP Morgan USD US High Yield Index. Acciavatti, Peter D., Tony Linares, Nelson Jantzen, CFA, Rahul Sharma, and Chuanxin Li. "2014 High-Yield Annual Review." J.P. Morgan, North American High Yield and Leveraged Loan Research. December 29, 2014, p. 7.

they will survive the cycle and have a very significant benefit of a falling Canadian dollar (costs are in C$, revenues in US$), in addition to lower royalties and slower declines. We also see opportunity in a handful of US conventional oil producers (on-shore or off-shore, not shale-related production). When the oil price deck moves higher (as it inevitably will), we would expect prices for many of these securities could see a strong rebound.

While many US companies appear to be cheap from a valuation standpoint, we continue to caution against investing in most of these producers. In the case of many U.S. shale producers, we believe they are broken business models (projects not companies) given the rapid decline rates and reliance on constant capital funding to sustain production. We are also not a believer in the consolidation cycle coming to the rescue. Why would a healthy company buy a business that generates huge free cash flow bleeds? As evidence I point towards Whiting Petroleum. After completing a massive acquisition (Kodiak), they almost immediately put themselves up for sale. Yet, a couple weeks ago they come to the market with a smorgasbord of securities including equity, high yield bonds and convertible securities. It doesn't appear to me that there are any consolidation buyers.

Another area where we believe investors should be very cautious is on the services side. The dramatic reduction in capital expenditures will be felt most by this part of the industry. We think revenue projections for many of these companies are delusional and the fixed cost nature of parts of this industry will lead to very significant pain and potentially considerable defaults to come in the space. Investors should be very conservative in their assumptions for these companies.

The energy industry and its various sub-sets remain one of the most interesting and attractive areas for long term fixed income investors. The current stress provides an excellent entry point, but also many traps. Caution and selectivity is critical, as investors need to understand the underlying fundamentals, including hedging, cost structure, and capital needs to sustain production of each company in which they invest. We believe active management is essential as investors take positions not only in energy-specific names, but in the general high yield market, since energy is such a large component of the space.